Internal transfer pricing; be careful, very careful

By Johan Kotze

Transfer pricing, along with its many implications, has long been a contentious tax issue.

Yet while conventional wisdom has it that transfer pricing is largely an offshore phenomenon involving related offshore parties, it frequently creates problems when it is conducted domestically.

The applicable legislation is the Income Tax Act's section 31, which deals with transfer pricing in international transactions. It uses the terms "connected person" and "related offshore parties", the definitions of which can be ambiguous.

Traditional transfer pricing problems arise when a local company is undercharging its supply of goods and services to connected offshore parties, or is being overcharged for the goods and services it is acquiring from connected offshore parties, thereby shifting taxable profits to other tax jurisdictions.

The tax return asks:

- Did the taxpayer enter into any cross-border transactions with connected parties?
- Does the taxpayer have a *transfer pricing policy document* in support of the transfer pricing policy applicable to cross-border transactions?

This exercise often overshadows internal transfer pricing; those between connected *onshore* parties.

In a recent case in the Johannesburg's Tax Court (Case No. 12262, in front of Judge Willis), charges by a holding company to its subsidiary for services rendered were challenged by SARS on the basis that they were excessive in the circumstances.

The holding company in question is a small JSE-listed company, which undertook to perform marketing and management services to its then (1999) newly-acquired wholly owned subsidiary, a fluorspar miner.

Upon conclusion of the acquisition, the holding company entered into an agreement to conduct a study of the world supply and demand priorities of fluorspar, and to specifically target Europe and Asia to expand the company's fluorspar customer base. The agreement also provided that the holding company would perform a host of marketing functions, for which it was to be paid on a monthly basis.

In 2001 the holding company and the subsidiary also entered into a management agreement, mostly for the performance of executive managerial functions – also for a monthly fee.

The Income Tax Act's section 11(a) provides that an expense will be deductible if it is actually incurred in the production of income, but not of a capital nature. Section 23(g) limits these expenses to those laid out or expended for the purposes of trade.

During the course of the case in question, the company had two company witnesses and an expert witness. The latter was an expert in the field of mining and a director of a company advising on a host of mine-related matters.

The expert was asked whether in his opinion the services rendered by the holding company to its subsidiary were:

- normal in the field of mining;
- what is generally charged by management companies for similar services in the field of mining; and
- had the expert's company been asked to quote on the relevant work, how much would it have charged.

He advised that it was normal for mining groups to strip out certain managerial functions into separate entities and that his company often charged much more than had been levied in this case.

The SARS assessor who dealt with the matter contended that the work could have been done by a single person, whom the holding company could employ for an annual remuneration of R600 000.

SARS relied solely on one expert witness, an economist, who concluded that in this case any form of marketing was effectively a waste of time.

Judge Willis responded: "With the possible exception of the proverbial 'hot cakes', there is almost no product in the world that sells by itself. Even with hot cakes, it may be a good marketing strategy to position one's bakery in such a place and design the layout so that the delectable aromas waft past the nostrils of passers-by, enticing them to buy.

"These cases make it clear that it is not for the Court (or the Commissioner) to say, with the benefit of hindsight, that business expenditure should be disallowed on the basis that it was not strictly ’necessary’, or that it was not as effective as it could have been.”

In terms of the management services that the holding company rendered to its subsidiary, Judge Willis said: “Management fees charged to subsidiaries by holding companies are not infrequently the subject of mutterings from different quarters. It is inherent in the relationship between a holding company and a subsidiary that the subsidiary is amenable to manipulation and exploitation by the holding company.

“This is especially the case where the holding company is located in a rich, first world country with a strong currency and the subsidiary is in a developing country with a weak currency. As between the appellant and [its holding company], the relationship was, of course, one between two local companies. Many a subsidiary is utterly dependent on its holding company for its effective functioning. Each case must be determined on its own merits.

“Management fees charged to subsidiaries by holding companies are not infrequently the subject of mutterings from different quarters. ... Furthermore, taking advantage of an accumulated assessed tax loss is not an inherent wrong. On the contrary, the advantages presented by such losses can influence strategic decisions which can save companies and turn them around to obvious benefit of employees and the Revenue Services, among others.”

In this case the taxpayer succeeded. But that does not mean other taxpayers should not be careful when charges are put through between connected parties.

Ultimately, one should ensure that those charges would stand up to the “mutterings against SARS.

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