



Tax & Legal – News Alert



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Transfer Pricing Controversy: ABD Limited v SARS

It is well known that the South African Revenue Service (“SARS”) has dramatically increased its focus on transfer pricing in an effort to challenge taxpayers in respect of any transfer pricing shortcomings. This results in taxpayers needing to be more vigilant in ensuring their transfer pricing compliance is in order. The most recent South African transfer pricing case was finalised less than a month ago. This is one of a couple of transfer pricing cases in South Africa, and certainly a noteworthy one as it is the first case dealing with the technical application of transfer pricing methods. We set out our observations below.

Background

The matter was between SARS and ABD Limited (“ABD”) (a South African telecommunications company with subsidiaries (“Opcos”) worldwide) whereby the latter appealed against an increased assessment in respect of its transfer pricing position regarding intellectual property that ABD licenced to fourteen Opcos during the periods 2009 to 2012. ABD charged these Opcos a flat royalty fee at a rate of 1% of revenue for the right to use its intellectual property. The extent of what that right represented was in dispute.

What emerged in the litigation is that there are different methodologies that experts can apply in performing calculations to prove the arm’s length nature of controlled transactions, in this case a royalty. However, the overarching principle, and this was also agreed by the parties to the dispute, is that the royalty must be at arms-length – i.e., what would the charge be if it was between two independent enterprises as opposed to a company taxed in one jurisdiction and its subsidiary taxed in another.

Observations

“Size and Division of the Pie”

SARS’ argument was that in terms of the arm’s length principle, a royalty greater than 1% should have been levied by the taxpayer to its foreign connected persons. On this basis, SARS appointed two experts to determine what an arm’s length royalty in the circumstances would be. The difference between the experts’ calculations was over how they calculated the amount of the royalty charge and how this should be allocated to the various Opcos, which the judge in the matter referred to as the determination of “the size and the division of the “pie”. SARS first relied on the methodology of the first expert whose report led to an additional assessment being levied by SARS that ABD considered excessive, and which formed the basis of this appeal. However, during the appeal proceedings, in October 2020, SARS retained the services of a second expert, who presented a different result. The taxpayer accused SARS of a “flip-flop” approach as SARS can only issue an additional assessment if it is satisfied that “.....an (original) assessment does not reflect the correct application of a Tax Act to the prejudice of SARS or the fiscus”.

Application of the Profit-Split Method

Subsequently, four experts testified as to what an appropriate methodology should be to test the arm's length nature of the royalty charge in question. Testifying for ABD were three experts, however they relied on different methodologies. Two of them testified that the royalty should be tested on the Transactional Profit Split Method ("TPSM"). The third expert relied on the Comparable Uncontrolled Price Method ("CUP"). The fourth, an expert appointed by SARS also then used the TPSM Method. Based on the vulnerability in disputes about intangibles, the application of the TPSM was rejected.

Reliability of the CUP method

Theoretically, the CUP method is the most direct and reliable way to apply the arm's length principle. In applying the CUP Method, ABD relied on information from a former subsidiary in Cyprus (this subsidiary was sold to a third-party). At the time of sale, there was no brand licence agreement in place, however, the parties concluded a brand licence agreement when the Cyprus entity was independently owned (referred to as the Cyprus CUP). ABD argued that the parties transacted at arm's length at the time of concluding the license agreement. SARS argued that as ABD and the Cyprus entity were once associated, and therefore the reliance of the CUP Method is flawed. ABD challenged the views of the SARS' expert on various grounds.

The Judgement

In summary, ABD argued that the Cyprus CUP is the most persuasive method on the basis that the rate charged between ABD and the Opcos is identical to the royalty charge between ABD and the independent Cyprus entity. The court upheld ABD's appeal.

KPMG's Recommendation

There has been an increase in SARS transfer pricing audits over the last few years. Taxpayers are urged to ensure that there is robust evidence to support the arm's length nature of their cross-border controlled transactions. Transfer pricing documentation needs to be not only technically sound but also factually accurate and elaborate enough to tell the transfer pricing story to a reader in adequate detail for a reader to understand the facts surrounding the transaction(s) being examined.

Please contact one of our professional transfer pricing advisors should you wish to discuss your transfer pricing strategy or have any related questions:

For more information please contact:



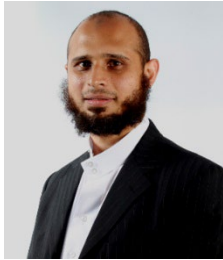
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¹ The term revenue is not defined in the judgement.

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