

South Africa: Transfer pricing legislation to be amended again

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The draft Taxation Laws Amendment Bill (“DTLAB”), released for public comment on 17 July 2014, proposes certain changes to the transfer pricing secondary adjustment mechanism in terms of which the amount of the secondary adjustment will now be deemed to be a dividend *in specie* paid by the South African taxpayer to the non-resident connected person.

Under the current provisions of the Income Tax Act, 58 of 1962, where there has been a transaction that has been entered into between connected persons and any term or condition of that transaction is different from any term or condition that would have existed had those persons been independent persons dealing at arm’s length then there will be a primary and secondary adjustment of the tax treatment of the transaction for the parties. Under the primary adjustment the taxable income or tax payable is calculated as if the transaction was entered into between independent persons acting at arm’s length. The secondary adjustment then deems a loan to have come into effect between the parties whereby the South African entity is deemed to accrue interest at an arm’s length rate which interest income is taxable. As an example:

- Non-resident parent company acquires goods from its South African subsidiary company for R10 million. The South African subsidiary records taxable income of R10 million for the sale. However, the arm’s length price for such goods is in fact R15 million.
 - The primary adjustment results in the South African subsidiary’s taxable income increasing from R10 million to R15 million; and
 - The secondary adjustment results in the differential of R5 million constituting a deemed loan by the South African subsidiary to its non-resident parent company in respect of which an arm’s length interest rate applies. So assuming an arm’s length interest rate is 8% then R400 000 of interest income will be deemed to accrue to the South African subsidiary every year until the deemed loan has been repaid.

The secondary adjustment mechanism, which came into effect in its current form on 1 April 2012, has been subject to a barrage of criticism because of the difficulties associated with the accounting treatment of the deemed loan and the implications of applying exchange control restrictions to a deemed loan. It also not clear from the current wording how the deemed loan can be repaid and consequently when it ceases to exist. The end result is that the South African taxpayer continues to accrue interest

income *ad infinitum*.

Fortunately National Treasury has recognised the problems associated with the

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secondary adjustment mechanism and has proposed getting rid of the deemed loan concept. In its place the amount of the secondary adjustment will now be deemed to be a dividend *in specie* paid by the South African taxpayer to the non-resident parent company. So in the above example the difference of R5 million will be deemed to be a dividend *in specie*. Dividends tax of 15% would then apply to such deemed dividend. Unlike cash dividends where the shareholder is liable for dividends tax and that tax is withheld by the company paying the dividend, the company that declares and pays a dividend *in specie* (or is deemed to have done so) is liable for the payment of the dividends tax.

It is also important to bear in mind that the transfer pricing provisions may be applicable in circumstances where the non-resident parent company provides financial assistance to its South African subsidiary. So for example, a non-resident parent company grants a R10 million loan to its South African subsidiary with an interest rate of 10%. Assuming that the amount of the loan is arm's length but the interest rate is not, then under the primary adjustment the South African subsidiary would only be entitled to claim an interest deduction based on the arm's length rate, say 8%. Under the secondary adjustment the South African subsidiary is deemed to have declared and paid a dividend *in specie* of R200 000 on which it must pay 15% dividends tax. The primary and secondary adjustment would continue to apply for as long as the loan is outstanding.

The above proposed changes are to come into effect on 1 January 2015.