

# Transfer pricing

Where in the range is the right point?



**In recent times, tax authority queries resulting in transfer pricing adjustments have increased significantly, both globally and in Africa. Often, the outcome of a transfer pricing benchmarking study is an arm's length range rather than a specific margin or price, and the question arises as to which point within such a range is appropriate and therefore arm's length?**

## SARS focus on transfer pricing

We note that the South African Revenue Service ("SARS") has become more stricter over the last couple of years when performing transfer pricing audits to combat non-compliant taxpayers, specifically, in this area... SARS Commissioner, Edward Kieswetter, has warned non-compliant taxpayers, on several occasions, that the revenue authority will act firmly against taxpayers who are engaged in tax transgressions. SARS is therefore determined to enforce tax laws in the country in a strict manner without exception.

In a media release dated 27 February 2020, Mr Kieswetter mentioned that "Transfer pricing remains a major concern across the globe and South Africa is no exception. Significant revenue leaves South Africa every year in the form of intra-group services linked to multinational enterprises (MNEs)". Kieswetter further added that "Through such transfer pricing some MNEs engage in aggressive tax planning to create a disconnect between the local activities which give rise to profits and then declare these profits in tax jurisdiction with lower tax rates."

The concern is therefore that such practices increase the risk of reducing the sovereign tax base of South Africa in that the prices charged between connected persons are not reflective of an arm's length price i.e. what independent third parties would agree. This clearly outlines the reasons for the aggressive transfer pricing audit practices adopted by SARS in the recent past.

## SARS transfer pricing adjustment – the best point in the range

When SARS applies the results of a benchmarking study in the case of an audit, it is understood that the median is usually selected without demonstrating that this point in the range is reflective of the facts and circumstances surrounding the controlled transaction. However, there is a view that the use of any point in the interquartile range may be appropriate. Even a point within the full arm's length range may be acceptable if the results achieved by the comparable companies contained in a benchmarking study are all very close together and the range is very small, indicating close comparability. In line with the aforesaid, SARS should provide substantiating reasons for selecting

the median. The reasons for this as well as the guidance available in South Africa are discussed below.

No two companies work in the same manner. External factors such as the industry, market trends, governments, legislation and competition (to name a few) together with internal factors including but not limited to value and supply chains, shareholder influences, management and so forth dictate the way entities operate. Certainly, transactions entered into by MNE's even within the same industry or markets cannot always mirror each other and consequently their results will differ.

The robustness of the arm's length range depends on the number of comparables that ultimately make up the comparable set. Some countries prefer the full arm's length range in determining whether prices are acceptable had the parties not been connected to one another. Other countries rely on statistical tools such as the weighted average inter-quartile range within the arm's length range to make this determination by focusing on, for example, the 25th percentile to the 75th percentile. There is also at least one country that focuses on a range within the 35th percentile to 65th percentile.

The inter-quartile range measures the spread of the comparables and assesses the variability of the comparables as to where most of the margins lie. In South Africa, the full use of the arm's length range is permitted.

Therefore, when adjustments are made by a revenue authority, the point on which that authority relies should be reasonable and it should be supported with appropriate evidence. What this means is that if the median is selected to be the best point in the range, this should be justifiable... There can be substantial financial implications associated with the selection of different points in the range, of course depending on how broad the range is. For example, the difference in selection of the 25th percentile and median of the arm's length range can result in hundreds of millions of Rands for a taxpayer. Therefore, the arbitrary and consistent selection of the median the range does suit SARS' stance in its efforts to collect tax revenue.



### Illustrations

The below example explains the potential impact of which point in a range is selected and considered to be appropriate: Assume that SARS, following a transfer pricing audit, identified that the taxpayer's profit was below the 25th percentile of the range of operating margins achieved by comparable companies, and it then makes a transfer pricing adjustment to the median of the range. Below is an illustration of the respective amounts involved, should SARS have considered settlements of either adjusting the operating margin to the minimum of the 25th percentile of the range versus the median of the range:

From the table below it is illustrated that if the adjustment was made to either the 25th percentile or the minimum of the range, instead of the median of the range, the taxpayer's liability would have decreased by R6 820 000 and R10 230 000, respectively. It should also be highlighted that the scenario

is only based on data for one year of assessment, , then the amounts involved will increase.

