Changes to Transfer Pricing Legislation

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Indirect transactions caught in the net

S31 of the Income Tax Act (58 of 1962), the transfer pricing section, will be substantially amended with effect from October 1 2011. The new s31 seeks to capture indirect transactions for transfer pricing purposes, thereby substantially widening the scope and application of the section.

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In terms of the new s31, transfer pricing will apply to any transaction, operation, scheme, agreement or understanding that has been directly or indirectly entered into between connected persons or that has been directly or indirectly entered into for the benefit of either or both connected persons. Effectively, therefore, transactions between third parties could potentially be caught in the net.

For purposes of s31, the new inclusion of "*indirect*" transactions is not novel as the current thin capitalisation provisions apply to both the direct and *indirect* granting of financial assistance by a non-resident to a resident connected person. Further, s9D(2A)(i) provides for the application of transfer pricing to any *transaction, operation or scheme* between a controlled foreign company and any connected person in relation to that controlled foreign company. This wording on its own is, arguably, wide enough to include transactions between CFC's and third parties. The new wording, to the extent that it refers to a transaction, operation, scheme, agreement or understanding is, therefore, very similar to the wording already contained in the current CFC legislation for purposes of imposing transfer pricing on inter-CFC transactions. The wording of the new s31 has also been used in other sections of the Income Tax Act, like the general anti-tax avoidance provisions contained in s80A.

In terms of the current legislation, transfer pricing and thin capitalisation provisions are dealt with separately under s31(2) and d31(3) respectively. d31(2) only applies to direct transactions whereas s31(3) applies to both direct and indirect transactions, as mentioned. The proposed s31 changes this by combining both transfer pricing and thin capitalisation principles into a single subsection and reads as follows:

"(2) *Where –*

(*a*) *any transaction, operation scheme, agreement or understanding has been directly or indirectly entered into between or for the benefit of either or both –*

(*i*) (*aa*) *a person that is a resident; and*

(*bb*) *any other person that is not a resident;*

(*ii*) (*aa*) *a person that is not a resident; and*

(*bb*) *any other person that is not a resident that has a permanent establishment in the Republic to which the transaction, operation, scheme, agreement or understanding relates;*

(*iii*) (*aa*) *a person that is a resident; and*

(*bb*) *any other person that is a resident that has a permanent establishment outside the Republic to which the transaction, operation, scheme, agreement or understanding relates;*

and those persons are connected persons in relation to one another; and

(*b*) *any term or condition of that transaction, operation, scheme, agreement or understanding –*

(*i*) *is different from any term or condition that would have existed had those persons been independent persons dealing at arm's length; and*

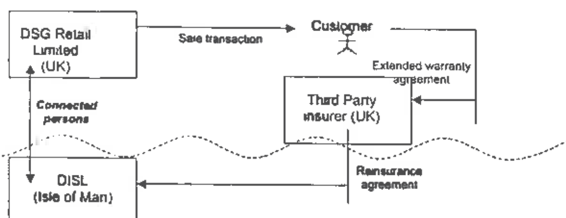
(*ii*) *results or will result in any tax benefit being derived by any person that is a party to that transaction, operation, scheme, agreement or understanding,*

the taxable income of each person that is a party to that transaction, operation, scheme, agreement or understanding that derives the tax benefit must be calculated as if that transaction, operation, scheme, agreement or understanding had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm's length." (emphasis added)

The specific inclusion of indirect transactions within the scope of South African transfer pricing was partly driven by a recent United Kingdom court case on transfer pricing, namely, *DSG Retail Limited v HMRC* [2009] STC (SCD) 397. The facts of this case are briefly that DSG Retail Limited (DSG), a UK resident company, sold electrical goods covered by a manufacturer's warranty. DSG's customers were also entitled to purchase an extended warranty, which was offered when purchasing the goods at DSG stores, for a fixed premium. The extended warranty was provided by a third

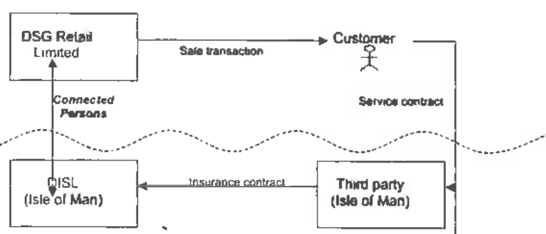
party insurer based in the UK, which in turn reinsured 95% of the risk with DSG's group captive insurance company established in the Isle of Man, Dixon Insurance Services Limited (DISL).

Below is a simplified outline of the transaction.



A few years later, DSG decided, for tax reasons, to stop offering insurance contracts to its customers and started offering service contracts instead. Accordingly, the agreement between DSG and the third party insurer was terminated. The liability for the new service contracts was assumed by a different third party company established in the Isle of Man and insured by DISL (after changing its regulatory authorisation from reinsurer to insurer).

Below is a simplified outline of the revised transaction.



The arrangement between the third party insurer and DISL led to DISL making a substantial increase in profits which were not taxable in the UK. Since the UK could not impose tax on insurance profits derived by DISL, the Commissioner for HMRC sought to impose tax by invoking transfer pricing provisions, notwithstanding the fact that the transaction involved a third party that had been interposed between the DSG and DISL. Furthermore, there was no agreement entered into directly between the DSG and DISL for purposes of offering insurance contracts to DSG's customers.

The HMRC successfully argued that DSG had entered into third party agreements based on the mutual understanding that the third party will reinsure/insure with DISL. The HMRC also succeeded in arguing that, had the whole transaction been entered into between third parties, DISL would have had to compensate DSG for the point of sale advantage. That is, because DISL benefited from insurance contracts sold within the DSG stores, this benefit should be charged for on an arm's length basis.

This case is, therefore, authority for the proposition that transfer pricing provisions may be invoked to attack indirect transactions where these transactions, if entered into between independent third parties, would result in a different allocation of profits between the related parties involved. Despite the persuasive authority of this case for South African courts, the legislature has considered it necessary to insert the so-called indirect principle in the DSG case into our transfer pricing legislation. It is against the background of this case, therefore, that the new reference to indirect transactions for purposes of transfer pricing should be interpreted.

It is to be hoped that the SARS will not, however, extend the application of transfer pricing principles to transactions which are so indirect that genuine commercial undertakings are thereby frustrated, as this will create considerable uncertainty for global multinationals with authentic commercial undertakings. Currently, such uncertainty already exists in relation to the application of thin capitalisation rules to local entities. For example, s31(3) is clearly wide enough to include a loan advanced by a foreign investor to a South African subsidiary company, Company B, held by another South African company, Company A. However, it is unclear whether the equity capital of company A can be added to that of Company B in order to calculate the 3:1 ratio. The wide wording of the new provisions of s31 could also potentially be abused by the SARS should it be unable to collect taxes by using other specific anti-avoidance measures, like CFC rules. It is to be hoped, therefore, that the SARS will offer some guidance on how indirect transactions will be subjected to these new transfer pricing provisions.

In this regard, the SARS has announced that its current practice note on transfer pricing (SARS Practice Note 7) will be withdrawn and a revised transfer pricing practice note will be issued sometime in the next six months. Guidance on this particular issue is expected in the new practice note. The current practice note on thin capitalisation (SARS Practice Note 2) will similarly be withdrawn and the new practice note will also include guidelines on how the SARS will treat thinly capitalised entities. ◆

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