Cross-border tax regulations can be costly

When South African businesses expand into other African countries there are cross-border tax implications, which can be costly and administratively burdensome if not considered upfront.

Michael Hewson, director, Graphene Economics

Several countries on the continental have introduced new transfer pricing regulations or updated existing legislation in recent years. Transfer pricing relates to the system of pricing between related parties transacting with each other.

“As modern transfer pricing regulations have developed, we’ve seen tax authorities shift their focus to multinational enterprises (MNEs) and their pricing practices applied to intercompany transactions. There’s been a notable increase in audit activity, with tax authorities performing detailed transfer pricing reviews and audits, with a common focus on intra-group services.

"These intra-group services, such as shared IT or HR services, are common within large MNEs for various reasons. It might be that certain skills are not widely available in each country in which the MNE operates, or to create synergies and uniformity within the group, or purely as a cost-saving measure," says Michael Hewson, director at Graphene Economics.

Intra-group service costs

MNEs operating in various African countries are being subjected to increased scrutiny in relation to intra-group service costs and are being asked to provide evidence to support business decisions taken in respect of such costs.

For example, an MNE's centralised IT function may have sourced Microsoft 365 licences for all its subsidiaries, including one in Botswana. It will then on-charge a percentage of the total fee from Microsoft to the Botswana subsidiary, for which the subsidiary will claim a deduction.

The relatively new regulations in Botswana note that for the in-country entity to claim a deduction for the amounts, it needs to be able to provide the invoices from Microsoft and the calculation of the proportional amount allocated to the Botswana subsidiary, to ensure this amount reflects the exact amount that is being claimed as a deduction by that subsidiary.

Given that this was arranged as a bulk purchase and there may be other Microsoft services acquired as well, that won't necessarily be something that an MNE may be able to easily provide. Furthermore, it is expected that the MNE be able to show how it calculated the portion of the total cost allocated to the Botswana subsidiary.

Executive activities costs

"Another example we're seeing more and more is tax authorities querying the costs attributed to executive activities. The executives of an MNE group may spend 20% of their time working on protecting shareholder investment and 80% of their time on strategy and other actions to grow the group's revenue. The business might decide that this 80% of the executives' time should be charged out (plus an arms-length mark-up) to the various group entities. However, in recent audits performed by the Tanzania Revenue Authority (TRA), these types of charges have been challenged," he says.

In such cases, MNEs are being asked to trace back executives' activities (sometimes as far back as six years ago) to justify what they have done for the benefit of the Tanzanian subsidiaries. Providing a high-level explanation of their activities has not proved adequate to satisfy the TRA that the service was rendered and the charge is appropriate.

"As a consequence, the groups may be at risk of losing their full tax deduction (or a part thereof). In the worst-case scenario, the TRA may even implement a transfer pricing adjustment and levy an equivalent penalty for the more recent years," Hewson says.

Complexities

The tax implications of supporting subsidiaries in Africa can become very complex. "Most businesses don't keep detailed timesheets for every employee or request an invoice per software licence purchased. Given that most tax audits also happen a few years down the line, it can often be difficult to remember why certain decisions were taken or to find specific physical evidence that tax authorities are requesting," he says.

"Some SA-headquartered groups have queried whether it's worth charging out intra-group services to subsidiaries, given the difficulties involved. However, if they don't charge for these services, the South African Revenue Services (Sars) is likely to deem they ought to have done so, and may apply penalties in cases where amounts have not been charged out to African subsidiaries."

Evidence required

Another complicating factor is that there is currently no clear guidance in many countries regarding the specific evidence required to substantiate intra-group charges, and a level of subjectivity may be involved.

"The most immediate solution for MNEs operating in Africa is to begin to obtain appropriate evidence to substantiate services rendered and to ensure that charges are warranted in a way that meets revenue authority requirements. This goes beyond having an intercompany agreement in place and requires actions such as ensuring all invoices are correctly captured and filed, business decisions are documented for future reference, and adequate levels of detail and actual evidence are available to justify services rendered," Hewson says.

As intra-group services within Africa continue to increase as groups look to drive intra-Africa trade, Hewson believes it is also imperative for policy solutions to be developed to address double taxation, which remains a pervasive issue on the continent, as well as ensuring greater alignment between countries in terms of their taxation approach to service transactions. “This will ensure businesses are able to operate more efficiently, revenue authorities are able to collect taxes more effectively, and economies throughout the continent benefit in the long term."