KPMG

Tax & Legal Flash

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Transfer Pricing

Timing of retrospective adjustments

Background

In a recent tax court matter (case number 24674 dated 25 November 2020), SARS reiterated that tax is an annual event and therefore expenses and/or allowances claimed must match the year during which such expenses or assets are actually incurred. The taxpayer agreed with SARS, but still went ahead and claimed an allowance pertaining to a prior year of assessment in the year under review, because it was not able to claim the allowance in the relevant year. The case is summarised in the KPMG Tax and Legal News: SARS: No more catch-up adjustments.

The principles discussed in the case may also have an impact with regard to section 31 of the Income Tax Act ("Act").

Transfer pricing implications

The principle that tax is an annual event is also applicable to transfer pricing. A taxpayer engaging in cross-border intra group transactions must do so at arm's length in respect of each year of assessment. If the arm's length test is not satisfied and there is a tax benefit for one of the parties to the transaction, then a transfer pricing adjustment must be made (the Act refers to affected transactions).

Retrospective transfer pricing adjustment

In order to achieve an arm's length result, taxpayers often make use of retrospective transfer pricing adjustments. For example if the taxpayer overpaid its foreign connected person supplier during the year and does not meet the arm's length operating margin set in terms of the transfer pricing policy, the supplier would need to issue a credit note to retrospectively adjust the operating margin to the arm's length level.

Timing

The question in practice is often at what point in time the retrospective transfer pricing adjustment must be made. If the retrospective adjustment is performed before the financial accounts are closed, the profitability as per the financial statements would reflect an arm's length result in line with the transfer pricing policy.

It has been argued that if a catch-up payment (additional invoice or credit note depending on the case) is made in a subsequent year, this would be acceptable and result in the taxpayer having transacted at arm's length in the year under review. This is on the basis that the subsequent catch-up payment when taken into account for the tax calculation of the profitability achieved in the year under review still results in arm's length profitability. Thus, this view suggests that the timing of the adjustment is not relevant for determining arm's length as long as the tax impact/treatment is correctly considered in the relevant year of assessment.

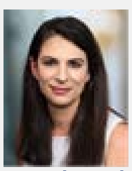
Conclusion

Applying the principle followed in the above tax court case it is doubtful that SARS would agree with a taxpayer performing a retrospective adjustment in terms of a catch-up adjustment in a subsequent year and treating it as part of the calculation of taxable income of the subsequent year.

It is therefore very important for taxpayers to not only document their transfer pricing policy, but to also ensure that it is correctly implemented in order to avoid costly disputes.

For any questions please contact one of the professionals in our transfer pricing team.

Contact us



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Regards
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