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Tax Implications of Transfer Pricing on Supply Chain Management

**By Tina Eich
(ECHBET001)**

Dissertation

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Supervisor:

Peter Cramer

Department of Accounting

University of Cape Town

DECLARATION

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Abstract

The issue of transfer pricing is gaining prominence as multinationals become more globalised. Additionally, the current recessionary economic climate is placing increased pressure on multinationals to continuously reduce costs (including their effective tax rates) by improving their global supply chain management.

The South African transfer pricing rules are set out in section 31 of the Income Tax Act 58 of 1962. South Africa has adopted an internationally accepted standard for the allocation of profits between connected persons, by legislating the use of the arm's length principle, as suggested by the Katz Commission, in order to prevent transfer pricing abuse.

No specific methodologies for determining the arm's length price have been legislated in South Africa, however guidance is provided in Practice Note No. 7 which is aligned with the international standard published by the Organisation for Economic Co-operation and Development.

This dissertation discusses the tax implications of transfer pricing rules on supply chain management and in particular the importance of aligning the transfer pricing strategy with the business strategy.

The provisions of the Income Tax Act, international guidelines and international transfer pricing court decisions, as well as other relevant South African legislation are discussed. The various transfer pricing methodologies acceptable to the Commissioner for the South African Revenue

Service are summarized below and a basic comparative summary of the transfer pricing rules applicable in Australia and Canada, is provided.

The principles of supply chain management are examined and consideration is given to the impact of transfer pricing legislation thereon.

Increased globalisation has lead to centralised risk management and decision-making in multinational enterprises, which gives rise to the principle of tax efficient supply chain management and the need to focus on the integration of tax considerations into the multinational's supply chain.

In order to retain a competitive advantage in the global economy, multinational enterprises need to constantly search for cost benefits. This has created a market for tax motivated structures and the consequential action by tax authorities world-wide to regulate transfer pricing, in order to protect their respective tax bases.

As revenue authorities increase their focus on transfer pricing compliance, it is vital that multinationals adhere to the arm's length principle and ensure their transfer pricing documentation can substantiate the transfer prices selected.

Chapter 1 – Introduction

1.1 Economic reality

The main objective of most companies is the creation of sustainable wealth. Economic theory dictates that the optimum level of output is where the marginal cost equals the marginal revenue. These marginal cost and revenue levels may however vary between divisions of an organisation and the organisation as a whole, creating a problem in determining transfer prices. The optimal transfer price is achieved when the overall company profits are maximised. However, one needs to consider that the external market is competitive and therefore generally companies are price takers and must accept prices determined by the market forces (being the arm's length transfer price) (Rees, 2008).

Supply chain management allows a company to gather information and effectively monitor processes in order to refine and optimize their operational structure. The growth of multinational enterprises (“MNEs”) in the business environment of the 21st century, has contributed to the rise in supply chain structures.

The application of supply chain management (“SCM”) in the globalised world economy raises the importance of adequate tax planning, in the light of transfer pricing challenges. Transfer pricing is inherent within the global economy, as the supply chain extends across borders, due to the variations in tax and other laws. Some countries have introduced domestic transfer pricing rules (eg.: United Kingdom), however in South Africa transfer pricing legislation applies only to cross border transactions.

Transfer pricing management serves as a strategic business tool to increase earnings and reduce risk. The main transfer pricing issues arise as MNEs review and understand their value chains by applying a functional and risk analysis of their operations. This brings about the identification of cross border inter-group savings (Rees, 2008).

Despite the importance of the transfer pricing phenomenon faced by MNEs, most enterprises may not have the in-house tax expertise or experience to address these issues in a timely manner and may therefore face exposure to revenue audits and large penalties, due to the contravention of the taxation law of that country (eg Glaxo Smith Klein & DHL cases) (Rees, 2008).

In the current turbulent economic climate, careful SCM is even more important than in growth periods. The financial crises and rising transport costs may lead to a slowdown in globalisation, however sensible SCM is the key to a company's successful navigation and survival in such uncertain times. Companies with an integrated approach to SCM will be better placed to survive a recessionary period and emerge as leaders, as the tax planning aspect can provide tax optimisation and minimise risk.

Transfer pricing legislation is topical especially in the developing world, as the taxing authorities have become more aggressive in the transfer pricing arena. This may result in double taxation or substantial penalties and interest being levied on a taxpayer. The most common services under review by taxation authorities are the levying of administration and management fees (as these are highly prone to abuse and therefore an easy target) (Holland, 1999), royalties payable for the use of intangibles and the transfer of manufactured goods for resale (Mayank, 2009).

In the current economic climate the South African Revenue Service (“SARS”) has incurred a significant shortfall in revenue collections. The Minister of Finance, Pravin Gordhan, specifically highlighted transfer pricing and cross border schemes as being one of the main areas of concern and noted that stricter measures will be implemented to prevent further increases in the budget deficit. Alongside these comments, the Commissioner for SARS, Mr Oupa Magashula, announced that SARS would be tightening up on compliance through increased audits, especially where taxpayers disclosed a sharp decline in taxable income. SARS is continuously working towards closing tax loopholes. The SARS Large Business Centre will specifically focus on transfer pricing and off-shore transactions among other issues. Transfer pricing is a complex field within international tax and therefore historically transfer pricing abuses have gone unpunished due to, among other things, the lack of qualified staff at SARS (Troskie & Buttrick, 2009).

No reliable estimates for the loss of global tax revenues exist, however based on a study performed by SJ Pak of Pennsylvania State University and JS Zdanowicz of Florida State University, US corporations have avoided in excess of US\$53 billion in taxes, through transfer pricing schemes, in 2001 alone. Developing countries are especially at risk, as tax authorities lack the necessary expertise to combat transfer price avoidance (Singh, 2007).

A disconnect exists between governments, who want to earn more tax and MNEs that want to save more tax (Mayank, 2009). Hence a conflict exists, as tax efficient supply

chain management (“TESCM) seeks to minimise costs (including direct and indirect taxes) while tax authorities attempt to maximise revenues.

1.2 Purpose and structure of the dissertation

Transfer pricing is an important aspect of the South African and international tax regime as it affects tax revenues globally. As countries attempt to protect their tax revenues, the increase of global supply chains makes it impossible to do so in isolation. For this reason, the OECD Guidelines are reviewed as they provide a global standard for the determination of international transfer prices.

The aim of this dissertation is to analyse the rationale behind the existence of transfer pricing legislation, the methods of determining arm’s length prices and the impact thereof on supply chain management (“SCM”).

The dissertation will discuss South African and international transfer pricing legislation, including a review of acceptable transfer pricing methods, double tax agreements, documentation requirements, penalties and interest, as well as possible secondary tax on companies’ implications. Additionally it will evaluate South Africa’s approach to transfer pricing, as well as compare it to the approaches selected by other countries, namely Australia and Canada.

The above discussion will encompass a review of the findings and recommendations provided by the Organisation for Economic Co-operation and Development and how these have been taken into account in South African law. In order to do this, relevant

provisions of the Income Tax Act 58 of 1962 as well as other applicable legislation will be examined.

The question of tax affects on supply chain management and the suitability of the South African transfer pricing rules and OECD Guidelines, with a view of examining the practicality of these on SCM, will be addressed in this dissertation. The ongoing dispute and search for a comparable valuation basis will be discussed by analysing the application of and problems surrounding the use of the arm's length principle. This principle is further underpinned by transfer pricing methodologies, which will be summarised and considered in reference to the above.

The dissertation will conclude on the importance of a proactive approach to tax efficient supply chain management ("TESCM") by MNEs and the significance of maintaining adequate transfer pricing documentation, especially in the light of the comparability principle.

1.3 Limitations of study

This dissertation is limited to the affect of transfer pricing tax planning on supply chain management. Certain terms and topics are not considered pivotal to the dissertation and will therefore merely be introduced during the transfer pricing discussion in order to contextualise the principles thereof.

Chapter 2 – Transfer pricing in the light of South African tax legislation and the Organisation for Economic Co-operation and Development (“OECD”) Model Tax Convention Treaty – Introduction to the Concepts

2.1 Background and history

South African tax authorities introduced the revised section 31 of the Income Tax Act 58 of 1962 (“ITA”), as amended, effective 19 July 1995. The relaxation of exchange controls with effect from 1 July 1997 and the reduction in customs duties, increased the shifting of profits by MNEs from South Africa, to associated group companies in lower tax jurisdictions. This prompted SARS to issue a comprehensive practice note in 1999. Practice Note No. 7 was issued to provide guidance to taxpayers on acceptable transfer pricing methods and related documentation requirements (SARS, PN No. 7, 1999).

The Katz Commission (Second Interim Report of the Commission of Inquiry, 1995) highlighted the lack of protection against price manipulation between related party transactions. In order to mitigate this risk, the Katz Commission recommended that the arm’s length approach to transfer pricing (as set out in the OECD Guidelines) should be adopted in South Africa.

South Africa introduced specific transfer pricing legislation to ensure that South African resident taxpayers are taxed in South Africa on international transactions and investments, which will be discussed in more detail below.

2.2 Transfer pricing definitions and terminology

The relevant transfer pricing definitions are contained in section 1 and section 31(1) of the ITA, as well as the SARS Practice Note No. 7 (SARS, PN No. 7, 1999) and read as follows:

Goods (section 31 of the ITA)

“Includes any corporeal movable thing, fixed property and any real right in any such thing or fixed property”;

Services (section 31 of the ITA)

“Includes anything done or to be done, including, without limiting the generality of the foregoing-

- a) the granting, assignment, cession or surrender of any right, benefit or privilege;*
- b) the making available of any facility or advantage;*
- c) the granting of financial assistance, including a loan, advance or debt, and the provision of any security or guarantee;*
- d) the performance of any work;*
- e) an agreement of insurance; or*
- f) the conferring of rights to or the use of incorporeal property.”*

Permanent establishment

Section 1 of the ITA defines a “permanent establishment” (“PE”) with reference to the definition contained in article 5 of the OECD Convention.

Connected person (section 31 of the ITA)

For purposes of section 31(2) of the ITA, a connected person as defined under subsection (1A) is “*any supply of goods or services...in respect of intellectual property...*” the term will include “a connected person as defined in section 1, provided that the expression “*and no shareholder holds the majority voting rights of such company...*” in paragraph (d)(v) of that definition must be disregarded. The definition of a connected person covers, natural persons, trusts, partnerships, companies and close corporations. The dissertation will be limited to the definition of connected person in relation to a company:

“ i) *any other company that would be part of the same group of companies as that company if the expression ‘at least 70 per cent’ in paragraphs (a) and (b) of the definition of ‘group of companies’ in this section were replaced by the expression ‘more than 50 per cent’;*

iv) *any person, other than a company as defined in section 1 of the Companies Act, 1973 (Act No 61 of 1973), who individually or jointly with any connected person in relation to himself, holds, directly or indirectly, at least 20 per cent of the company's equity share capital, or voting rights;*

v) *any other company if at least 20 per cent of the equity share capital of such company is held by such other company, and no shareholder holds the majority voting rights of such company;*

- vA) *any other company if such other company is managed or controlled by-*
- aa) *any person who or which is a connected person in relation to such company; or*
- bb) *any person who or which is a connected person in relation to a person contemplated in item (aa);”*

Controlled transactions (SARS, PN No. 7 para 1.2.1)

“A transaction in terms of which the ownership or control relationship is able to influence the transfer price set. In relation to section 31, a controlled transaction will be any transaction between connected persons, as defined in section 1 of the Act.”

The principle of a controlled transaction would be classified as a transaction between connected persons in terms of section 31 of the ITA, as defined in section 1 of the ITA.

Uncontrolled transactions (SARS, PN No. 7 para 1.2.1)

“A transaction which is concluded at arm’s length between enterprises that are not connected persons in relation to each other. This could, for example, include transactions at arm’s length between a member of a multinational and an unconnected person. Uncontrolled transactions form the benchmark against which a multinational’s transfer pricing is appraised in determining whether its prices are arm’s length.”

2.3 Transfer pricing legislation in South Africa

2.3.1 Gross income & the general deduction formula

The definition of “gross income” in section 1 of the ITA refers to the total amount, in cash or otherwise, received by or accrued to or in favour of a South African resident or in the case of a non-resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic, during such year or period of assessment, excluding receipts or accruals of a capital nature. Gross income must be included in the resident’s gross income for income tax purposes, irrespective of where in the world such income was earned.

In the *First National Bank of Southern Africa Ltd v Commissioner for Inland Revenue* 64 SATC 245/2002 (3) SA 375 case, the court held that the origin of the borrowed funds and the taxpayer’s business activities was South Africa and therefore fell within the definition of “gross income” in section 1 of the ITA and was subject to tax in South Africa.

The general deduction formula has been applied in connection with transfer pricing rules in *ITC569 13 SATC 447*, where the courts held that the expenditure was grossly excessive and not deductible. It must be noted though that there are no specific guidelines to assist taxpayers in identifying grossly excessive expenditure other than in the case of *Tobacco Father v COT 17 SATC 395* (Also cited as *1951(1) SA 150 (SR)*) where it was held that the open market price could not be determined. The general deduction formula is of limited use for the purpose of adjusting transfer prices (Olivier & Honiball, 2005).

2.3.2 Substance over form

The general assumption is that enterprises are set up as going concerns, which are strategically incorporated and positioned within the market to achieve profitable results through the appointment of staff who establish adequate financial and corporate governance controls, in order to operate the business (Commonwealth of Australia, 2008).

Business profits are generally taxable where the PE from which they arise, is located. For this reason it is necessary for tax authorities to determine whether off-shore entities are PEs, agencies or merely addresses with no premises, equipment or employees.

A PE is defined as a fixed place of business from which an enterprise carries on business. A PE includes a place of management, a branch, an office, a factory, a workshop and the activities of a person acting as an agent of the enterprise. An agent will be considered a PE, where the agent has the authority to conclude contacts in the name of the enterprise and is not merely limited to the purchasing of goods (OECD, 2008:5).

The agency ruling was decided in *SIR v Downing 37 SATC 249* where a Swiss resident owned a share portfolio in South Africa which was administered by South African brokers. The court had to evaluate the Swiss - South African Double Tax Agreement (“DTA”) to determine whether these share dealings could be taxed by SARS. It was held that the brokers operated as independent agents in their own premises and therefore their activities were not considered to be a PE of the taxpayer.

The international tax principle for attributing profits to a PE is provided in Article 7 of the OECD (OECD, 2008:7). The importance of the PE concept can be seen from the following extract from paragraph 1 of the Commentary on Article 7 of the OECD Model Tax Convention (OECD, 2008:7(1)):

“When an enterprise of a Contracting State carries on business in the other Contracting State, the authorities of that second State have to ask themselves two questions before they levy tax on the profits of the enterprise: the first question is whether the enterprise has a permanent establishment in their country; if the answer is in the affirmative the second question is what, if any, are the profits on which that permanent establishment should pay tax. It is with the rules to be used in determining the answer to this second question that Article 7 is concerned. Rules for ascertaining the profits of an enterprise of a Contracting State which is trading with another enterprise of another Contracting State when both enterprises are members of the same group of enterprises or are under the same effective control are dealt with in Article 9.”