Transfer pricing audits can come around in different ways. An example is where an entity is reclassified from a limited risk distributor to a fully-fledged distributor and SARS feels that the benchmarking study is not reflective of the latter or the functional profile of the taxpayer does not match the benchmarking study performed. Another example is where SARS does not agree with one of the filters applied in the benchmarking exercise, for example a filter that rejects companies with high stock ratios compared to sales, if an entity with large stockholdings would be non-comparable to the tested party selected in the benchmarking study and might opt to expand or narrow down this criterion in the search. The inclusion or exclusion of loss-making companies may yet be another reason for an audit. Where an audit is justified, so should the selected point in the range be vindicated.

	Adjustment to Minimum (ZAR'000)	Adjustment to 25 <sup>th</sup> Percentile (ZAR'000)	Adjustment to Median (ZAR'000)
<b>Adjustment value</b>	238 500	244 000	255 000
<b>Primary adjustment – Tax impact</b>	66 780	68 320	71 400
<b>Understatement penalty</b>	33 390	34 160	35 700
<b>Secondary adjustment – Tax impact</b>	47 700	48 800	51 000
<b>Total tax liability</b>	<b>147 870</b>	<b>151 280</b>	<b>158 100</b>

<sup>[1]</sup> The scenario relates to a profitable entity and the corporate tax rate of 28% is applied to the adjustment amount.

<sup>[2]</sup> The understatement penalty is calculated at 50% of the primary adjustment, considering a standard case of no reasonable grounds for 'tax position' taken, as per section 223(1) of the Tax Administration Act No.28 of 2011. The penalty, however, range from 10% to 200%, depending on the circumstances.

<sup>[3]</sup> Dividends withholding tax is levied at a rate of 20% of the adjustment amount and there is no DTA relief available when a secondary adjustment is made.

#### South African transfer pricing law

As per section 31(2) of the Income Tax Act, where it is determined that a transaction does not comply with the arm's length principle, the Commissioner (or the taxpayer) must adjust the taxable income or the tax payable by a taxpayer to reflect arm's length pricing. However, there is no specific rule contained in the law as to how such adjustment must be applied and what point in the range is considered appropriate.

#### South African transfer pricing guidance

Practice Note 7 was released in 1999, with an addendum issued in 2005. In the Practice Note it is stated that a high level of comparability is required to apply a traditional transaction method. Upon application of such methods and the outcome falls within a proper arm's length range, it should be regarded as being at arm's length. In the instance where the transaction falls outside of the arm's length range, judgement should be exercised as to where in the range the most appropriate point is for an adjustment to be made. Furthermore, the Commissioner is in agreement with the view of the OECD that "the adjustment should reflect the point in the range that best accounts for the facts and circumstances of the controlled transaction." Paragraph 11.4.7 also states that in the absence of persuasive evidence for selecting a particular point in the range, the Commissioner may select the median of the range. As previously stated, SARS should then also provide reasoning and evidence for not selecting any other point in the range. However, Practice Note 7 is outdated and there have been no

updates, which bears the question as to whether the legislation contained therein can be relied upon and is still applicable.

Therefore, there is a lack of guidance provided by SARS in relation to the adjustments made in the case of a transfer pricing audit and their reasoning for selecting the median of the range for all audits.

#### OECD guidance

The transfer pricing regime in South Africa follows the Organisation for Economic Co-operation and Development ("OECD")'s Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, recently updated in January 2022 ("OECD Guidelines"), which provide supporting guidance for the application of the arm's length principle contained in the South African domestic transfer pricing legislation. Although not an official member of the OECD, South Africa enjoys an observer status, and it is a member of the Inclusive Framework on BEPS. South Africa has adopted these guidelines to develop its transfer pricing rules. As such, guidance from the OECD should also be followed when selecting a point in the arm's length range in the case where SARS performs its own benchmarking study to determine whether or not prices charged between entities within an MNE Group are arm's length.

