# Transfer pricing – changes to secondary adjustments

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**The proposed amendment**
The Draft Taxation Laws Amendment Bill 2014 proposes a revision of transfer pricing compliance in in the form of a deemed dividend, from 1 January 2015. It proposes that in future, the Section 31 secondary adjustment be deemed a dividend in specie, to be paid by the South African taxpayer to its foreign connected person.

In other words, if a South African company fails to charge its foreign holding company an arm’s length price, the difference of such an affected transaction will be deemed a dividend paid to the foreign holding company, subject to dividend withholding tax (DWT). For example, a foreign holding company pays its South African subsidiary R65m for goods while the arm’s length price is R100m. Section 31 will apply, increasing the income of the South African subsidiary by R35m and creating a deemed dividend in specie which, in terms of the proposed revision, will be subject to DWT.

**Secondary adjustments explained**
The Organisation for Economic Co-operation and Development’s Transfer Pricing Guidelines explains the term secondary adjustment as follows:

“To make the actual allocation of profits consistent with the primary transfer pricing adjustment, some countries having proposed a transfer pricing adjustment will assert under their domestic legislation a constructive transaction (a secondary transaction), whereby the excess profits resulting from a primary adjustment are treated as having been transferred in some other form and taxed accordingly. Ordinarily, the secondary transactions will take the form of constructive dividends, constructive equity contributions, or constructive loans."

In short, transactions that do not take place at arm's length will be subject to an additional, or secondary, adjustment that taxes the excess profit generated from the transaction.

**Cause for change**

Since the introduction of transfer pricing legislation in South Africa in 1995, secondary adjustments were made in the form of deemed dividends. However, when DWT replaced Secondary Tax on Companies (STC), secondary adjustments were made in the form of "deemed loans". In other words, an affected transaction resulted in a deemed loan for the South African resident, in respect of which the taxpayer is deemed to have accrued arm's length interest, subject to South African tax.

However, the Draft Explanatory Memorandum explained the reasons for reviewing the legislation, including that these loans are never repaid in practice and no contractual obligation exists to repay such loans. Furthermore, the legislation caused uncertainty about the currency of the loans as well as exchange control and accounting problems.

**Conclusion**

SARS is still relentlessly conducting transfer pricing audits. The challenge for taxpayers is that they still await updated transfer pricing guidelines and the uncertainty is compounded by the lack of legal precedence as no transfer pricing cases have reached our courts yet.

Therefore, although not specifically required by SARS, drafting a transfer pricing policy document is essential to any taxpayer that may need to defend foreign transactions with connected parties to SARS. These documents must set out the economic justification and the considerations before entering into a transaction, as well as the method used to establish an arm’s length price and the systematic process followed to set arm’s length international transfer prices. Additionally, companies’ international transactions with foreign connected persons should be reviewed annually, noting any changes in the functions or structure of the company that may affect transfer pricing policies.

Contact our South African Transfer Pricing leader, AJ Jansen van Nieuwenhuizen on aj@za.gt.com if you need assistance regarding any transfer pricing related matters, or if you wish to discuss the effect of Section 31 on your business.