Article 7 provides two approaches to determining the existence of a PE; the “functionally separate entity” and the “relevant business activity”. Although these approaches may produce a similar result, in many cases the risk of double taxation exists where different tax jurisdictions, affected by the transaction, apply different approaches (OECD, 2008:7).

The OECD report on the attribution of profits to a PE encourages the “functional separate entity” approach as the standard method. This method recognises the profits of a PE based on the functions, asset and risk adopted by the PE. Therefore based on the transfer pricing rules and the OECD Guidelines, the profits allocated to a PE should be assessed using a comparability analysis rather than the apportionment of global profits. Effectively the substance over form rule prevails, requiring that the business model is based on a functional, industry and economic analysis (OECD, 2008:7).

2.3.3 Source and deemed source

Before 2001, South African tax was based on source basis, which considers the originating cause of the income and the location of the originating cause. The test of “source” was established in the *CIR v Lever Brothers & Unilever Ltd (1946 AD)*, 14 SATC 1 case, where the learned judge, Watermeyer CJ, noted: “*The source of income is not the quarter from which it comes but rather the originating cause of its receipt. The originating cause is the work which the taxpayer performs to earn the income, the quid pro quo given in return for which it is received.*” The court held that the income in question was not from a South African source. The originating cause and location of the income was held to be the supply of credit and not where the debtor resided. Effective for years of assessment commencing on or after 1 January 2001 the residence based system of tax was introduced in South Africa.

In terms of the current South African tax legislation, South African residents are taxed on a worldwide basis and non-South African residents are taxed on a source or deemed source basis (refer to the *First National Bank of Southern Africa Ltd v*

Commissioner for South African Revenue Service 64 SATC 245 case). Identification of the source of income is important when assessing the impact of double tax agreements.

Other than natural persons, a resident is defined in section 1 of the ITA as any taxpayer that has been incorporated, established or formed in South Africa or if the “place of effective management” is in South Africa. The concept of “place of effective management” refers to where the day-to-day operations of the company are carried on. The OECD view of “place of effective management” is where the management direction is exercised (OECD, 2008:8).

The 2008 OECD model update introduced an arbitration provision through a “mutual agreement procedure” and what this entails. Additionally “place of effective management” was replaced by the concept of “mutual agreement procedure”.

A non-resident company transacting in South Africa through a branch will be taxed on a source or deemed source basis.

2.3.4 Section 9D & section 6quat

Section 9D of the ITA was introduced to prevent the avoidance of South African tax on foreign income by South African residents (eg: channelling their income earning activities through an off-shore company). Section 9D of the ITA provides that in certain circumstances a proportion of the income earned by a Controlled Foreign Company (“CFC”) is taxed in the hands of the South African shareholder (Edward Nathan & Friedland, 2001).

A CFC is any foreign company where one or more South African residents hold more than 50% of the participation or voting rights or where one or more South African residents can directly or indirectly exercise more than 50% of the voting rights in that foreign company. A foreign company is defined as any association, corporation, company, arrangement or scheme contemplated in paragraph (a), (b), (c), (e) or (f) of the definition of “company” in section 1, whose place of effective management is outside the Republic.

The income, part of which may be taxable in South Africa, is measured in terms of the percentage of the resident’s participation rights in the CFC compared to the total participation rights in the CFC. “Participation rights” refers to the right to directly or indirectly share in the capital or profits or other distribution made by a company (Edward Nathan & Friedland, 2001).

In terms of section 9D of the ITA a South African resident is taxed on an amount equal to the proportional amount of net income of the CFC even though this amount is notional rather than an actual amount received or accrued. Numerous exemptions governing the application of section 9D of the ITA exist, which are beyond the scope of this dissertation.

In order to alleviate possible double taxation in the case of CFCs, section 6quat of the ITA allows a South African resident a tax rebate, ie the resident is entitled to deduct any foreign taxes paid in respect of foreign income which is also subject to tax in South Africa. Section 6quat of the ITA is only available to South African residents. A resident cannot elect whether to opt for a rebate or a deduction as relief from South

African taxes. A rebate is directly deducted from South African tax in comparison to a deduction which reduces the South African taxable income. Section 6quat(1)(a) provides that a rebate may only be claimed in respect of income received or accrued from any source outside the Republic that is not from a source in the Republic or deemed to be from a source within the Republic (Snyckers, 2009).

SARS recently reissued Interpretation Note No. 18 which explains the rebate or deduction of foreign taxes as set out in section 6quat of the ITA. The interpretation note comprehensively discusses the scope, analysis and application of section 6quat. The interpretation note states that the source rule does not apply to DTAs, where a deemed source rule exists in the DTA. The deemed source rule referred to in the interpretation note is generally contained in the interest article of a DTA. This dissertation will not discuss the topic further, however it draws attention to SARS view of the interrelationship between section 6quat and DTAs (Snyckers, 2009).

2.3.5 Section 31 of the Income Tax Act

South African transfer pricing tax rules are governed by section 31 of the ITA. The section was introduced into the Income Tax Act in 1995. South African transfer pricing legislation applies to non-arm's length transactions for the supply of goods and services between connected persons, where one party is a South African resident and the other a non-resident, or one party is a non-resident and the other a South African PE of a non-resident or alternatively a PE of a resident. Effectively the transfer pricing rules enable SARS to adjust the transfer price to an arm's length price, where it considers the transaction value not to be arm's length, in calculating the resident's taxable income.

Section 31 of the ITA provides special anti-avoidance measures to regulate two types of international transactions, being transfer pricing and thin capitalisation. This dissertation is limited to a transfer pricing review only. The principle behind the transfer pricing rules is to neutralise the tax benefits arising from transactions between related parties on non-commercial grounds (Masithela & Pierce, 2006).

The transfer pricing rules are dealt with in section 31(2) of the ITA, which assess the reasonability of the price at which goods and services in an international transaction between connected persons are transacted with reference to the arm's length principle.

Section 31 of the ITA empowers the Commissioner to adjust the price of goods and services supplied in terms of an international agreement between connected persons to an arm's length transfer price, in order to prevent the shifting of pre-tax profits by MNEs from high to low tax jurisdictions.

Capital adjustments are dealt with in paragraph 38 of the Eighth Schedule of the ITA. The Eighth Schedule of the ITA is not discussed in further detail in this dissertation.

No guidance on how to identify an arm's length price is provided; therefore one would look to paragraph 9 of Practice Note No. 7 for assistance.

It must be borne in mind that practice notes are not binding in law, as the Commissioner cannot amend the law in order to avoid unintended results due to

wording of the legislature. This principle has been evidenced through a number of court decisions, such as *ITC 1830*, *70 SATC 123* and *ITC1675 62 SATC 219*. The courts have held that the Commissioner must review the facts and circumstances of each case individually in order to determine the validity and reasonability of the arm's length price.

Certain noteworthy changes to section 31 of the ITA were introduced by the Revenue Laws Amendment Act of 2007. One of the changes comprised the deletion of the term "international agreement" which it was suggested widened the application of section 31 of the ITA to include domestic transactions between residents, which form part of an overall cross border arrangement (E&Y:s31, 2010). This issue was raised as an area of concern at a tax seminar on transfer pricing presented by Lee Corrick (Corrick, 2010), who refuted the idea. Lee Corrick noted that the principle behind transfer pricing legislation is to prevent situations where profits leave South Africa, which are then taxed elsewhere. Subsection (2) continues to refer to transactions between residents and non-residents, which refutes the above view that SARS intended to bring domestic transactions within the scope of the transfer pricing legislation.

The more significant of these amendments were effective from 1 January 2009. One of which is the change to the definition of "connected person" in line with new regulations imposed with regard to intellectual property. Based on this change, transfer pricing rules will apply where any intellectual property transaction between two parties (where company 1 owns at least 20% of company 2) takes place, irrespective of whether or not a third party owns the majority shareholding in company 2. The reason for increasing the scope of the transfer pricing rules in terms of intellectual property is

to address royalty arrangements, as well as transfers of intellectual property. The changes to the tax legislation for the treatment of intellectual property, are considered to fall outside the scope of this dissertation and are therefore not addressed in detail. Section 23I of the ITA disallows South African taxpayers a deduction for royalties, unless the royalty income is taxed in South Africa in the hands of the holder of the affected intellectual property or limits the deduction to one third of the royalty fee paid, where the royalty income is subject to section 35 withholding tax (of at least 10%) (Joubert, 2008).

The current transfer pricing rules are still fraught with uncertainties and therefore open to abuse. The Taxation Laws Amendments Bill 2010, was introduced on 24 August 2010 and contains some significant proposed changes to section 31(2) of the ITA. Based on the current proposal, South African transfer pricing rules should be revised in line with international practices, in order to alleviate perceived weaknesses as noted below. The amendment contained in the Taxation Laws Amendments Bill 2010 is effective in respect of years of assessment commencing on or after 1 October 2011 (E&Y: s31, 2010).

A prime example of a weakness in the current section 31(2) is the fact that the literal wording of the section refers to isolated transactions rather than placing emphasis on the economic substance of the inter-company arrangements as a whole. Business decisions are usually based on an all-encompassing group objective, not individual transactions. SARS intends to widen the scope of section 31(2) as to allow the Commissioner to amend the terms and conditions of a cross border transaction and not

merely the price, in order to achieve compliance with the arm's length principle (Brodbeck, 2010).

It furthermore suggests removal of the excessive emphasis on the application of the comparable uncontrolled price ("CUP") method over other possibly more practical transfer pricing methodologies. Additionally, the proposal provides for the replacement of the reference to "the supply of goods and services" with "transaction, operation, scheme, agreement or understanding which has been directly or indirectly entered into" between connected persons, across national borders, where a South African tax benefit arises in the hands of one party. The changes propose that greater focus is placed on the economic substance rather than the legal form of the transaction. Effectively the suggested amendment to section 31(2), will allow SARS to assess the taxable income of a party to the transaction, operation, scheme, agreement or understanding as if the aforementioned had been entered into on market-related arm's length terms and conditions (SARS, Taxation Laws Amendments Bill, 2010).

The above proposed amendments serve to widen the transfer pricing legislation significantly, because SARS will no longer be required to identify a specific transaction comprising the supply of goods and services. Additionally the proposed new wording would alleviate the restriction of price assessments only; as SARS will be able to attack non-arm's length terms and conditions which exist between related parties (Brodbeck, 2010).

SARS is required, under the proposed legislative changes, to identify the income that would have accrued to the taxpayer where a "tax benefit" was gained from the

transaction, operation, scheme, agreement or understanding. This change is in line with South African general anti-avoidance regulations contained in Part IIA of the ITA, where “tax benefit” is an existing term. The main point of interest for transfer pricing legislation is the fact that the burden of proof will rest on SARS, to show that a “tax benefit” was derived by the taxpayer, due to the transaction not having taken place on an arm’s length basis (Brodbeck, 2010).

These proposed changes are however not in line with the OECD Guidelines (OECD, 2008:9), which allow an adjustment to be made to bring the transfer prices in line with arm’s length agreements, accepting the terms and conditions of the transactions as represented by the taxpayer. Only in exceptional circumstances (refer to 5.5.1 Issue Note 4) does the OECD model recommend non-recognition of a part or the entire transaction, where it is found that the substance of the transaction does not support the economic reality (E&Y:s31, 2010).

Furthermore, section 31 refers mainly to “price” rather than “profit” which is in contradiction with Article 9 of the OECD Guidelines (OECD, 2008:9) and other tax treaties which can negatively affect tax agreements with other countries.

Removal of emphasis on the CUP method appears to have arisen from the proposed OECD Guidelines amendment which calls for the application of the “most appropriate” transfer pricing method on a case by case basis.

The new transfer pricing rules were amended to align with those contained in DTAs, as the focus is shifted from goods and services to transactions, operations and schemes undertaken on an international level between connected persons.

2.3.6 Practice Note No. 7

South Africa has not legislated any specific transfer pricing methodologies for determining an arm's length price. A process for identifying an arm's length price has however been provided by SARS, which advises companies to perform a review of the global and local industry and of the global group structure in order for a functional and risk analysis to be conducted (Bowman Gilfillan Attorneys, 2003).

Guidance for determining an arm's length price can be sought in Practice Note No. 7, which identifies the following standard pricing methods referred to in the OECD Guidelines (OECD, 2008:9) as acceptable, to determine a taxpayer's transfer prices, in order of preference (SARS, PN No. 7, 1999:9.1.1 & 9.2.2):

- Comparable uncontrolled price ("CUP")
- Resale price ("RP")
- Cost plus ("CP")
- Transactional net margin ("TNMM"), and
- Profit split ("PS")

Even though South Africa is not a member of the OECD, the Practice Note (SARS, PN No. 7, 1999:3.2.2 & 3.2.3) is based on the OECD Transfer Pricing Guidelines and

these Guidelines should be followed if no specific guidance is given in Practice Note No. 7 or section 31 of the ITA.

SARS Practice Note No. 7 para 7.3 states that:

“... the problem to be resolved is how a multinational should determine what price would have arisen if transactions between its members were subject to market forces. The solution advanced by the arm’s length principle is that a comparable transaction between independent parties (an uncontrolled transaction) should be used as a benchmark against which to appraise the multinational’s prices (the controlled transaction). Any difference between the two transactions can then be identified and adjusted. An arm’s length price that will reflect the economic contributions made by the parties to the transaction can be determined for the controlled transaction.”

By choosing an internationally accepted transfer pricing method for determining the allocation of profits across group companies, South Africa is more adequately placed to deal with other countries when enforcing transfer pricing rules (Bowman, 2003).

Additionally this improves the international image of South Africa in the global business arena providing an opportunity for international investment. Unfortunately as highlighted in the latest OECD report, high labour costs, relatively high tax rates and restrictions on the repatriation of funds act as a disincentive to foreign investors, especially in comparison with other developing countries such as India and China (Pickworth, 2008).

2.3.7 OECD

The OECD Model Tax Convention was started in 1956 as a project to develop a uniform tax treaty for European countries. The first OECD model was completed and published on 1 July 1958 with the involvement of less than 15 countries. Thereafter the model was revised and the Double Tax Convention version was completed in 1963 and published in 1977, by which time the member countries had increased to 20.

By 1996 the process of contributing towards the drafting and continuous development of the model was opened up to non-member countries and businesses, through the hosting of a global forum annually in September (Owens & Bennett, 2008).

The most common guidelines to follow, when concluding bilateral tax treaties, are the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, first published in 1995, as amended from time to time. The OECD Model Tax Convention on Income and on Capital forms the basis of an extensive network of bilateral income tax treaties between OECD member countries. The intention was to assist both business and tax authorities to prevent double taxation and tax evasion by providing a treaty model template on international taxation. The adoption by South Africa of an internationally accepted standard to allocate profits between connected parties can prevent double taxation issues (Owens & Bennett, 2008).

