



February 2021

## South African Transfer Pricing Case Law: IT 14305

IT 14305 dealt with an extraordinary transfer pricing related matter, which was recently heard by the Tax Court.

The judgement was handed down on 7 January 2021 and relates to an application for separation of a legal issue by the appellant in an appeal against a transfer pricing adjustment in respect of FY2011 (ie prior to significant amendments to the South African transfer pricing legislation).

The taxpayer was involved in the automotive industry. Specifically, it procured precious group metals (PGM) from a foreign connected person, which was then used in the manufacturing of catalytic converters for exhaust systems, which were sold to third party customers in South Africa. The taxpayer did not have transfer pricing documentation in place to support the arm's length nature of the PGM purchases during the period under review, and SARS consequently performed its own analysis relying on an external database benchmarking search for the identification of independent comparable companies. SARS selected and applied the Transactional Net Margin Method relying on a Net Cost-Plus as the Profit Level Indicator (Full-Cost approach) and benchmarked the mark-up on total cost achieved by the taxpayer against the comparable companies determined in the database search. Based on this, SARS came to the conclusion that the taxpayer's margin was between the minimum and the 25<sup>th</sup> percentile of the weighted average arm's length range achieved by the comparable companies. SARS therefore imposed a transfer pricing adjustment resulting in the taxpayer's Net Cost-Plus margin being increased to the median of the weighted average interquartile arm's length range determined.

Below are some key observations from the judgement in respect of the taxpayer's application:

- The preparation of robust transfer pricing documentation is critical for a taxpayer to be able to support and defend the arm's length nature of its cross-border related party transactions. This is evidenced by the income tax return under the transfer pricing disclosure section which requires a taxpayer to state whether it has transfer pricing documentation to demonstrate the arm's length nature of their related party transactions.
- Under the old (pre-2012) transfer pricing legislation, the testing of and adjustment in respect of a cross-border controlled transaction is not limited to the price charged, but also the profitability achieved by the tested party (with the amendment of section 31 this issue has been addressed anyway).
- A taxpayer electing not to prepare transfer pricing documentation is at risk because it is likely that SARS will

review the taxpayers transfer pricing position, and if SARS challenges the taxpayer's transfer pricing based on an analysis conducted by SARS, the likelihood of a successful defence for the taxpayer becomes difficult since the taxpayer effectively gives up its right of documenting and proving the arm's length nature of its related party transactions prior to a SARS query.

- SARS is correct in applying the TNMM even if there is a potential CUP on the basis that it demonstrates that the TNMM is the best suitable method based on the information available. Further, the argument presented by the taxpayer on the CUP appeared to be incomprehensive.
- It is appropriate to place reliance on Practice Note 7 and the OECD Transfer Pricing Guidelines in testing the arm's length nature of a transaction and when effecting a transfer pricing adjustment.

### Conclusion

In line with SARS' focus on transfer pricing compliance and enforcement, taxpayers are well advised to review their transfer pricing position, prepare appropriate documentation, and to ensure that documentation aligns with actual transactions carried out (form and substance). This is particularly important in the context of the Covid-19 pandemic where the transfer pricing landscape has changed considerably. Taxpayers cannot use blanket arguments in defending the arm's length nature of their transfer pricing practices as this is unlikely to be satisfactory to SARS. Taxpayers need to ensure that they are able to evidence that they have applied their minds in the determination and application of the arm's length principle from a South African perspective.

If you have any questions regarding the potential implications of the judgement or have any other transfer pricing related questions please contact a member of our Global Transfer Pricing Services Team in South Africa.

If you have any questions regarding the above or wish to speak to one of our Senior Transfer Pricing Specialists, please contact either of the below:

### Contact us



**Natasha Vaidanis**  
Head of International Tax &  
Transfer Pricing  
M: +27 (0)82 458 1043  
E: [natasha.vaidanis@kpmg.co.za](mailto:natasha.vaidanis@kpmg.co.za)



**Amit Chadha**  
Partner, International Tax &  
Transfer Pricing  
M: +27 (0)79 130 8540  
E: [amit.chadha@kpmg.co.za](mailto:amit.chadha@kpmg.co.za)



**Christian Wiesener**  
Associate Director, International Tax &  
Transfer Pricing  
M: +27 (0)82 719 2012  
E: [christian.wiesener@kpmg.co.za](mailto:christian.wiesener@kpmg.co.za)



**Lourika Goodburn**  
Associate Director, International Tax &  
Transfer Pricing  
M: +27 (0)63 682 0029  
E: [lourika.goodburn@kpmg.co.za](mailto:lourika.goodburn@kpmg.co.za)



**Jonathan Sweidan**  
Associate Director, International Tax &  
Transfer Pricing  
M: +27 (0)82 719 5876  
E: [jonathan.sweidan@kpmg.co.za](mailto:jonathan.sweidan@kpmg.co.za)

Regards  
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