The OECD states "if the relevant condition of the controlled transaction (e.g. price or margin) is within the arm's length range, no adjustment should be made". The OECD further mentions that "If the relevant condition of the controlled transaction (e.g. price or margin) falls outside the arm's length range asserted by the tax administration, the taxpayer should have the

opportunity to present arguments that the conditions of the controlled transaction satisfy the arm's length principle, and that the result falls within the arm's length range (i.e. that the arm's length range is different from the one asserted by the tax administration). If the taxpayer is unable to establish this fact, the tax administration must determine the point within the arm's length range to which it will adjust the condition of the controlled transaction". In addition, the OECD highlights that "In determining this point, where the range comprises results of relatively equal and high reliability, it could be argued that any point in the range satisfies the arm's length principle. Where comparability defects remain, it may be appropriate to use measures of central tendency to determine this point, in order to minimise the risk of error due to unknown or unquantifiable remaining comparability defects." The wording of the OECD guidelines expands on the aforementioned and places the burden of proof on SARS.

Therefore, in our view, where SARS does choose to conduct its own benchmarking study, and if the results of the tested party of the controlled transaction falls within the interquartile range, no adjustments should be made. If the results of the controlled transaction fall outside the full range and where the taxpayer is unable to present arguments of it being arm's length in nature, SARS should then be in a position to determine and demonstrate a point in the range which is reflective of the facts and circumstances of the controlled transaction. It certainly would be interesting to understand the reasons as to why SARS has issued guidance and follows a practice to always adjust to the median of the arm's length range.

### Case Law

A further concern is the lack of reliable case law precedent in South Africa to use as guidance in the selection of the point in a range where an adjustment is made.

In January 2021 SARS released the outcome of a transfer pricing case (IT 14305). The case dealt with an application for separation of a legal issue in terms of Rule 33(4) of the Uniform Rules as provided for in terms of Rule 42(1) of the Rules relevant to the Tax Court. SARS conducted an audit in 2014 in respect of the taxpayer's 2011 year of assessment and raised an additional assessment consisting of an adjustment to the taxpayer's taxable income in terms of section 31(2). SARS stated that the transaction between the taxpayer and its connected party in Switzerland did not meet the arm's length standard.

Unfortunately, the aforementioned case does not supply taxpayers with favourable guidance on the manner as to which SARS are allowed to apply an adjustment, but the decision was also made in terms of an application, and not by a higher court that would set a precedent. The question arises whether South African taxpayers can rely on foreign case law to argue SARS' methods of adjusting to the median of the range.

On 13 September 2021, Finland's Supreme Administrative Court published a year- book decision (SAC 2021:127) wherein it was concluded that the company's taxable income should be adjusted only to the extent the subsidiaries' operating profits had exceeded the upper quartile of the comparable companies, not to the extent they had exceeded the median. The court based this conclusion on paragraph 3.60 of the OECD Guidelines, which states that no adjustments should be made when the controlled transaction is within the (in this case, narrowed) arm's length range. This case has clarified two points contained in the OECD Guidelines: Firstly, where the results fall within the arm's length range, no adjustment is required; and secondly, where the results fall outside the range, the adjustment must be made to the end (higher or lower) of the range.

### Conclusion

In light of the lack of sufficient guidance in South Africa, other than that in the outdated Practice Note 7, taxpayers are dependent on SARS' interpretation when the tax authority makes a transfer pricing adjustment. Thus, even if another point in the range of prices or returns achieved by the comparable companies determined in a

database study is more appropriate based on the facts and circumstances in the case, SARS would adjust to the median resulting in significant additional tax and penalties etc. However, the year-book decision published by Finland's Supreme Administrative Court, which includes guidance from the OECD guidelines, can offer some leverage when an audit arises, and the taxpayer needs to argue the appropriate point in the range as to which SARS is allowed to make an adjustment. Taxpayers should ensure that their transfer pricing approach to controlled transactions is sufficient to ensure that their results are within the range. However, where taxpayers are not able to demonstrate that their controlled transactions are within the arm's length range, such taxpayers are at the mercy of the tax authority and the path that SARS will take remains unclear.

[Where to from here for taxpayers?](#)

## Authors



**Amit Chadha**  
Director (Partner)  
Global Transfer  
Pricing Services



**Mohammed Pochee**  
Senior Manager  
Global Transfer  
Pricing Services



**Ignus Rademeyer**  
Manager  
Global Transfer  
Pricing Services

[kpmg.com/socialmedia](https://kpmg.com/socialmedia)



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