The OECD Guidelines provide a standardised approach to countries preparing and negotiating double tax treaties. These Guidelines are not binding by law but rather

recommendations based on contributions by its members, who undertake to follow the model and its commentaries, when revising or entering into tax treaties (Owens & Bennett, 2008).

The strength of the OECD model is its flexibility, versatility and transparency. The OECD model is compiled through continuous discussions with members, non-members, business and tax authorities. Furthermore, as the model is not law, changes are initially published in draft format in order to allow member and non-member countries to provide valuable feedback, prior to release of the updated model. The Committee on Fiscal Affairs provides periodic and timeous updates of the Guidelines, generally issued every two to three years.

The OECD Guidelines provide an approach for MNEs to applying the arm's length principle in order to determine reasonable transfer prices in respect of related party transactions. Transfer pricing methods are generally based on sound economic theory; however it can be advantageous for companies in a group to arbitrarily select prices to ensure that most of the profits are generated in countries with low taxes, thereby shifting profits to reduce the overall taxes payable by a MNE. In most countries this shifting of profits is discouraged by the revenue authorities, as tax laws exist which limit the value range within which transfer prices can be set (Owens & Bennett, 2008).

South Africa has adopted the arm's length principle promulgated in para 1 of Article 9 of the OECD Convention in order to protect itself against excessive price manipulation between related parties (Second Interim Report of the Commission of Inquiry, 1995).

Article 9 in the OECD Guidelines (OECD, 2008:9) sets forth the approach for the determination of the transfer price as follows:

“when conditions are made or imposed between two enterprises in their commercial and financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.”

The OECD Guidelines provide a practical approach on how certain transactions should be treated and encourage the use of more than one transfer pricing method. Article 9 (OECD, 2008:9) stipulates the need for transfer pricing adjustments to be accounted for where the terms and conditions of transactions between related parties vary from those between independent parties. The OECD Guidelines furthermore allow for the adjustment of profits, to reflect profits which would have realistically been earned in the open market under realistic business terms and conditions, between unconnected persons.

The OECD Guidelines Chapters I – III were recently revised with the final date for submissions of written representation to the OECD having been 9 January 2010. The proposed changes will provide clarification and possibly changes in meanings to the existing transfer pricing rules, however the impact of these changes is not yet known (Morris & Atkinson 2009).

2.3.8 Tax treaties

Double tax relief is associated with cross border transactions and refers to any tax relief method which may exist in the domestic legislation or tax treaty. South African law provides for double tax relief by either exempting the foreign income earned by the taxpayer or allowing the taxpayer a credit or a deduction for foreign taxes.

In order to avoid the problem of double taxation, South Africa subscribes to the OECD Model Tax Convention Treaty, although it is not formally a member. For that purpose, tax treaties ensure that profits are adequately allocated between tax treaty partners (Edward Nathan & Friedland, 2001).

The Vienna Convention on the law of treaties of May 1969 generally governs international agreements. DTAs are international agreements entered into between governments of different countries in order to prevent, mitigate or suspend the levying of tax in respect of the same transaction under the domestic law and the law of the other country subject to the agreement (Edward Nathan & Friedland, 2001).

DTAs are prepared to assist in resolving transfer pricing discrepancies between different taxing authorities, as they set out agreed rules between countries to determine which country has the right to levy tax in respect of a cross border transaction. One must therefore refer to any existing DTAs in order to determine which country has the right to collect tax in respect of specific amounts.

The importance of DTAs was brought to the foreground with the introduction of the residence based tax system in South Africa. Once signed, a DTA has the force of law.

Section 108 of the ITA empowers the National Executive to enter into DTAs. There has been no court decision on whether or not a DTA overrides the domestic law, if there is a dispute between the two. One must look to section 233 of the South African Constitution, which stipulates that the Court must favour any reasonable interpretation of the law that is consistent with international law, to any alternative. It is therefore accepted that an existing DTA may override the domestic legislation, where inconsistencies are present (Bowman Gilfillan Attorneys, 2003). It has been noted, however that the provisions in the various DTAs concluded by South Africa are not necessarily consistent (Edward Nathan & Friedland, 2001).

Based on the OECD Guidelines the source state has the first right to classify the income according to its domestic law. Where the source state taxes the income, an automatic obligation exists on the residence state to either exempt the income or give a credit for taxes paid at source, where that state also taxes the income (OECD, 2008:4).

The OECD model is flawed as it was compiled by developed countries and therefore focuses on standards set by capital exporting countries. This does not reflect the interests of developing countries, as they are generally importers of technology, capital, goods and services. The UN model (United Nations, 1980) compensates for this situation by allowing developing countries to share in the profits associated with importation, contrary to only the developed countries having an exclusive right to tax those profits (Edward Nathan & Friedland, 2001).

2.3.8.1 Distributive rules

Chapter 3 of the Model DTA usually contains the distributive rules which are important for South African taxpayers. Generally the distributive rules include income from certain activities eg: independent and dependent personal services, agriculture and forestry, income from certain assets, dividend, interest, royalties and immovable property, capital gains and income not dealt with otherwise (ie catch all-rule).

Section 35 of the ITA stipulates that a 12% withholding tax is payable on royalties arising from the use of intellectual property rights, owned by a non-resident, which are located in South Africa. The liability for the payment of the withholding tax is the responsibility of the person paying the royalty (Huxham & Haupt, 2010). Section 35 of the ITA is in contradiction with the DTA model stipulations, as royalties are usually taxed by the country where the intangible asset is held. This would mean that South Africa would have no right to tax the royalties; however the term “royalties” is defined differently in section 35 of the ITA compared to the DTA model definition, which includes the payment for the right to use information relating to industrial, commercial and scientific experience or even equipment in some cases (Edward Nathan & Friedland, 2001).

2.3.9 Documentation guidelines

South African companies are required to disclose details of international transactions on their annual IT14 tax return with effect from the 2004 year of assessment. In 2001 SARS issued a questionnaire on interest-free loans to non-residents aimed at identifying section 31 of the ITA and Practice Note No. 7 transactions.

Practice Note No. 7 (SARS, PN 7, 1999:10.2.1) specifically makes reference to the importance of maintaining suitable transfer pricing documentation in the light of the methodology selected and the adequate documentation of benchmark studies performed. Additionally, a specific information request for the existence of intra-group cost recovery agreements noting the nature of the service provided, terms and pricing structures, is noted (SARS, PN 7, 1999:10.2.2).

Practice Note No. 7 (SARS, PN 7, 1999:10.2.6), does acknowledge that the preparation of transfer pricing documentation is expensive and time-consuming, however a taxpayer is not expected to employ significant resources to achieve compliance, where such expenditure would be disproportionate to the nature and complexity of the international agreement entered into between the taxpayer and the related party. It is noted in Practice Note No. 7, that it is in the taxpayer's best interest to demonstrate, through the creation and maintenance of detailed transfer pricing policy documentation, how the transfer prices applied, were determined and that they are in compliance with the rules set out in the legislation (Mazansky, 2005).

The information requirement can be quite onerous, as companies need to disclose details of the pricing method used and comparative uncontrolled prices for the transactions under consideration as conducted between independent parties. The process of gathering sufficient and accurate comparable information can be very costly. Additionally, it is recommended that businesses update their comparability analysis every three years.

It can be notoriously difficult for companies to prove to SARS that the transfer price selected is an arm's length price due to the various factors that may influence the price used (Holland, 1999).

SARS issued an addendum (SARS, Transfer Pricing Addendum, 2005) to Practice Note No. 7, which stipulates that there is no legal requirement for taxpayers to have a transfer pricing policy document, however taxpayers must disclose whether such a policy document exists, in their annual returns. Where such a policy exists, a copy thereof must be submitted by taxpayers together with the tax return. Effectively taxpayers would not be in breach of the transfer pricing regulations if no policy document existed, however they might have difficulty justifying that the transfer price applied was arm's length.

The documentation procedures as set out in Practise Note No. 7 are broadly aligned to Chapter V of the OECD Guidelines (SARS, PN 7, 1999:10.3).

2.3.10 Penalties and interest

South Africa has no penalties specifically applicable to transfer pricing transactions. General default penalties are imposed where a taxpayer does not furnish adequate disclosure documentation or attempts to evade tax, which are set out in sections 75, 76 and 79 of the ITA and will also apply in transfer pricing situations.

SARS can penalise the taxpayer for failing to furnish “any documentation”, which includes transfer pricing documentation, as required by the Income Tax Act or as requested by the Commissioner.

In terms of section 76 of the ITA, where the taxpayer makes an incomplete or incorrect submission, penalties can be imposed which amount to double the tax chargeable. However under section 76(2)(a) the Commissioner has the discretion to revoke additional charges imposed, unless there was an intention by the taxpayer to evade tax.

The Commissioner may raise an additional assessment in terms of section 79 of the ITA, as long as he is satisfied that any amount subject to tax should have been assessed and was not or any tax chargeable was not charged or any other tax (eg: donations tax or STC) due and payable, was not paid. However, in terms of the proviso to section 79 of the ITA, SARS is prohibited from opening an assessment after three years, from the date of assessment, except where non-disclosure occurred, in which case SARS may reopen the assessment at any time in the future.

Effectively the legislation gives SARS the power to adjust the taxable income to the extent that prices are not arm's length and the amount of the adjustment will be deemed to be a dividend (section 64C of the ITA). Additionally, unless the taxpayer can show on reasonable grounds that his arm' length prices are correct, the adjustment to taxable income will automatically trigger the application of section 89*quat* of the ITA, resulting from an underpayment of provisional tax due to non-compliance with section 31 of the ITA (SARS, PN 7, 1999:13).

ITA provides for penalties to be imposed, where there is an intention to evade tax rather than due to the actual underpayment of tax. Tax evasion is the illegal means of reducing a tax liability through fraud, misrepresentation or the non-disclosure of material facts by a taxpayer.

Tax avoidance refers to situations where taxpayers attempt to minimise their tax liability through legal means. In order to reduce anti-avoidance schemes, SARS introduced the General Anti-Avoidance Rules (“GAAR”) which are contained in section 80A to 80L of the ITA. In order for GAAR to apply, consideration must be given as to whether the agreement is an impermissible avoidance agreement, which will be the case, if the sole or main purpose of entering into the transaction was to obtain a tax benefit and it was entered into under abnormal business reasons (apart from obtaining the tax benefit) or the transaction lacks commercial substance.

Transfer pricing risk was highlighted in *ITC 1582 (57 SATC 27)*, where a company sold products to a related party without fixing a purchase price. The purchase price was determined at year end, in order to minimise the group tax liability. The court held that the transaction was abnormal, as independent parties would have only entered into such a transaction at a predetermined purchase price.

This case shows the extent to which the onus rests on the taxpayer to provide adequate disclosure of connected party transactions, although the tax returns were correctly filled out, submitted and accompanied by full financial statements. The Commissioner must however ensure that all material facts have been reviewed and are satisfactorily disclosed prior to issuing an assessment.

2.3.11 Secondary tax on companies and deemed dividend tax

Secondary Tax on Companies (“STC”) was reduced from a rate of 12.5% to 10% on the net amount of dividend declared by a resident company on or after 1 October 2007. An indirect penalty may exist where STC is payable on an adjusted amount that is deemed to be a dividend, as contemplated in section 64C(2)(e) of the ITA (although Practice Note No. 7 erroneously refers to s64C(3)(e) of the ITA), which specifically deals with section 31 of the ITA disallowed or adjusted amounts (SARS, PN 7, 1999:14.1). Where SARS considers a deemed dividend to have occurred, it may levy STC on the revenue adjustment, causing the taxpayer to be liable for STC at 10%. This can negatively impact the cash flow position of a company and result in liquidity issues, as SARS ignores the fact that the dividend is fictitious. Section 64C(4) of the ITA provides a list of items which would be exempt from the deeming provisions.

Section 64O of the ITA is a new provision relating to value extraction and was introduced into ITA by the Taxation Laws Amendment Act of 2009 and comes into effect when the new dividends tax becomes effective (E&Y:s64O, 2010). The provision imposes a withholding tax on value extracted through methods other than a direct dividend payment.

2.3.12 Cases

2.3.12.1 GlaxoSmithKline

In the case of GlaxoSmithKline (“GSK”), the hearing centred on the transfer price paid by the company to a related Swiss company. The transfer price charged was in the range of US\$ 1,600 per kilogram for ranitidine, the active ingredient in Zantac,

produced by a Singapore company (related to the Swiss company). It was brought before the court that during this time, the average selling price of the drug was approximately US\$ 200 – US\$ 300 in the generic drug market (Kraay, Garland & Allik, 2010).

The transfer pricing rules in effect at the time applied the “reasonable in the circumstances” test (since replaced with the “arm’s length” test) to determine the arm’s length price between the taxpayer and the non-resident. The Canada Revenue Agency adjusted the taxable income of GSK upward by \$51 million for tax years spanning from 1990 to 1993 (Kraay, Garland & Allik, 2010).

The court found that the uncontrolled price method is preferable in determining an arm’s length price. On 30th May 2008, the Tax Court of Canada found in favour of the Canada Revenue Agency on grounds that, the price paid should have been based on comparable uncontrolled prices of generic versions of Zantac available in the market, taking into account an adjustment for the additional granulation process performed by the Swiss company. The Tax Court also confirmed the applicability of indirect benefits and deemed dividend provisions (Kraay, Garland & Allik, 2010).

On 26 July 2010, the Federal Court of Appeal found that the Tax Court had not taken into account the business realities which dictate that a premium is generally payable for the right to use a trademark, nor had it given due consideration to the group transactions as a whole. The Tax Court only considered the supply agreement and not the related licence agreement under which GSK, through a 6% royalty payment, was allowed to sell the drug under the Zantac trademark. The Tax Court held that on the

basis of the Supreme Court of Canada's decision in *Singleton v Canada*, [2001] 2 SCR 1046 ("Singleton"), the license agreement was outside the scope ie should have no impact on the transfer price charged. The Federal Court however rejected any comparisons to be drawn between the GSK and the Singleton cases.

The Federal Court relied on the "reasonable business person" test as arose in *Gabco Limited v Minister of National Revenue*, 68 DTC 5210, when assessing the reasonableness of the transfer price charged, which it held could only be determined by looking at all the inter-company transactions within the group as a whole rather than a transaction in isolation. Furthermore, the case highlights the importance of adequate adjustments, with respect to product, market and business situation, in order to obtain comparable data. The Federal Court referred the case back to the Tax Court for reconsideration (Kraay, Garland & Allik, 2010).

2.3.12.2 Roche

Roche Products (Pty) Ltd v the Commissioner of Taxation ("Roche") case represents the first preliminary decision by an Australian judge on a noteworthy transfer pricing issue. The transfer pricing audit in the Roche case extended over a period of 11 years up to 2002 (Gill, 2008).

