

**THE OECD TRANSFER PRICING GUIDELINES: AN ANALYSIS OF
THEIR APPLICATION IN THE SOUTH AFRICA LEGAL REGIME**

By

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I do hereby declare that I have read and understood the regulations governing submission of a master of laws dissertation, including those relating to length and plagiarism, as contained in the rules of this University and that this dissertation conforms to those regulations.

DECLARATION

I Onsando Omari Allan, do hereby declare that this minor dissertation submitted for the degree of Master of Laws at the University of Cape Town has not been previously submitted by me at this or any other University, that it is my own work and that all referenced material in it have been duly acknowledged.

Signature.....

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ABSTRACT

The provisions of S 31 of the Income Tax Act 58 of 1962 governing certain cross-border transactions amongst entities form the basis of transfer pricing legal regulatory regime in South Africa. The arm's length principle forms the backbone of applying the provisions of the section. The existing legislation is wide in scope hence difficult to apply on the taxpayer's hand; consequently, in some instances it does not serve its intended purpose. For this reason, the South Africa Revenue Service (SARS) has provided a practice note (SARS practice note No. 7 of 1999) which gives guidance on the determination of taxable income of certain persons from international transactions. The practice note is largely based on the Organisation of Economic Cooperation and Development (OECD) comprehensive transfer pricing guidelines. These guidelines are found in the OECD Report, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1997)

These guidelines have increasingly been adopted by many states. South Africa is a non-member state of OECD Model Tax Convention but has however adopted the transfer pricing guidelines therein. This study, examines the OECD transfer pricing guidelines, with a view of analysing the manner and extent to which South Africa has adopted them in its current transfer pricing policy. The unique South African economic situation is taken into account. The rationale and extent to which such guidelines have been adopted is relevant and critical in determining efficacy.

The findings of this study are threefold. Firstly, the OECD transfer pricing guidelines provide globally accepted standards and methodology by which tax authorities act in common interest to share satisfactorily in the tax which is properly due to them from the taxpayer. Secondly, South Africa has, to a larger extent, managed to keep abreast with the international developments in transfer pricing and compares favourably with the OECD guidelines. Finally, existing legislation has shortcomings such as regulation of financial intra-group assistance services especially the characterisation of certain intra-group debt for transfer purposes. This suggests deviations from the OECD guidelines. Therefore, whether existing law suites local circumstances is doubtful.

Chapter I

1 INTRODUCTION TO THE STUDY.....	1
1.1 Introduction	1
1.2 Background	2
1.3 Statement of the problem.....	5
1.4 Objectives of the study.....	6
1.5 Significance of the study.....	6
1.6 Outline of the study.....	6
1.7 Methodology.....	7

Chapter II

2. TRANSFER PRICING: THE OECD APPROACH.....	8
2.1. The Arms Length Principle.....	9
2.1.1. Definition of arm's length.....	9
2.1.2. Historical origins of the arm's length principle.....	10
2.1.3. OECD approach to the arm's length principle.....	11
2.1.4. Criticism of the arm's length principle identified by the OECD.....	13
2.2 Application of the Arm's Length Principle: OECD proposed Methods.....	15
2.3 Issues taken into account in applying the arm's length Principle.....	17
2.3.1 Comparability Analysis.....	17
2.3.1.1 Factors affecting comparability.....	18
2.3.1.2 Functional analysis.....	18
2.3.1.3 Contractual terms.....	19
2.3.1.4 Economic circumstances.....	19
2.3.1.5 Business strategies.....	19
2.3.1.6 Characteristics of property or services.....	20
2.3.2 Recognition of the actual transactions undertaken.....	20
2.3.3 Evaluation of separate and combined transactions.....	20
2.3.4 Arm's length range.....	21
2.3.5 Multiple year data.....	22

2.3.6 Losses.....	23
2.3.7 The effect of government policies.....	23
2.3.8 Intentional set-offs.....	23
2.3.9 Use of customs valuations.....	24
2.4 OECD methodology of determining the arm's length principle.....	24
2.4.1 The traditional transaction methods.....	24
2.4.1.1 Comparable uncontrolled price method (CUP).....	25
2.4.1.2 Situations in which the CUP method cannot be used.....	27
2.4.1.3 Cost plus method (CP).....	27
2.4.1.4 Situations where the cost plus method cannot be used.....	28
2.4.1.5 Resale price method.....	29
2.4.2 Transactional profit methods.....	30
2.4.2.1 Profit split method (PS).....	30
2.4.2.2 Transactional net margin method (TNMM).....	30
2.5 A non-arm's-length approach: Global formulary apportionment.....	31
2.6 Administrative approaches to avoiding transfer pricing disputes.....	32
2.6.1 Burden of proof	33
2.6.2 Penalties.....	33
2.6.3 The mutual agreement procedure.....	33
2.6.4 Concept of safe harbours.....	34
2.6.5 Advance pricing agreements (APA).....	34
2.7 Documentation.....	34
2.8 Tax treaty position of the OECD guidelines.....	34

