

By Robin Friedland

How to fix a transfer price

The imminent publication by the SARS of a long-awaited practice note on transfer pricing is causing a stir in business circles.

TAX authorities in advanced industrial countries have long recognised that price manipulation in deals involving linked parties has been a fruitful basis for tax avoidance across international frontiers.

Judicious manipulation of a transfer price may enable much of the taxable income to be placed in a low-tax jurisdiction. In deals with SA, exchange control avoidance may provide extra incentive.

To describe the forthcoming practice note on transfer pricing as "long-awaited" hardly does justice to the situation. Section 31 of the Income Tax Act – enabling Revenue to adjust cross-border pricing between "connected persons" to reflect arm's-length prices – was inserted in 1995. This brought our tax law into harmony with that of other trading nations.

The concept of "connected persons" is crucial to enforcing tax laws on transfer pricing. Elaborately defined in tax laws, the term is designed to nail down situations where buyer and seller are not truly independent entities and transfer prices can be manipulated to suit either.

The concept implies a relationship where one party is not likely to act independently of the other in negotiation. Prime examples would be corporate parents and subsidiaries or, for individuals, close blood relatives.

Suppose industrial products are sold by a manufacturer abroad to a South African subsidiary. The manufacturer may want most of the profit and will charge an inflated price to the subsidiary, which will have to suffer a depleted profit margin.

Revenue, having established that a transaction falls within section 31 because it took place between connected persons, is entitled to impute a price for the trans-border transaction and secure what it considers to be a fair share of tax.

Arthur Andersen tax partner Michael Honiball says the final form of the

practice notes is expected only towards the end of next month. But the broad principles contained in the draft are likely to remain in place in the final version.

The draft is based on OECD international guidelines on transfer pricing. Honiball is pleased Revenue is following the approach of the Katz Commission – interpreting provisions of our Income Tax Act in accordance with the international norms of developed countries.



The practice note is doubly welcome because Revenue recently introduced onerous transfer pricing tax disclosure requirements for companies and individuals. Further, Revenue has been employing section 31 recently even in the absence of a practice note to impute transfer prices and raise additional assessments.

Thus the taxpayer is required to justify the setting of prices for the supply of goods and services to a connected person abroad. There is now a real risk that Revenue will be able to claim that the statutory prescription period of three years from the date of an assessment will not apply to transfer pricing issues where a taxpayer did not disclose the extensive information required.

This means Revenue could reopen an

assessment on the issue at any time in the future.

The first step in establishing an acceptable arm's-length transfer price is to undertake a detailed analysis of all business functions and risks undertaken by the connected persons – a "functional analysis".

This opens the door to applying various methods of calculation to determine an arm's-length price.

Allowing for the complexity of the process, Revenue accepts there is no absolutely correct price but that a price may be fixed within an acceptable range.

The traditional transfer pricing methods set out in the draft should be regarded as guidelines. Honiball says additional OECD guidelines are not necessarily excluded from SA practice in determining an acceptable transfer price under section 31.

The draft suggests, for a start, the "comparable uncontrolled price method" – a direct comparison between the price charged for an item by related parties and that between unrelated parties. But it's not always possible to find a closely comparable product traded freely.

Then the taxpayer must employ other methods. The "resale minus method" applies to a producer's sale to a related distributor which sells on in the market. You start with the final price to the consumer and subtract an arm's-length retail margin for the distributor to establish a fair transfer price from the producer.

The "cost-plus method" starts with the producer's cost base and adds an arm's-length margin to establish selling price to the related party.

Lastly, there is the "profit split method" and its variant, the "transactional net margin method".

The profit split method is applied where transactions are so interrelated that they cannot be evaluated separately. The combined profit is therefore split between the related parties, based on their respective roles.

The transactional net margin method considers the net profit margin relative to criteria such as return on assets or the ratio of operating income to sales earned by a connected person. This is compared with the margin which would have been earned by an independent party in similar circumstances.

The draft stresses the importance of retaining relevant documents, which will be scrutinised closely by Revenue upon audit of the tax return. Tendering sound documentation will probably avoid an attack under section 31. □