The Roche group carries on the business of manufacturing, selling and delivering pharmaceutical and diagnostic products. The Tax Office based its assessment on the transactional net margin method in comparison with net profits earned by unconnected third parties, adjusted for functional differences. The Administrative Appeals Tribunal ("AAT") judge found the Tax Office's assessment to be excessive and therefore

reduced the total income tax adjustment for the periods under review to AUS\$58.7m (Gill, 2008).

The judge criticised the averaging approach applied by the Tax Office and stated that the income adjustments should rather have been performed on a year by year basis. The judge also found that two of the divisions under scrutiny had incurred losses as they were attempting to gain additional market share rather than due to non-arm's length transfer prices. In respect of the third division the judge place reliance on the comparable uncontrolled price method. The judge further commented on the lack of Australian comparative data being used and the lack of conclusive evidence delivered by the number of expert witnesses (Gill, 2008).

It should be noted however, that this case does not result in the complete discounting of the use of the profit based methods where traditional transaction pricing data is not available. With respect to the pricing approach selected, the AAT judge placed no reliance on the taxing rules referred to by the Tax Office but rather placed reliance on the OECD Guidelines. The case highlights the problem of asymmetry of information and the lack of reliable comparable transaction level data. The main issue with the transactional net margin method noted by the judge was the fact that statistical average profits result rather than actual profits (Gill, 2008).

The judge seems to have ignored the fundamental economic concept whereby increased risk translates into increased expected profits. The judge's view prevents the ability of MNEs to rely on the basis that the operations in Australia are merely risk stripped distribution or manufacturing units. Effectively this judgement highlights the

need to analyse each case on its own merits rather than applying a general approach to transfer pricing, as this may provide misleading results (Gill, 2008).

The case also indicates the importance of evidencing the traditional transfer pricing method applied and the clear presentation and documentation of the steps followed in selecting and determining the final transfer price methodology implemented by the enterprise. In particular the recording of commercial reasons for poor profitability should be maintained for each division (Gill, 2008).

2.3.13 Other Related Legislation

2.3.13.1 Exchange Control

The South African Reserve Bank is tightening its requirements to grant approval for payments to off-shore connected persons. The stricter compliance rules now require confirmation from both the external auditors and SARS, that the transfer pricing approach chosen by the taxpayer to determine the arm's length price is reasonable (Van der Merwe, 2009).

In South Africa royalty arrangements are subject to exchange control rules, as well as transfer pricing and other income tax laws. Payments of royalties require preapproval from the Exchange Control Authorities or in certain cases, such as manufacturing related cross border royalty payments, require approval by the Department of Trade and Industry (Joubert, 2009).

Chapter 3 – Transfer pricing

3.1 What is transfer pricing?

“Transfer pricing means, in respect of a transaction, an amount paid or payable or an amount received or receivable, as the case may be, by a participant in the transaction as a price, a rental, a royalty, a premium or other payment for, or for the use, production or reproduction of, property or as consideration for services as part of the cross-border transaction.” (Canada Revenue Agency, n.d.)

Transfer prices are set for various purposes for example, utilising transfer prices as a management tool to motivate department heads to make sound economic decisions in order to increase group profitability, where divisions operate autonomously. Setting accurate transfer prices at the incremental cost of the supplying division is important, to ensure autonomy results in correct decision making, from a group point of view. However without central intervention, conflict can arise as negotiated transfer prices depend on the negotiation skills of the department heads which can be time consuming and ultimately leading to a dead-lock (Drury, 2004).

Numerous factors influence the transfer prices charged by MNEs, including performance measurements, import quotas, customs duties, VAT and income taxes.

The selected transfer price can affect the allocation of profits within an organisation and a group of companies and therefore affect input and output decisions. Transfer prices should be set at a level which will optimise the total group profits.

The theoretically correct transfer price equals the marginal cost of producing the intermediate product to optimise output levels in the absence of capacity constraints (Lipsey, 1975: 245-247).

3.2 The significance of transfer pricing

As developing countries interact more on the international scene, the enforcement of transfer pricing legislation is becoming a prominent concern for tax authorities as they attempt to protect their tax revenues. Since the relaxation of exchange control regulations, South African tax authorities are concerned that MNEs may set transfer prices in such a means or manner, as to affect the minimisation of taxes in South Africa (Troskie & Buttrick, 2009).

Transfer pricing rules are, generally, aimed at ensuring that taxpayers do not allocate income and expenses artificially in different tax jurisdictions, thereby taking advantage of tax arbitrage between different tax regimes. Especially during the current recessionary environment, when a state budget deficit is expected, tax authorities become more aggressive in monitoring compliance. This generally leads to a rise in transfer pricing enforcement and ultimately creates major tax compliance issues for MNEs.

The importance of compliance with the transfer pricing tax regulations was evidenced in the GSK case (refer to 2.3.12.1).

The main transfer pricing risk arises when transactions take place between companies in a group which are located in different countries. Transfer pricing is a business opportunity. Incorporating transfer pricing into corporate planning adds value and reduces risk for companies competing in the global economy. Through the identification of favourable tax locations and risks, transfer pricing can play a key role in minimizing worldwide taxes and thereby increase earnings.

Transfer pricing tax planning must occur in the context of the relevant international tax rules in order to be effective and must be part of the initial strategic planning process of a MNE, rather than an after the fact consideration. The lack of proper transfer pricing tax planning prior to the implementation and execution of any restructuring plan or strategic decision-making, can causes companies to lose leverage in the global market.

MNEs use transfer pricing as a strategic business tool in order to minimise global tax. The value chain can be restructured to create tax savings, through the shifting of profits to countries with low taxes. From the view of the revenue authorities, this is the most common area of risk attached to transfer pricing. Most countries taxation laws counter this problem by enforcing the principle of an arm's length price as defined in the OECD Guidelines, thereby limiting the method in which transfer prices can be set and ensuring an equitable allocation of profits for taxing purposes (OECD, 1995:1:A1.8).

3.3 The arm's length principle

The application of the arm's length principle is based on a comparison of the conditions applicable in a controlled transaction with the conditions applicable in an uncontrolled transaction.

The transfer pricing methods discussed below will address the difficulties which arise in determining arm's length transfer pricing values and the lack of available third party transaction level data, as uncontrolled and independent comparable transactions are becoming rarer. One must consider the adequacy of third party comparable information in the light of relevance, objectivity, multiple year data, comparability adjustments and interpretation of data collected (OECD, 1995:1:Ci):1.36-1.70).

Discrepancies exist in the individual countries' transfer pricing laws and the application of the arm's length principle. This is mitigated, by the existence of the OECD Guidelines which are followed by most countries transacting in the international arena.

The arm's length principle is generally internationally accepted; however it is not without criticism. There is a view that the arm's length approach does not adequately reflect the economic reality of MNEs, as the individual entities forming a MNE should be treated as separate companies, rather than as a unified business operation. The reason for the integration of entities is generally to gain economic advantages, such as economies of scale and brand development, which in turn translate into greater bargaining power for the MNE (Gavious, 2010).

Another criticism is that the arm's length principle cannot be applied in certain circumstances. Examples of transactions which would not take place between unconnected parties are where a subsidiary company is maintained at a loss or favourable loan terms are extended to a group company (KPMG International, 2005).

Although there are practical problems with the arm's length principle, as noted above, the critics agree that there is no justifiable substitute for the arm's length approach (KPMG International, 2005).

3.4 Comparability

Comparability is an intrinsic part of the application of Article 9 of the OECD Model, which requires comparison of conditions under which related enterprises transact compared to those entered into by unrelated enterprises. "*The issue of comparability ... remains the cornerstone of transfer pricing*" (Morris & Atkinson, 2009). The comparability analysis should result in a range of prices, set for uncontrolled transactions with conditions similar to those of the controlled transactions (Joseph, 2007).

The five existing comparability factors are (i) the characteristics of the property or services transferred, (ii) the functions performed taking into account the assets used and risks assumed, (iii) the contractual terms, (iv) the economic circumstances of the parties and (v) the business strategies pursued by the parties (OECD, 1995:1:1.17). These factors should be weighted based on the nature of the transaction and the transfer pricing method selected.

Incorporated in the above functional and risk factors are other economic circumstances, for example geographic location, size, extent of competition, the availability of substitute goods and services, level of supply and demand, consumer purchasing power, cost of production and transport cost which are of relevance when evaluating market comparability (OECD, 1995:1:1:30).

In large MNEs, the functions and risks are not static as they evolve based on the business strategy of the entity, which can further hamper comparability. Generally it is difficult to obtain adequate third party transactional data which meet the five comparability factors. In theory the introduction of the International Financial Reporting Standards should assist with alleviating the comparability problem, as technical information is standardised internationally (European Commission, 2004).

In order to determine if a company's profitability is reasonable, it is compared against companies with similar types of activities. Comparable company data is usually determined through the use of a database search. Certain countries have set up commercial databases containing company specific geographical operating information in order to assist companies with the comparability analysis. The main problem with information contained in commercial databases is that they only provide historical data. Results obtained from the databases need to be adjusted to take cognisance of any material differences between the related party transaction versus the third party transaction. South Africa does not have such comparability databases available. SARS chooses to use the Amadeus Database of pan-European comparables (Joubert, 2009).

No specific guidance is provided on how adjustments should be valued, rather the option of valuing adjustments on a case-by-case basis is given (OECD, 2008:1:1:1.17). Adjustments of a quantitative nature, such as volume and margin effects, are considered to be relatively straightforward, while adjustments of a qualitative nature, such as market conditions or product specifications, are more burdensome.

Tax authorities prefer that companies perform the comparability analysis with data sourced from the country in which the company is based (ie local data). Due to increase globalisation, it should be noted that country specific data does not always generate reliable comparables, which comply with the comparability factors. For this reason tax authorities should accept and not penalise a taxpayer for the use of non-domestic comparables where the taxpayer can demonstrate that a reasonable effort was made to use traditional transaction methods, as recommended by the OECD Guidelines.

The current economic recessionary environment affects transfer pricing policies as these are based on the profitability levels of a company. Volatility in the market will create a gap between the data sets available through a database enquiry and current business profitability levels, resulting in a lack of comparable information (Joubert, 2009).

In recessionary times it is even more important for a taxpayer to maintain adequate transfer pricing documentation in order to explain historical transfer prices. As demand and therefore company profits decline, a corresponding decrease in the transfer prices

is expected. This may however not always be the case, as the transfer price or the profits (eg: due to a limited risk contract guaranteeing a predetermined level of profits) may remain stable, creating a mismatch. In such a circumstance, the taxpayer can be faced with the impossible task of attempting to substantiate the validity of the arm's length price to SARS (Joubert, 2009).

For this reason it is very important for the taxpayer to critically assess the acceptability of the comparable data chosen, consider and document any adjustments and ensure that an adequate comparability analysis, including the review of more than one transfer pricing methodology, has been performed and recorded in full. It is crucial that the taxpayer is able to indicate to SARS that the decline in profitability of the international company is as a result of the economic downturn, rather than attributable to non-arm's length transfer pricing (Joubert, 2009).

In summary, companies need to proactively plan and manage their transfer pricing policies to ensure compliance with regulatory requirements. As part of the proactive planning approach, a company should strive to identify the economic, commercial and business factors which are contributing to its current financial position and document these, within the enterprise's transfer price records (Joubert, 2009).

3.5 Methods of determining an arm's length price

The arm's length standard is met through the application of various specific pricing methods. These pricing methods are designed to determine comparable unrelated transaction prices to be used as a benchmark for connected person transactions. The

arm's length principle treats the various entities of an international group of companies as separate business units (Gavious, 2010).

Any transaction must have commercial substance from an individual entity perspective as well as from the group point of view.

The OECD Guidelines encourage a taxpayer to use more than one transfer pricing method. The Guidelines do however stress that there is no best method rule. A taxpayer is only required to show that the method selected delivers a reasonable result. Regarding the "reasonable outcome" the OECD Guidelines note that "transfer pricing is not an exact science" (OECD, 1995:1:1.12).

The main concern of transfer pricing regulations is the issue of arriving at an arm's length price. For this reason, it is important for MNEs to analyse their group structure, in order to select the most appropriate transfer pricing method. Following this, the taxpayer must gather relevant uncontrolled transaction information. The company must then adjust their transfer prices in order to align them with the identified benchmark transaction values. In this manner an adequate audit trail will be maintained and the likelihood of late price adjustments by SARS, will be limited (Edward Nathan Sonnenbergs, 2010).

Costs should be allocated to the various entities within a group based on the functions they perform, the risk they carry and the assets which are used in the value chain. Various basis of allocating costs exist, which include, but are not limited to,

contributions based on value-added by the unit, a percentage of sales or production volumes. The basis of allocating costs among the group enterprises may have significant tax implications (International Tax Institute, n.d.).

3.6 Traditional transaction pricing methods

The traditional transaction pricing methods compare specific direct (eg: actual prices) or indirect (eg: gross margins) third party measurement indicators with those applied to a controlled transaction (International Tax Institute, n.d.).

The OECD Guidelines favour the use of the traditional transaction pricing methods (refer to paragraph 2.3.6) and taxpayers must demonstrate that a reasonable effort was made to apply these methods. The traditional transaction methods are considered to provide the most accurate assessment of whether the commercial and financial transactions, between related parties, are at arm's length. Due to lack of reliable external data and the complexities of business operations, the application of the traditional methods may present practical complications.

Traditional transaction methods include the comparable uncontrolled price ("CUP"), resale price ("RP") and cost plus ("CP") methods.

3.6.1 Comparable uncontrolled price method

The CUP method compares the price at which a controlled transaction is conducted, to the price at which a comparable uncontrolled transaction is conducted, where the circumstances are also comparable. If differences exist, it may be possible to make

adjustments to allow for comparability. However, comparability may be impeded by the fact that small difference in the circumstances of trade (eg: in geographical location, product quality, type of intangible asset utilized and market levels) may have a significant impact on the price (International Tax Institute, n.d. & SARS, PN No.7, 1999:9.4.1 – 9.4.3).

Based on the SARS Practice Note No 7, the CUP method is the preferable method to be applied, where comparable uncontrolled transaction data can be sourced. Every effort should be made to adjust the data, so that, it may be used appropriately in a CUP method (SARS, PN No.7, 1999:9.4.2). The mere fact that adjustments may be difficult to make does not preclude the application of the CUP approach. The CUP method is considered to provide results closest to the ideal arm's length price.

The CUP method is the preferred over the other two traditional transaction methods, as it looks to the product or service transferred and is relatively insensitive to the specific functions which are performed by the entities being compared (SARS, PN No.7, 1999:9.4.1).

Where comparable uncontrolled prices are not available, the RP method may be applicable, especially in the case of marketing and distribution companies (International Tax Institute, n.d.).

3.6.2 Resale price method

The RP method starts with a product that is purchased from a related party and then sold to an unrelated third party. The sales price is determined by working backward ie the price at which a product is sold to an unrelated third party reduced by an appropriate gross margin would result in an arm's length price, at which the original product should have been transferred between the related parties (SARS, PN No.7, 1999:9.5.1).

An appropriate gross margin is the amount a reseller would charge in order to recover its operating, procurement and associated costs and earn an arm's length profit, based on the work performed, assets used and risks assumed.

Where the transactions are not comparable (especially with regard to work performed, assets used and risks), an adjustment should be made for material differences in order to establish a reasonable arm's length price.

The RP method is most appropriate in the situation of a reseller, as less the value is added by the seller, the more reasonable the computed resale margin will be (SARS, PN No.7, 1999:9.5.2).

3.6.3 Cost plus method

Using the CP method an arm's length price, usually in respect of finished goods, is computed by taking the costs incurred by a supplier of a product or service, which is sold to a related party and adding an appropriate market-related mark-up to those costs.

When applying a cost based method, the costs are divided into direct, indirect and operating costs (SARS, PN No.7, 1999:9.6.1).

It is important under this method that the cost base, as well as the functions, assets and risks are comparable in order to achieve an appropriate arm's length price. As under the RP method, functional comparability is more important than product comparability (SARS, PN No.7, 1999:9.6.2).

Different cost based approaches to choose from include actual cost, variable cost, standard cost and marginal cost.

In practice the CP method is problematic, as effectiveness and efficiency of the different companies may differ, resulting in cost variances. The cost plus method removes any incentives to lower costs as the transfer price may simply be raised in order to recover increased costs, which then erodes competitiveness of the final product. Furthermore, the same types of costs need to be compared, in order for the necessary adjustments to be processed, to allow for comparability. Lack of available market data may be an issue, as normally segregated product data is required, which is not usually available in respect of comparative uncontrolled entities (OECD, 1995:II:Ciii):2.14-2.36).

The CP method is most appropriate where the entity supplies semi-finished goods or services to connected parties. The CP method is also mainly applied in order to remunerate companies for outsourced services (OECD, 1995:II:Ciii):2.14-2.36).

3.7 Transactional profit method

The transactional profit method compares the total net operating profit earned on controlled transactions to the net operating profit arising on comparable uncontrolled transactions.

The traditional transaction pricing methods discussed above are considered the most reliable means, of determining arm's length prices. It may be difficult however to apply these methods, due to the complexity of modern business practices and the lack of availability of sufficiently detailed comparable information. In such instances, the OECD Guidelines suggest the use of the transactional profit methods (OECD, 1995:II:Cii)b):3.26-3.33).

The OECD Guidelines advocate the use of the Transactional Net Margin Method ("TNMM") and the Profit Split ("PS") method; however in theory, other methods which provide a reasonable arm's length price, should not be disallowed (OECD, 1995:II:Cii)b):3.26-3.33).

The main difference between the TNMM and PS method is that the PS method is applied to all parties involved in the controlled transaction; while the TNMM is applied to only one party (ie one-sided analysis). The PS method will provide more reliable results in situations where uncertainty exists, with respect to comparability (International Tax Institute, n.d.).

3.7.1 Transactional net margin method

The TNMM evaluates the net profit margin relative to an appropriate base (eg.: costs, sales or assets) that a taxpayer earns from a controlled transaction. The profit margin is measured pre-interest, as the interest expense is considered to reflect the company's operational financing expenditure and therefore unrelated to transfer pricing (OECD, 1995:II:Cii)a):3.26).

This method may produce a more sensible arm's length price in situations where comparables, as required by the traditional methods, are not available, because the businesses are too integrated to allow for individual evaluations to be performed (SARS, PN 7, 1999:9.8.2).

Practical problems associated with the TNMM method are that this method requires a level of comparability similar to the RP and CP methods. Where the required information exists the taxpayer should rather select the RP or CP methods (SARS, PN 7, 1999:9.7.3).

The TNMM method measures the relationship between the net profit and an appropriate base. Choosing an accurate base considering the nature of the business is important, as otherwise the arm's length price may be inaccurate or unreliable (SARS, PN 7, 1999:9.6.2).

3.7.2 Profit split method

Under the PS method, the total profit earned by the related parties in a controlled transaction must be determined. The combined profit generated by the related parties in a controlled transaction, is then allocated among the related parties on an economically viable basis; with reference to a market related uncontrolled transaction split (SARS, PN 7, 1999:9.8.1).

The PS method can be applied in situations where no reliable comparable external transaction data is available, because the external information is used, to determine the value of the contribution, each related party makes to the transaction. The PS method attempts to eliminate the effect on profits of special stipulations made or imposed on controlled transactions.

The profits can be split based on either the residual or contribution analysis approach:

3.7.2.1 Residual analysis

The related parties are allocated a basic return based on identifiable routine, low value-added departments (eg: manufacturing or distribution) with reference to comparable transactions between unrelated parties. The residual profit, comprising profit that cannot be readily assigned to one of the parties, due to its high value or unique nature, is then allocated between the related parties on a relative contribution basis, taking into consideration the allocation basis that would be applicable, in the case of uncontrolled transactions under similar circumstances (SARS, PN 7, 1999:9.8.2).

3.7.2.2 Contribution analysis

The total profit generated is split between the parties based on the level of their contributions to the controlled transaction, on a functional basis (ie work performed, assets used and risks assumed) taking into consideration how unrelated parties would have split the profit under similar circumstances (SARS, PN 7, 1999:9.8.2).

The PS method is considered to be the least preferred method and should be applied only to cases and methods described in the OECD Guidelines (SARS, PN 7, 1999:9.8.2).

3.8 Advanced pricing agreement

An advanced pricing agreement is an agreement between a taxpayer and the taxation authorities that a future transaction may be conducted, over a stipulated time period, at an agreed upon price, which will be recognised as an arm's length price (SARS, PN 7, 1999:16.1).

South Africa does not have any advanced rulings or APA's, as stated in Practice Note No 7 (SARS, PN 7, 1999:16.2). The lack of the availability of APA's seems to strengthen the view that SARS lacks adequate staff and resources (Bowman Gilfillan Attorneys, 2003).

No further consideration will be given to APA's in this dissertation as they will not be available to South African taxpayers in the foreseeable future as noted in Practice Note No 7 (SARS, PN 7, 1999:16.2).

3.9 The international environment

Transfer pricing rules are complex and therefore taxpayers should investigate each jurisdiction's transfer pricing rules, prior to setting up or extending their supply chain into different countries.

For comparative purposes certain parts of the Australian and Canadian transfer pricing rules and tax treaties are considered below.

3.9.1 Australia

3.9.1.1 Transfer pricing rules

The Australian Tax Ruling 97/20 provides for the application of the arm's length principle on international transactions with reference to Australia's Division 13 of the Income Tax Act 1936. Both the traditional and transactional profit methods may be used to determine arm's length prices, as long as the chosen methodology produces a reasonable range of arm's length prices. The Australian Taxation Office however prefers the application of transaction based rather than profit based transfer pricing methods (Deloitte, 2008).

No specific transfer pricing disclosures are provided for in the Australian tax return. No transfer pricing documentation requirements over and above prudent business practices is stipulated, however the Taxation Ruling 98/11 recommends that taxpayers

maintain up to date documentation in order to mitigate transfer pricing audit risk. APA's are available as noted in Taxation Ruling 95/23 (Deloitte, 2008).

Comparable financial data from published accounts is available through various databases. The Australian Tax Office prefers the application of local comparable data, however will accept foreign benchmarking data, if none is available locally.

Specific transfer pricing penalties of 50% on additional taxes payable may be imposed by the Australian Taxation Office in cases where the dominate purpose was tax avoidance and penalties ranging between 10% and 25% in all other cases. Interest penalties are based on interest rates gazetted at the time. No provision for the reduction of transfer pricing penalties exists in Australia (Deloitte, 2008).

3.9.1.2 Tax treaty

The 2008 South African Protocol was signed on 31 March 2008, and amends the existing agreement between Australia and South Africa which was signed in 1999 (Australia - South Africa tax treaty, 1999).

Based on the 2008 South African Protocol dividends, interest and royalties are taxable in the country where the beneficial owner of the income is resident subject to a portion being taxable in the source country (Articles 10 – 12). Dividends may be taxed, limited to 5%, in cases where the beneficial owner holds directly at least 10% of the voting rights of the company paying the dividend and limited to 15%, in all other cases (Australia - South Africa tax treaty, 1999: 10(2)(a) - 10(2)(b)).

Article 9 of the Australian and South African DTA provides for the re-allocation of profits on an arm's length principle; where the transactions between Australia and South Africa have not been concluded on normal open market terms or prices, as expected between independent parties. The article states that a taxpayer is entitled to request a compensatory adjustment be processed by the non-initiating country, where a re-allocation of profits is made by the other treaty partner (Australia - South Africa tax treaty, 1999).

3.9.2 Canada

3.9.2.1 Transfer pricing rules

The Canadian Income Tax Act deals with transfer pricing rules under section 247, effective for tax years beginning after 1997. Transfer pricing information can be found in Circular 87-2R, Transfer Pricing Memoranda published by the Canadian Revenue Agency on 27 September 1999. No transfer pricing methods are stipulated in the Canadian Income Tax Act; instead the Canadian Revenue Agency applies transfer pricing methods, as stipulated in the OECD Guidelines (Deloitte, 2008).

The Canadian Revenue Agency refers to the most appropriate method in the Circular 87-2R, however transaction based methods are preferred over profit based methods. Furthermore, the PS is preferred over the TNMM method and the residual PS method over the PS approach (Deloitte, 2008).

The completion of form T106 forms part of the annual tax return disclosure requirement. Disclosure in respect of the types and amounts of international

transactions, as well as the methodologies applied and whether transfer pricing documentation is maintained, is requested. APA's are available as stipulated in Information Circular 94-4R (Deloitte, 2008).

Comparable financial data on public companies is available through numerous databases. Foreign comparable data is widely used to supplement local information, as long as the foreign data is adjusted to meet the comparability standards noted in the Canadian transfer pricing methods (Deloitte, 2008).

The Canadian Revenue Agency imposes penalties of 10% on the amount of the transfer pricing adjustment. No transfer pricing penalties will be levied where the taxpayer has made a reasonable effort to determine arm's length prices and provided up to date documentation (Deloitte, 2008).

3.9.2.2 Tax treaty

The Canada – South Africa Income Tax Convention was signed on 30 April 1997 and amends the existing agreement between Canada and South Africa which was signed in 1976 (Canada - South Africa tax treaty, 1997).

Article 9 of the Canadian and South African DTA provides for an adjustment to be made where transactions between associated persons are not concluded on conditions which would have existed between independent parties. The contracting state may only make such income adjustments for a maximum period of five years, from the end of the year in which the income should have been adjusted. No reference to the arm's length standard is made in this article (Canada - South Africa tax treaty, 1997).

3.9.3 Conclusion

All three countries have adopted the arm's length principles and follow the OECD Guidelines. None of the countries prescribe a hierarchy for selecting a suitable transfer pricing method however preference is given to the use of the transaction based methods over the profit based methods (Deloitte, 2008).

The availability of reliable data determines the reasonability of the arm's length price selected. The main compliance problem in South Africa would be the lack of comparable data, as this is not publically available. For this reason, the transactional profit methods may be the more suitable option (Deloitte, 2008).

In the main, it can be seen that the transfer pricing rules applicable in Australia and Canada are aligned with the OECD Guidelines, which is the route South Africa is following as well.

The main differences to be noted are that both Australia and Canada have specific transfer pricing penalties in place and allow for the application of APAs, neither of which exists in the South African legislation to date.

Chapter 4 – Supply Chain and Supply Chain Management

4.1 What is a supply chain and supply chain management (“SCM”)?

A supply chain is an assembly of companies linked through the upstream or downstream flow of products, services, finances and information, including the beginning to end process commencing with the suppliers and ending at the customers. The management of a supply chain is referred to as SCM.

SCM is a cross-functional approach which spans all movement and storage of raw materials into the enterprise, the conversion of raw materials into finished goods, and the transfer of finished goods out of the enterprise from the point of origin to, ultimately, the sale of the finished goods to the consumer (Michael, 2006).

The SCM concept also encompasses the systemic, strategic coordination of the traditional business functions and the tactics across these business functions within a particular company and across businesses within the supply chain, with the purposes of improving the long-term performance, of the individual companies and the supply chain as a whole.

The SCM approach focuses on the identification of core competencies to allow a company to become more flexible. To understand the supply chain of a company, one must identify the elements which create value, as these functions differentiate it from its competitors and determine its competitive advantage (De Franceschi, 2009).

4.2 Supply chain considerations

A supply chain by its very nature requires adequate planning and management in order to ensure efficient and effective interaction between the various supply chain members. The supply chain implementation process highlights the following strategic, tactical and operational factors (Mentzer, et al, 2001):

4.2.1 Strategic

Strategic supply chain considerations encompass the optimisation of the supply chain structure, including the number, location and extent of storage and distribution depots. A focal point of a successful supply chain is the building of strong relationships with supply chain participants (supplier, distributor and customer) through the sharing of critical information and operational improvements, for example cross docking, direct shipping and third party logistics. The adequate management of product life cycles is important, to ensure that new and existing products are integrated into the supply chain and the capacity planning activity. A detailed assessment of the entity's infrastructure, especially in the information technology field, is recommended to ensure sufficient capacity and fit in order to support the supply chain activities. The decision to make or buy products, as well as the determination of the most viable operation location of the group, can affect the profitability of the supply chain. The overall business strategy of the enterprise must align with the supply chain in order to operate a successful supply chain.

4.2.2 Tactical

Tactical supply chain considerations include the sourcing of contracts and other purchasing choices, production planning or contracting and inventory management,

comprising the quantity, quality and location decision. The existence of inventories raises the issue of transportation ie the use of internal or external transporters, distance and frequency. A periodic review and comparison of the enterprise's performance and operational set-up against competitors and the implementation of best industry practises is recommended. The supply chain is driven by customer demand; therefore the entity needs to remain focus on customer requirements and satisfaction.

4.2.3 Operational

Daily production and distribution planning form part of the operational factors of a supply chain. Internal production planning is essential, to the efficient operation of the supply chain and encompasses the daily production scheduling, by product and machine in each manufacturing unit, detailed demand planning and forecasting by customer. The customer demand is then translated into an inventory demand forecast and communicated to the relevant suppliers along with planned delivery dates for the receiving of inventory on order. Detailed production management of planned quantity and quality of raw materials consumed and the flow of finished goods is necessary, to ensure raw material inventory stocks are consumed in line with planned production estimates. Finished goods inventory management and transportation scheduling are important factors in keeping inventory levels and storage costs low as well as ensure customer satisfaction. Proper inventory management is central to the successful operation of the entity's supply chain, as the possibility of supplier, manufacturing and distribution constraints and unplanned customer demand need to be considered.

4.3 The traditional supply chain

In the traditional supply chain model, MNEs have generally set up their global supply chain by retaining management control in the country of origin; the manufacturing sites are located near the raw material suppliers while the sales organisations are dispersed across the globe (Rao, 2008). Each function (eg manufacturing, distribution, sales) within the organisation carries the risks associated with its business activity.

For this reason it is impossible for central management to control every operating unit and therefore large enterprises are usually split into divisions. However monitoring the performance of the division managers is difficult in a decentralised organisation. One way of assessing the performance of a division, is to measure the contribution each division provides to the bottom line profitability of the organisation as a whole. In order to evaluate the profitability of a division, companies set transfer prices for intermediate goods to be transferred from one division to the next, within a company (Gavious, 2010).

The common transfer pricing approaches utilised by business managers are the cost method, market price method, dual price method or negotiated price method. The cost approach can be based on cost plus fixed fee, cost plus percentage of the fixed cost, cost plus mark-up, variable cost or marginal cost. Under the cost method, the transfer price equals a certain proportion of the production costs of the sales department, which may or may not include a fixed cost component. A market based transfer price equals the market price less selling costs. Under the dual price approach, central management determine an optimal sales volume which results in an optimal price, to the organisation as a whole. This method provides the most desirable profits for the

enterprise, however also requires significant involvement and constant price reviews by central management. The negotiated price method allows divisional managers the autonomy to set their transfer prices. The negative aspect of this last approach is that the profitability of the division hinges on the respective manager's negotiation skills (Gavious, 2010).

More often than not the goals of the organisation and those of the divisional managers are not aligned although both strive towards the maximisation of profits. The organisation faces the problem of determining a transfer price at which it maximised overall group profits without impeding the objectives of the individual divisions. This problem is not a simple one to solve, as divisional managers may wish to conceal certain information where they believe that keeping the information secret, may give them a competitive advantage (Gavious, 2010).

In the past few years MNEs have been expanding and restructuring the entities within their group from decentralised stand-alone manufacturing and distribution centres to a "hub and spoke" approach, whereby a hub ("principle") company will take on centralised group functions and risks. A common function of the principle entity is group procurement. Centralisation allows a MNE to build up a centre of excellence, which provides a global business planning platform with improved information gathering and processing, a centralised customer focus, centralised decision making, corporate branding and in certain instances and enhanced business profitability through centralised tax planning (Newby, 2008).

Moving from a domestic to a global supply chain adds complexities and uncertainties. Globalising processes involve the geographical extension of economic activities across national boundaries and the functional integration of such internationally dispersed activities.

4.4 Global supply chain problems

The traditional supply chain has its downfalls in that customer relationships are decentralised, with multiple points of contact and the situation may arise where entities of the same group compete with each other. Certain business functions may be replicated resulting in reduced profitability. The taxes rendered on profits generated in the respective tax jurisdictions must coincide with the economic activity of the entity in that country. The existence of the income generating entities in high tax jurisdictions will result in a higher effective tax rate, on a group basis (Rao, 2008). Therefore, the different national tax laws affecting MNEs cannot be looked at in isolation, but must be considered in an international context. Effective transfer price planning must occur in the context of international tax rules (De Franceschi, 2009).

Tax issues are intertwined in each step of a supply chain from the acquisition of goods or services, to transportation (including imports), distribution and the final sale of the goods or services to the customer. Tax planning strategies which effect the location of activities can also create opportunities for the minimisation of Value-Added Tax (“VAT”), customs duties and other indirect taxes because these taxes arise based on the level and value of the goods and services traded (E&Y:s31, 2001).

In order to compete in the global economy, organisations need to place greater reliance on efficient supply chains (Delfmann & Albers, 2000). The most relevant variables affecting the supply chain, due to ongoing globalisation, are: market forces, cost drivers, government regulations and competition. An essential part of a competitive supply chain is the sourcing goods globally, favourable logistics and cost variances across countries.

4.4.1 Procurement

Centralised procurement encompasses reviewing the purchasing, manufacturing and distribution strategies of the enterprise on a global platform. Global procurement provides a company with the opportunity to improve both quality and manufacturing expenses, as the principle concentrates on sourcing the best quality inputs at the lowest prices, on a world-wide basis. Increased volumes will also improve the negotiation power of the company. Additionally global purchasing centres are continually searching the international markets, for improvements in both price and quality of goods. They are aware of product, industry and regulatory changes throughout the global organisational network and therefore can react timeously to changes or counteract any changes (Newby, 2008).

A global procurement department should focus on landed cost which is the total cost of the product purchased including freight, customs and clearing costs. Favourable trade policies (eg WTO and GATT agreements) promote international trade. Therefore, a global procurement department must factor in transaction taxes into the landed cost of the product, in order to avoid making the expensive mistake of choosing a foreign

supplier, based on commodity price alone. Proper planning can ensure a reduction in customs duties (Rees, 2008).

Tax efficient procurement includes cross-functional integration, optimal inventory carrying levels and easy availability, efficient transportation and storage resulting in increased economic profit and shareholder value (Rees, 2008).

Tax benefits should be sought and utilised where possible, for example, in most countries intangible assets are not subject to property taxes and electronically downloaded software is not subject to sales tax. The tax jurisdiction, in which the intangible asset is held (ie where the value is added) and the source of the goods, is where the taxes arise.

4.4.2 International commercial terms

Thirteen international commercial terms (“Incoterms”) of sale exist (eg FOB, CIF, C&F, etc) which are standardised and accepted worldwide. Incoterms determine the rights and obligations of the buyer and seller, specifically at which point the risk of ownership transfers and who is responsible for the transport costs. Incoterms should be determined by the company’s tax department, as different terms may result in more or less favourable tax effects (eg who is liable for import VAT) which increase the financial risk carried by the company (Rees, 2008).

4.4.3 Location

Strategically placed central distribution centres may result in reduced transport costs.

4.4.4 Cash flow

Transaction taxes, incoterms, sourcing decision and in-transit inventory may impact the cash flow of the enterprise and should be taken into account when planning the supply chain. Taking into consideration tax reductions or country specific tax breaks can make significant working capital funds available and improve the company's finances (Rees, 2008).

4.4.5 Customer satisfaction

A centralised procurement function can improve customer satisfaction as greater product quality is achieved through central procurement and improved delivery times, because manufacturing and distribution centres react more quickly to customer demand. The principle procurement hub will effectively control stock movements across the entire supply chain thereby allowing local sales teams to focus on customer satisfaction.

Centralised planning and delivery of goods can reduce storage costs and improve customer satisfaction, as generally, the customers are globalised enterprises as well and therefore purchase centrally for decentralised use (Newby, 2008).

The invoicing system's transaction taxes must be correctly computed when selling goods across borders, to avoid any compliance issues or additional processing and transaction costs (eg: issuing credit notes, re-invoicing, etc) (Rees, 2008).

4.4.6 Risk management

For most MNEs the global supply chain spans across an increasing number of countries, causing the risk management to become increasingly complex. Major risks faced by a global supply chain are natural (eg earthquakes, floodings), political (eg political instability, frequent changes in laws), economic (transaction & translation exposure, taxes) and social (eg religion, culture) risks. The impact of these risks on the elements of a MNE's global supply chain will depend on the type of industry the company operates in, predictability of the risk and its ability to deal with the risk (Mentzer, 2001:46-57).

An adequate overall preventative or / and compensatory risk management strategy can be implemented through proactive planning and identification of possible risks, before the event occurs. Risk management in a supply chain is more difficult than within a company as the global supply chain cannot be looked at in isolation, due to the existence of interdependencies. A benefit of a global supply chain is that the main risks are diversified which generally reduces the overall group risk (Mentzer, 2001:46-57).

4.5 Goals and objectives of supply chain management

The concept of supply chain management arose out of the idea of reducing management control in relation to the daily logistical operation and increasing the number of companies participating in the production and delivery of a product to the customer (Delfmann & Albers, 2000). The principle of SCM is to improve the working relationship between supply chain participants, thereby improving the visibility and speed of the production, storage, delivery and management of inventories.

The objectives of successful SCM are the overall reduction of costs, the centralisation of distribution channels, the reduction of investment and storage cost relating to inventories and improved customer service resulting in higher customer satisfaction. These, among other, benefits are mainly achieved through the harnessing of economies of scale, relocation of business functions to more favourable international locations and seeking out jurisdictions which offer improved institutional factors (eg government regulations and tax laws). The overall competitive position of the entire supply chain must be taken into consideration in order to determine the cost benefits of a change (Delfmann & Albers, 2000).

The main goal of SCM implementation is considered to be the attainment of a competitive advantage (Sutton, 2009). A competitive advantage arises out of superior products, either through cost savings or improved product features which differentiates the product from competitors' goods, in the eyes of the consumer and through expansion into new markets. The building of a competitive advantage can be achieved through the cumulative attainment of the various SCM objectives (Delfmann & Albers, 2000).

The major drivers identified in creating a differential cost or product advantage are: linkages, economies of scale, learning, capacity utilisation, integration, timing, discretionary company policies, location and institutional factors. The above competitive advantage drivers may lead to better information flows and overall product superiority (Delfmann & Albers, 2000).

Improved relationships and information sharing between suppliers and manufacturers are considered an important aspect of a successful supply chain. Both vertical and horizontal **linkages** exist within a company. Linkages are the central points between the supplier and customer and show the interdependence of activities within SCM. Linkages between the various functional areas in a supply chain need to be taken into consideration, as management seek to exploit these links in order to gain a competitive advantage (Delfmann & Albers, 2000).

Economies of scale occur where the costs of an activity increase less than proportionally to the volume of output. This is considered to be one of the most significant cost saving sources (Delfmann & Albers, 2000).

The benefits of **learning** can be observed as activities are performed more efficiently, which would also include improved sharing of knowledge between departments and exploiting inter-departmental synergies within an entity. The introduction of new techniques may result in cost advantages, which may also lead to improve customer service levels (Delfmann & Albers, 2000).

Capacity utilisation can be improved through advanced production and procurement planning, allowing the company to provide more timely and accurate information to the supplier which consequently translates into greater reliability and improved customer service (Delfmann & Albers, 2000).

From a theoretical point of view, **integrating** activities within the company saves costs as they no longer need to be sourced from the market and allows the company to better control the product specifications. However the benefit of integration must be assessed on an individual basis (Delfmann & Albers, 2000).

One of the most important factors to gain a competitive advantage in business is **timing**. Production process and customer delivery optimisation may result in greater flexibility and ultimately greater customer satisfaction, which would result in increased profitability (Delfmann & Albers, 2000).

Within SCM decisions should not be taken in isolation (ie departmental) but the impact of **company policies** should be considered in respect of the company as a whole (Delfmann & Albers, 2000).

Generally, the following main aspects need to be taken into account when determining the **location** decision of an entity: labour costs, infrastructure, energy costs and skills level of the labour market. Both the location of suppliers and distributors must be borne in mind when choosing a suitable location.

Additional strong decision factors in the determination of an adequate location are **government laws and regulations** as these may impact the profitability of the enterprise (Delfmann & Albers, 2000). A country's regulatory framework can affect the comparability of available information which is an important aspect affecting transfer price determination.

“The ability to learn faster than your competitors is the only truly sustainable competitive advantage” (Sutton, 2009). Globalisation has created interdependencies due to integration of functional activities across national boundaries, as companies strive to obtain a competitive edge and remain profitable. For this reason, one of the main strategic business goals of a MNE is cost reduction (including the minimisation of tax costs) through ongoing management review. The integration of tax planning into the supply chain assists in identifying and managing supply chain costs (Mentzer, 2001: 271-279).

Furthermore, globalisation opens the gateway for MNEs to manipulate transfer prices in order to maximise profits in low tax jurisdictions or tax havens. A conflict exists: “Governments want to earn more tax (or save outflow of justified tax) and MNEs want the flexibility to save taxes” (Mayank, 2009).

4.6 Transfer pricing manipulations

Transfer pricing is a complex issue, as the prices charged by connected persons could be completely unrelated to the prices charged by third parties. Effectively companies within a group could, through minor adjustments in their accounting records, reap obscene profits, without having changed their underlying income-earning asset base. Take for example a Chinese company which manufactures widgets for US\$100, the US subsidiary buys the product at US\$199 and sells it to consumers at US\$200. It can clearly be seen, that the group as a whole is generating US\$100 profit, however it has reduced its overall tax burden, through maximising revenue in a low tax jurisdiction. In

this manner the overall group profits will increase by the value of the tax saving (Singh, 2007).

Globalisation has brought about increased mergers and acquisitions and therefore the number and value of inter-company transactions has increased substantially. In addition to the reduction in barriers to entry, countries are making their environment more conducive for foreign investment. This has resulted in a large rise in global enterprises and consequently inter-company trade, which is considered to comprises one third of all world trade (Singh, 2007). As illustrated above, the complexities involved in determining the reasonability of prices charged between connected parties and the nature of MNE structures, in certain cases, make it almost impossible for tax authorities to monitor and control all inter-company transactions in a group of companies (Mayank, 2009).

The advent of internet-based transactions (“E-commerce”) has further complicated the compliance enforcement role played by tax authorities. The E-commerce topic is however outside the scope of this discussion paper, as it is considered to be a separate stand alone research topic, due to the significant volume of transaction flows and widespread use in recent years.

Transfer pricing manipulation refers to the application of non-arm’s length transfer prices by MNEs, which results in an overall tax saving, by shifting accounting profits from a high to a low tax jurisdiction. MNEs are effectively using legal means to organising their business transactions in such a manner that less tax is payable, by taking advantage of loopholes in tax regulations across national boundaries.

Various motivating factors induce MNEs to enter into transfer pricing avoidance schemes (Mayank, 2009), for example:

- Corporate tax arbitrage resulting in the shifting of production and profits
- High customs duties cause companies to under-invoice goods
- Imposed profit repatriation ceilings result in inflated raw material import prices or understated export prices thereby circumventing the government restriction
- Ownership restrictions lead to reduced returns on intellectual property which MNEs defeat through the charging of royalties

An abundance of other motivating factors exist which are generally based on inter-company transactions, for example the charging of administration fees, management fees and royalties (Mayank, 2009).

4.6.1 Transfer pricing adjustments

4.6.1.1 Administration and management fees

The most common approach to charging administration and management fees is to use the CP method, based on an underlying identifiable cost or a fixed formula in order to determine a fair return (E&Y:s31, 2001).

Generally, however it is difficult to find a comparable price for administration and management activities carried out by a MNE, as the allocation of such administration

and management fees is subjective and unlikely to take place between unconnected parties (Holland, 1999).

SARS will most likely challenge any duplicate inter-group service fees (ie incurred in the subsidiary and the holding company) or inter-group cost recharges which are specific to the holding company (E&Y:s31, 2001).

4.6.1.2 Year-end adjustments

Tax authorities are generally suspicious of profit manipulation taking place, where year-end adjustments are processed. Year-end adjustments may arise due to differences in management verses statutory reporting. Management decisions are based on management reporting which may not include transfer pricing ranges acceptable to tax authorities, as management may not considered these to be value-adding when considering the economic contribution achieved by the company. Tax authorities will want to be aware of the differences in reporting arrangements, in order to access the risk of non-arm's length transfer pricing adjustments (Commonwealth of Australia, 2008).

Setting up inter-company contracts based on arm's length terms and conditions, which could result in year-end adjustments, is not in contradiction with the arm's length principle (De Preter, 2008).

4.6.1.3 Royalties

Tax authorities regard the holding of intellectual property titles in low tax jurisdictions, as suspect, because MNEs tend to use royalty payments to strip their domestic operating companies of profits (Commonwealth of Australia, 2008).

The ownership of intellectual property rights and royalties is considered a separate research topic and therefore not discussed in this dissertation.

4.6.2 Effect of transfer pricing manipulation

Developing countries are generally at greater risk of transfer price manipulation, as the enforcement of transfer pricing rules is not adequately monitored and enforced or transfer pricing rules do not exist. Developing country governments' depend on corporate tax revenue to fund social development programs. Furthermore, developing countries tend to lower taxes in order to attract foreign investments. Consequently, this additional tax burden falls on the rest of the population of the country, as governments attempt to make up the shortfall (Singh, 2007).

Transfer pricing manipulations also lead to the distortion of the Balance of Payments between the affected countries and in some cases, due to the size of the firms involved, can challenge the sovereignty of the nations (Mayank, 2009).

It can be observed that South Africa is lagging behind in enacting transfer pricing rules and enforcing compliance, as the changes to section 31 of the ITA were only introduced recently, with the release of Taxation Laws Amendments Bill, on 24

August 2010. However, the revised section 31 of the ITA provides SARS with the tools to reduce price manipulation and widen the tax net to ensure that MNEs contribute to the South African economy, thereby preserving the net balance. To date, no domestic transfer pricing disputes have been tried in our courts.

To mitigate the risk of transfer pricing manipulations taking place, tax authorities set acceptable transfer pricing bands, based on established pricing methodologies. In some cases, due to the lack of adequate comparative data and the subjectivity of comparability price adjustments, transfer prices may be open to abuse.

For the above reasons it is of particular importance for tax authorities to identify fictitious transfer prices, which result in price distortions and ultimately effect tax revenues (Mayank, 2009).

As tax authorities world-wide increase transfer pricing enforcement and the international market continues to exert increased pressure on MNEs to reduce their effective tax rates, in order to remain competitive, this has created a market for tax-motivated transactions or products, as organisations seek out value-enhancing ideas in order to better manage and reduce their tax burdens.

Chapter 5 – The impact of transfer pricing rules on supply chain management

5.1 Introduction

In today's market, global competition and trends change the nature and shape of supply chains (Rees, 2008). Tax planning applies to the supply chain (ie supplier, distribution function, retail channels and customer delivery) and to processes that drive successful SCM such as procurement, electronic data interchange, merchandising, finance, branding and asset management.

The geographically dispersed MNEs now have to address the issue of international tax impacts on the group as a whole (Rao, 2008). MNEs can optimise their operation efficiency and minimise global tax through the strategic allocation of taxable income, between the group companies based on determined function, asset and risk allocations (Rees, 2008).

Transfer pricing can play a key role in the reduction of world-wide taxes, as it offers a principled methodology for the strategic location of economic activity in the context of global tax planning (Mayank, 2009). The optimisation of operational efficiency and attainment of a reduced global group effective tax rate is referred to as tax efficient supply chain management ("TESCM") (Rao, 2008).

5.2 Tax efficient supply chain management

MNEs are under pressure to increase shareholder value. Shareholder value is measured on a post tax basis and therefore tax planning and business strategies must be integrated in order to achieve greater benefits (Rees, 2008).

TESCM is a business model which integrates tax considerations into the design and implementation of the company's supply chain and business processes. The two fundamental drivers of TESCM are the avoidance of tax and legal obstacles in the pursuance of business objectives and the maximisation of tax benefits as part of the business restructure (E&Y:s31, 2001).

The TESCM approach advocates the implementation of an internationally flexible structure, completely aligned with the business processes, in order to deliver sustainable, long-term reductions in the effective tax rate and optimisation of indirect taxes (Rees, 2008).

5.2.1 Principles of effective TESCM

Enterprises must grow and evolve with the changing market environment in order to remain competitive. MNEs grow through focusing on their core business which would entail growing the products and services, entering new markets, strategic business acquisitions, the selling off of assets and product ranges, which no longer meet the strategic future plans of the enterprise (Commonwealth of Australia, 2008).

Strategic mergers and acquisitions as well as new international market entrants have increased the global competitor base. Certain of these new competitors may be operating in favourable tax jurisdictions and therefore are subject to lower effective tax rates. Increased centralised decision making results in effective commercial risk planning, with a view to minimising tax (Phataphekar, 2008).

The principle underlying the TESCM model is the centralisation of the higher value-adding functions, major risks and intangible assets into a separate legal entity, the principal company. In order to maximise transfer pricing benefits, an organisation must understand the value drivers and economic contributions made by related members of the group and how these value drivers differentiate the organisation from its competitors. This has resulted in MNEs reviewing the allocation and location of the group's value adding functions and income earning assets (Phataphekar, 2008). Additionally, the MNE must identify and value its intellectual property and determine how well the intangible is being utilised throughout the world.

The benefits of global TESCM are: improved consistency, global decision making, centralisation of procurement function and key supplier management, cost effectiveness through economies of scale, more effective use of fixed assets and working capital with respect to risk and tax management and improved performance measures across business units (Phataphekar, 2008).

5.2.2 Planning & designing a TESCM structure

The most beneficial approach is for the global principle company to control the group management activities and the supply chain therefore housing the aggregate group entrepreneurial risk. The principal company is usually located in a low tax jurisdiction.

The main trading company can own the intellectual property of the group or produce goods under license from the holding company. Cash flow benefits arise, as funds are easily accessible through the holding company (Rao, 2008).

The operating entities are located within close proximity of suppliers in order to reduce transport costs, perform routine functions and bear subordinate risks while earning stable but low returns (Newby, 2008). Effectively the value-added functions, income-generating assets and commercial risk are allocated with the view of rationalising total world-wide taxes (Phataphekar, 2008).

The overall allocation of profits is split based on the functions and risks carried by each operating entity and any residual profits are seen to be representative of entrepreneurial risk (Phataphekar, 2008). Residual profits are generally expensed in the form of administration and management fees, which flow to the holding company (Rao, 2008).

The location of the principal trading company would be influenced by various tax and non-tax factors. From a business aspect, management should consider the existence of a suitable and stable regulatory, legal and political environment within the country of choice. Additionally, favourable exchange, border regulations and beneficial employee

laws need to be taken into consideration, when determining where to trade. From a tax point of view, a low effective tax rate, favourable withholding tax, low foreign income taxes and beneficial tax treaties are important location decision factors, as well as restrictions on the remission of funds out of the country and the consolidation of losses in a single entity.

In order for a MNE to shield itself against PE exposure (ie the home country entity is considered to have a PE in the host country and therefore may be liable for tax in the host country), transactions need to be adequately structured and key personnel relocated. (Newby, 2008).

Other key tax issues to be considered as part of TESCO implementation (Phataphekar, 2008):

- Migration of business profits may result in an investigation from tax authorities in the country where the income has declined due to the implementation of a strategic tax efficient supply chain plan
- Certain countries have introduced an exit tax or exchange control restrictions on the repatriation of funds to off-shore holding companies, to circumvent the shifting of profits (e.g exit tax effective in Germany since January 2008)
- Adequate transfer pricing strategy documentation, explaining and justifying the realignment of business functions, assets and risk and therefore the change in profits from an operational point of view
- Transfer of business functions may negatively affect the company's systems or product delivery, thereby reducing efficiency

- Tax incentives and assessed losses should be taken into careful consideration
- The impact on the operation of indirect taxes and VAT due to the shifting of profits, must be considered
- Location of intangible assets
- System issues
- Shifting of functions and risks may be set off by a decline in customer service or efficiency with respect to customer deliver and production
- Lack of a competitive advantage due to high effective tax rates

Although various transfer pricing solutions exist, the organisation's choice of transfer pricing method can have a significant effect on its performance. This problem has been analysed and studied in length, however no fail safe one size fits all solution exists. Each organisation must understand and manage its supply chain adequately to identify a company specific transfer pricing methodology (Phataphekar, 2008).

The involvement of supply chain experts at the onset of the TESCO process implementation is highly recommended (Delfmann & Albers, 2000).

5.2.3 Ensuring sustainability of the TESCO structure

A successful TESCO structure can only be sustained and protected through a thorough understanding of the risks faced by the organisation and constant monitoring of the supply chain and any ongoing changes thereto, in order to mitigate any internal and external threats (Oster, 2009).

The main internal threat faced by the organisation is that the TESCO structure may become disconnected from the original design due to an evolving business model. Any business expansions or disposals need to be reviewed in light of the existing TESCO structure (Oster, 2009).

The MNE may face a range of external threats from changes in underlying transfer pricing assumptions due to market volatility to changes in laws. These risks individually or in aggregate can erode the original business model and the operational and tax benefits expected by the entity (Oster, 2009).

Companies could fall subject to transfer pricing audits where some of the following characteristics are displayed (Boller & Keerl, 2008):

- Large cost pools
- Low profitability and / or loss making enterprises within the group
- Material tax rate gaps
- Lack of cost allocation agreements
- Lack of adequate benchmark analysis
- Lack of or poor transfer pricing documentation

The current economic recession may have a negative impact on a MNE, if and when it is unable to substantiate that the decrease in profitability, is caused by the challenging economic conditions. A tax issue can arise on a group basis, as the principle company,

where the risks and therefore the associated profits are allocated, will have to pay tax although the group as a whole is incurring a loss. In order to avoid a dispute with SARS, the transfer pricing rules applied in a stable economy need to be reviewed in a recessionary one. Any changes to the existing business model need to be reflected in the current transfer pricing policy documentation of the enterprise.

In order to maintain and protect the benefits of the company's TЕСM structure, the following leading practices should be borne in mind (Oster, 2009):

1. Implement limited risk structures: A loan to a loss making subsidiary can result in additional taxes; and the lending company may risk double taxation as the profitable foreign connected party is taxed, in the foreign and local country, on the funds transferred.
2. Ensure the business risk model and tax strategy is aligned to avoid additional transfer pricing taxes which could arise if SARS investigates the allocation of profits locally. In order to safeguard and substantiate the business structure from an operational view, a robust and comprehensive documentation package should be created, which includes detailed internal processes and control manuals and technical tax support.
3. Proactively manage threats, focusing resources on the main risks and consider APA's (not available in South Africa to date). Maintain adequate, up-to-date and complete documentation to minimise the risk of tax audits.
4. In the case of restructuring, document both the group and individual entity's perspective, including compensation or indemnification payments to restructured entities (a specific provision in the OECD discussion draft).

5. As APA's are not available in South Africa critically consider possible double tax risks.
6. Transfer pricing documentation must be aligned with the group business model and the related allocation of profits between the various entities in a group.
7. Management awareness and enforcement of the documented company policies and processes is an important aspect of the sustainability of the TESCO structure. A periodic internal audit review can be implemented to monitor and control compliance with the company strategy. Continuous maintenance of the TESCO structure - the importance of relevant and accurate process documentation must be considered a life style rather than an after thought. As the business evolves, the documentation should at all times be kept up-to-date, to allow management to make effective business decisions based on the existing TESCO structure.
8. Remain up-to-date with the latest technical tax developments in all jurisdictions where group companies are located.
9. Seek professional advice where necessary and devise a process to deal with tax audits.

MNEs are not driven by tax benefits alone, generally other considerations such as a developed infrastructure, stable regulatory environment, time zone and language compatibility with customers and quality of life of management personnel can take precedence over anticipated tax savings (Newby, 2008).

Other reasons which have been sighted by MNEs for forgoing the benefits of setting up tax efficient structures, are the maintenance of a corporate good citizen image in order to avoid damage to the company's reputation (eg Barclay's image in South Africa¹), especially locally, can exceed any estimated tax benefits. Additionally depending on the nature and type of the industry, the company may choose to locate its business operations in a specific country as this is considered the focal point (eg financial services in New York or London) or causing the company to be restricted in its restructuring plans (eg mining, oil & gas).

The consequence of TESCM is that as tax revenues move away from the home country, partly driven through transfer pricing rules and compliance issues, the country will be under pressure to reduce the corporate tax rate (Kampman 2004).

5.3 Tax Competition

In the global environment, tax planning is a strategic business tool employed by both businesses and governments in order to maximise net returns. This can be evidenced through the emergence of tax competition between countries, which create tax arbitrage and contributed towards the emergence of off-shore companies and MNEs choosing to restructure, in order to reap the proffered tax benefits.

Tax competition is more common in developed countries where exchange controls have been relaxed or eliminated allowing international trade to flourish. Tax

¹One of the three main areas of international boycotts of apartheid in South Africa was economic sanctions. In Britain students started a campaign against Barclays Bank, which eventually spread to local authorities resulting in Barclays Bank selling off its South African subsidiaries.

competition has had the effect of lowering taxes. Tax competition plays an important role in TESCO (Newby, 2008).

Large developed industrial economies have various advantages, such as strong and advanced markets, modern infrastructure, educated labour market and stable regulatory environments, on offer to potential investors. Due to their strong bargaining positions, these economies are less likely to use tax incentives to attract investment. Developed countries are more likely to expand their tax nets, for example through transfer pricing rules and regularising possible tax revenues arising out of PE's (Newby, 2008).

On the other hand, smaller wealthy countries lack the market resources large economies have; therefore they are prone to compete on a different level, such as tax differentiation to attract future investment. Examples of low tax jurisdictions are Hong Kong, Singapore, Switzerland, Ireland and Luxembourg. Emerging economies tend to compete for investment with developed countries through the introduction of tax incentives and low labour costs (Newby, 2008).

Enterprises increasingly choose to outsource certain functions to specialised entities that can perform the activities better or more cost effectively. In this way companies reduce the risks and costs of maintaining a domain-specific supply chain competency in-house.

Alternatively MNEs tend to beneficially structure their supply chains in such a manner so that certain types of functions are transferred to favourable taxing jurisdictions, thereby resulting in a net reduction of the group's tax liability.

5.4 Off-shoring

Off-shoring refers to the situation where a company shifts activities abroad, to either a connected party or a third party service provider. Off-shoring is distinct from outsourcing, as generally the activity transferred off-shore is retained in-house. (Damji & Freimoser, 2008)

Generally service fees payable to off-shore companies are computed using the traditional transfer pricing methods. Off-shore service companies are usually based in low tax jurisdictions and emerging economies as significant cost savings can be attained due to reduced input costs, particularly in the form of payroll tax, VAT and customs tax reductions. The underlying theory is that the less complex the off-shore activity is the lower are the expected returns. As more complicated functions or departments are outsourced the tax authorities in the developing countries argue that the traditional CP method is inequitable, because this is considered to be unrepresentative of the risk and functions undertaken (Damji & Freimoser, 2008).

The off-shoring or outsourcing decision should not be taken lightly. Companies must consider their needs through cost analysis, location, relevant regulatory environment and the ability of the off-shore supplier to provide adequate operational support to the organisation. An alternative approach is not to find an external supplier but rather establish a related party off-shore thereby retaining the activity in-house. In order to

assess the net cost saving, all costs, including employee relocation cost, need to be analysed in detail and adjustments processed for differences which can arise due to possible decline in volumes, product quality or efficiency. In most cases, these cost savings are passed on to the customer, in order to remain competitive or entice the customer to purchase a lower quality product (Damji & Freimoser, 2008).

A further important aspect of the off-shoring analysis is the need to obtain an understanding of the effects of not only direct but also indirect taxes and any additional regulatory frameworks operating within the off-shore location, which may eliminate any cost savings and direct tax benefits the MNE hopes to achieve through off-shoring. This analysis is imperative when considering any type of restructuring exercise, particularly in the current economic environment where tax authorities are tightening up the tax regulations (Damji & Freimoser, 2008).

Where the off-shore service provider is retained in-house, economic theory dictates that a bargaining situation exists, which will usually determine the allocation of the total estimated cost savings, between the related parties. The party with the greater bargaining power, either through ownership of intellectual property or a competitive advantage, will be entitled to a greater share of the cost-benefit from off-shoring. The bargaining power concept is even referred to in the OECD Guidelines (OECD, 1995:3.2.1). Effectively the pricing method which results from the bargaining situation is the profit split or residual profit split approach.

Large MNEs, which are generally domiciled in developed industrial economies, can achieve cost savings through the transferring of certain activities (mostly comprising

manufacturing, administration, call or information technology centres) to low cost off-shore locations. The company based in a high cost jurisdiction will then purchase products or services from the related party entity in the low cost country. These types of inter-company transactions are usually (where the countries involved subscribe to the OECD Guidelines) concluded at arm's length prices in the low cost jurisdiction (Damji & Freimoser, 2008).

The holding company generally only off-shores routine, low risk functions which do not require substantial capital investment prior to commencing business. The application of the CP method results in the holding company reaping the bulk of the location cost savings, which effectively translates into improved profitability. Not only businesses but also tax authorities, in the certain countries, have an incentive to claim the location savings. Although a strong argument exists for the low cost tax jurisdiction to require a higher share of the profits, conversely the tax authorities of the company which previously performed the function may claim for loss of profits (Damji & Freimoser, 2008).

As MNEs seek continued cost savings off-shore, low cost markets are flourishing causing demand to exceed supply. Therefore the majority of cost savings should be retained where the benefits are reaped ie within the low cost economy, however based on economic theory and practice, cost savings only create a competitive advantage for a short period of time until they are eroded by market forces and increase competition. The company reviewing an off-shoring decision must take into consideration the fact that cost saving allocations will not remain constant over time but change as the off-shore company grows (Damji & Freimoser, 2008).

In most cases the off-shore activities will increase with time both in volume and complexity. This will consequently result in a shift in relevant bargaining power of each entity involved in the off-shored transaction. However, it must be born in mind that wherever the principle company has invested funds to set up the off-shore location or an off-shore supplier has incurred set up cost to provide a certain service thereby having committed to the transaction, this will affect their respective bargaining powers (Damji & Freimoser, 2008).

A further tax issue may arise where intellectual property is transferred, as the company will then demand royalty payments. The ownership or creation of an intellectual asset can be exceptionally valuable, as it creates a competitive advantage (Damji & Freimoser, 2008). Intellectual property is considered to be a separate discussion topic in its own right and will therefore not be reviewed in more detail in this dissertation.

Economic theory provides the taxpayer with a fundamental concept (eg.: bargaining power) along the lines of which the cost savings and allocation of these savings can be computed; the results may not be comparable with practical business situations (Damji & Freimoser, 2008).

5.5 Restructuring - business cause and effect vs tax minimisation

External market pressures such as increased competition and changes in the operating or regulatory environment are stated as reasons for MNEs choosing to restructure. Tax authorities need to understand the business goals of a MNE in order to ascertain the

commercial reality of a transaction. The reasons for a restructure must be commercially rather than tax driven (Owens & Bennett 2008).

“The dialogue between business and government on this issue tends to be a dialogue of the deaf. Business states that the restructuring is driven by sound commercial consideration and tax administrations think that it is all tax-driven. Both are in some respects right and wrong.” (Owens & Bennett 2008)

5.5.1 OECD discussion draft

The main principles of transfer pricing considerations in relation to business restructuring are detailed in a discussion draft, issued on 19 September 2008, by the OECD. The discussion draft encompasses certain aspects of transfer pricing on business restructuring, such as stressing the importance of business objectives being the main driver of restructurings and compensation payments to be set at arm's length prices based on reasonable comparatives. These topics are analysed in four Issue Notes (Rao, 2008):

- Issue Note 1 – Specific consideration relating to the allocation of risks in limited risk structures
- Issue Note 2 – Compensation payments for restructuring itself
- Issue Note 3 – Post-restructuring transactions
- Issue Note 4 – Circumstances allowing for non-recognition of certain transactions undertaken by the taxpayer

Issue Note 1

Economic theory is based on the assumption that as the level of risk increases, so do the expected returns. Transfer prices must be set based on functions, risks and assets of the entity. Related parties need to evidence the existence of written contractual price agreements based on commercially viable business practises. The manner in which a taxpayer allocates risks in its controlled arrangements may differ from similar uncontrolled transactions; however this does not evidence a lack of economic substance. An important factor in determining the validity of the risk allocation is ability to exercise control. Contractually outsourcing the administration of a function, risk or asset does not equate to the risk having been transferred to such other organisation. The issue of identifying a PE and attribution of profits to a PE agent must be considered (Crassweller, 2009).

Issue Note 2

In order to adequately assess the suitability of arm's length indemnity or compensation payment to an entity when a TESCO restructuring is performed, one needs to review the reasons for the reorganisation and the effect of the restructure on the functions, risks and assets transferred. An important factor to consider is whether the profitability level associated with the transferred tangible or intangible assets has been undertaken at an arm's length price. Additionally an approach for the allocation of group synergies and efficiency gains needs to be determined (Crassweller, 2009).

Certain tax jurisdictions are focusing on loss of future taxable income due to restrictions, which translate into an exit charge to the local enterprise for goodwill. The

OECD Guidelines currently do not address what would be considered a reasonable valuation method in determining compensation payments (Crassweller, 2009).

Issue Note 3

The transfer pricing rules apply equally to pre- and post-restructuring transactions ie the arm's length principle must be applied. The transfer price approach and computations pre- and post-restructuring must be documented taking into account any changes which may have occurred due to the restructure. Any savings arising from geographical business unit relocations need to be allocated based on location specific savings based on functions, assets and risks (Crassweller, 2009).

Issue Note 4

In certain exceptional situations, the tax authorities may choose to disregard or re-characterise a transaction for transfer pricing purposes. Most domestic tax regulations cater for these types of circumstances through anti-avoidance legislation eg CFC rules (refer to 2.3.4). Based on the OECD Guidelines, the arm's length pricing rationale arises from the fact that third parties would not enter into transactions which would affect their businesses detrimentally. In order to judge the commercial viability of a transaction, it is important to review the entire agreement as a whole. This discussion draft stipulates that two types of transactions may be disregarded. Firstly, agreements which result in transactions which are not commercially sound from the point of view of two independent parties. Secondly, situations in which it is impossible to determine an arm's length price (Crassweller, 2009).

The OECD concedes that there can be various legitimate reasons for a MNE to restructure. The restructure transaction must have commercial reality and be a reasonable option from a business point of view (Crassweller, 2009).

Effectively the Issue Notes stress the need for restructuring decisions to be based on valid commercial reasons rather than transfer pricing benefits. The importance of the arm's length principle is reiterated (Rao, 2008).

Currently the OECD Guidelines (OECD, 1995:1:1.37) provide for two situations under which tax authorities may disregard the structure adopted by a taxpayer:

1. The principle of "substance over form", whereby the substance of the transaction does not coincide with its legal form
2. A situation can occur where the substance and legal form of the transaction may be the same, but the transaction as a whole does not reflect a commercially viable transaction between independent enterprises.

This second point captures not only the commercial reality of the price, but also considers the reasonability of the terms and conditions of a transaction, as would be expected to exist between unconnected persons (Newby, 2008).

The substance over form principle raises concern among taxpayers, as it effectively mirrors the invocation of anti-avoidance provisions. The second situation is also concerning, as it allows tax authorities to substitute the terms and conditions of a transaction with those which the tax authorities would consider arm's length between independent parties. This substitution could possibly result in a price impact on the

transaction as a whole. This situation will hopefully be addressed in the discussion draft as a distinction is drawn between the arm's length principle in Article 7 and Article 9 and the anti-avoidance provisions in local tax regulations (Newby, 2008).

A major concern is that the tax authorities may apply these principles regularly, rather than only in exceptional circumstances, as is believed, was the intention of the OECD Guidelines (Newby, 2008).

5.5.2 Business cause and effect

From a tax perspective it is important to distinguish between the group as a whole and the individual geographical location of the entities making up the group. Generally MNEs centralise certain functions in order to harness the benefits of economies of scale. The group will adopt a structure which optimises the group taxation and ensures the reduction of costs and beneficial cash flows within the group, to minimise the cost of funds. These types of transactions make commercial sense, however they may result in transfer pricing issues, as the true economic results of the entity may be distorted (Commonwealth of Australia, 2008).

The most important aspect for a MNE to bear in mind, when planning a business restructure, is to ensure that the value chain structure is changed for realistic commercial reasons. Any reorganisation should result in significant operational change causing the profitability and risk profile of the enterprise to transform. In this manner a MNE may be able to avoid attracting unnecessary tax risk or negative publicity (Newby, 2008).

Careful documentation of the business strategy (including any business changes and associated, anticipated operational benefits) behind the restructure is vital in order for the MNE to withstand possible scrutiny from the local tax authority. In this manner a company will be able to evidence sound commercial reasons for any incidental direct or indirect tax savings arising subsequent to a substantial operational reorganisation. Prudent tax planning can minimise unintended consequences and allow a MNE to achieve significant global tax synergies (Newby, 2008).

Another important aspect to bear in mind when planning an international restructuring exercise is to perform a detailed transfer pricing analysis including risk and geographic location assessments, in order to support any potential loss of profits by the manufacturing and distribution divisions (Newby, 2008).

The preferred treatment of manufacturing and distribution operations is to set these up as agents of the principle, as certain risks are transferred to the principle. Proper tax planning is required to ensure tax authorities do not view the operating subsidiaries as PEs of the principle, under any local tax legislation or tax treaty (Mayank, 2009).

Scenario planning provides a method which ensures adequate flexibility exists within the long-term business plan. This will allow MNEs to check compliance, determine cash flow impacts and provide audit trails more efficiently and effectively. The implementation of a comprehensive transaction tax solution is recommended in order to gain visibility of the global tax picture across the entire enterprise and provide “value-added” tax planning advice (Rees, 2008).

It is good practice to perform a transfer pricing analysis considering the difficulty taxpayers and tax authorities have in gathering satisfactory data for the purposes of applying the principle of free competition. This is required to achieve comparability (OECD, 1995:1: Ci):1.12).

Companies should ensure that they can provide evidence of an adequate audit trail. A complete audit trail should include a functional analysis of the group and show how the transfer prices, as determined, align with the methodology selected and the data collected (Newby, 2008).

Tax authorities around the globe are increasingly starting to investigate business reorganisations which result in substantial and permanent tax saving or where the profit levels of the company in that tax jurisdiction suddenly drop. Any situations, where inconsistencies arise between the activities with other parties (whether related or not), intangibles have been transferred or the underlying agreements evidence an overall lack of commercial substance, will be challenged by the local tax authorities (Newby, 2008).

As is possible in South Africa, tax authorities may attempt to apply the principle of “substance over form” when challenging the business objectives behind certain transactions. Other approaches being used by tax authorities to retain tax revenues within their jurisdictions include asserting that the principle has a local presence or PE in the country or the introduction of exit charges, where functions are moved off-shore (Newby, 2008).

Most countries comply with the OECD model which overrides local legislation, however “*the current lack of an international consensus on how the arm’s length principle applies to TECSM business restructures*” (Newby, 2008) increases the cost of compliance with various documentation requirements between tax jurisdictions and the risk of non-compliance (E&Y Transfer Pricing, 2001).

Good tax planning requires a thorough knowledge of the relevant international tax laws. For this reason the employment of transfer pricing as a strategic tool in minimizing global tax must be cost effective, reviewed by international tax advisors and implemented with appropriate care.

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Chapter 6 – Conclusion

This dissertation provides an analysis of transfer pricing legislation in South Africa and the OECD Guidelines which form the basis of the South African transfer pricing rules. Furthermore an examination of supply chain management and the importance of aligning tax planning with the MNE's business objectives were provided. The aim of this dissertation was to examine the tax impact of transfer pricing rules on supply chain management.

The results of the dissertation indicate that the revised section 31 of the Income Tax Act, read together with Practice Note No. 7, provides South African taxpayers with an internationally aligned transfer pricing regime based on the arm's length principle. Overall the arm's length principle, applied through the specific pricing methodologies reviewed in this dissertation, is considered to provide a reasonable transfer price range. The applicability of the various pricing methods is however, specific to each supply chain and documentation of the process is crucial, in order to justify the transfer price selected. The lack of adequate comparable uncontrolled transaction data in South Africa makes it difficult to apply the arm's length principle.

It was noted that the most important aspect of transfer pricing within supply chain management is the fact that transfer prices should be aligned with and driven by the business model. This ability of MNEs to evidence the commercial substance of the transaction is a fundamental business requirement and a key factor of transfer price determination. Each organisation must understand and manage its supply chain

adequately, in order to identify a company specific transfer pricing methodology, as the method selected may have a significant effect on the entity's performance.

It was established that the effective management of a MNE's transfer pricing policy can provide the MNE with a competitive advantage. The main driver in achieving a competitive advantage was found to be cost reduction. The favoured business strategy followed to achieve this goal is for an MNE to restructure applying the TESCO approach. The golden rules of TESCO promote the introduction of substantive business changes to ensure that the operational and investment supply chain planning and tax planning are aligned, to create value. Transfer pricing is a business opportunity which MNEs should take advantage of.

The dissertation indicates that the application of the separate entity approach, in determining arm's length prices is contrary to economic reality of MNEs. No cognisance is given to the improved bargaining power MNEs have. SARS should take this into consideration when assessing the reasonability of the arm's length transfer price.

SARS should consider implementing APA's in the future as these can be beneficial in avoiding disputes and unnecessary audits.

The preparation of transfer pricing documentation, in order to satisfy SARS that arm's length prices have been applied, is burdensome on the taxpayers and can be costly. SARS should consider specifying the minimum content required. Additionally,

reducing the documentation requirements for transactions below a certain limit or entities with a turnover below a certain value would ease the disclosure burden on smaller organisations which would probably not fall subject to a SARS audit review.

Area for further research

1. The impact of E-commerce on tax compliance enforcement by tax authorities.
2. Tax issues effecting the intellectual property ownership location decision

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