CHAPTER III

3. TRANSFER PRICING: SOUTH AFRICAN APPROACH.....	36
3.1. History of transfer pricing in South Africa.....	36
3.2 Statutory position in respect of transfer pricing in South Africa before 19 July 1995: Original section 31 (now repealed).....	37
3.3 Statutory position in respect of transfer pricing in South Africa after 19 July 1995: Revised section 31 of the Income Tax Act.....	40
3.4 Section 31 (1) definitions 41	
3.4.1 Goods	41

3.4.2 International agreement.....	41
3.4.3 Services.....	41
3.5 Relevant section 1 definitions (Income Tax Act 58 of 1962)	42
3.5.1 Permanent establishment.....	42
3.5.2 Connected Person.....	42
3.6 Relevant SARS Practice Note No. 7 definitions.....	43
3.6.1 OECD Guidelines.....	43
3.6.2 Transfer prices.....	43
3.6.3 Controlled transaction.....	44
3.6.4 Uncontrolled transaction.....	44
3.6.5 Multinational.....	44
3.6.6 Managed or controlled.....	44
3.7 Manner in which South Africa adopts the OECD transfer pricing guidelines.....	45
3.8 Tax treaty position.....	46
3.8.1 Status of OECD Model Tax Convention in South Africa.....	46
3.9 SARS Practice Note No. 7.....	48
3.9.1 Status of SARS Practice Note No. 7.....	48
3.9.2 Doctrine of estoppel.....	49
3.9.3 Doctrine of legitimate expectation	51
3.10 SARS Practice Note No. 7 transfer pricing guidelines	54
3.11 SARS guidance to the application of the arm's length principle	56
3.12 SARS transfer pricing review process and approach	60
3.12.1 SARS four-step approach	63
3.12.2 Hypothetical illustration of SARS review process: Cosmetic dealing tangibles and MNE with tangible.....	66
3.13 SARS transfer pricing documentation and reporting	69
3.13.1 SARS general documentation and reporting requirements	70
3.13.2 Other documentation requirements that should be met	71
3.13.3 Documentation in relation to subsidiaries in tax havens	71
3.13.4 Documentation in relation to foreign branches in tax havens	72
3.13.5 Tax returns documentation and disclosure and the relation to transfer pricing	73
3.14 NON compliance: Transfer pricing penalties	75

3.15 Shortcomings of transfer pricing regulations in a South Africa	79
CHAPTER IV	
4. CONCLUSION AND RECOMMENDATIONS	83
4.1 Conclusion	83
4.2 Recommendations	85
BIBLIOGRAPHY	86

ABBREVIATIONS

- ADR** Alternate Dispute Resolution
- CFC** Controlled Foreign Companies
- CGT** Capital Gains Tax
- CUP** Comparable Uncontrolled Price Method
- CP** Cost Plus Method
- DTA** Double Tax Agreement
- IBFD** International Bureau of fiscal Documentation
- IT** Income Tax form
- MNE** Multinational Enterprise
- OECD** Organisation for Economic Co-operation and Development
- OEEC** Organisation for European Economic Co-operation
- PS** Profit Split method
- RP** Resale Price method
- SARS** South Africa Revenue Service
- STC** Secondary Tax on Companies
- TNMM** Transaction Net Margin Method
- UN** United Nations

Chapter I

1. INTRODUCTION TO THE STUDY

'This [preparing my tax return] is too difficult for a mathematician. It takes a philosopher' – Albert Einstein¹

1.1 Introduction

Transfer pricing is an important yet complex tax issue. It is a process by which related entities set prices at which they transfer goods or services among one another on an international scale.² The importance of transfer pricing derives from the current global commercial arena which experiences a huge percentage of cross-border trade within Multinational Enterprises groups (MNE groups) or Multinational Enterprises (MNE).

Technological advancements in communications which allow flexibility in these MNEs shifting activities internationally have become a major contributing factor to the importance of taxation of MNEs internationally. These advancements encouraged a unified global approach to eradicate difficulties that have arisen in applying some of the fundamental tax concepts, currently used in different tax jurisdictions.³ The difficulties were experienced due to the reasons mentioned below. Firstly, there is progressive relocation or location of the production of final products and components by MNEs to appropriate territories. Secondly, there is difficulty arising out of the concentration of service functions within MNEs.⁴ Thirdly, there is the new phenomenon of global, twenty four hours per day, trading in commodities and financial instruments.⁵ These create an impact on production

¹ Famous quotes available at <http://www.famous-quote.net/quotes-taxes.shtml> [accessed 15 August 2007]

² Second Interim Report of The Commission of Inquiry into Certain Structures of South Africa *Thin Capitalisation Rules* 1995 at par 1.3b

³ Bernard du Plessis and Michelle Viljoen 'Taxation of e-commerce: Income Tax.' chap 8 at 231 available at <http://www.cyberlawsa.co.za/cyberlaw/cybertext/chapter8.htm> [accessed 3 August 2007]

⁴ Ad Hoc Group of Experts on International Cooperation in Tax Matters Tenth meeting Geneva, (2001) 'Transfer Pricing History C State of the Art C Perspectives' Paper prepared by the United Nations Secretariat. at 3 available at <http://unpan1.un.org/intradoc/groups/public/documents/un/unpan004399.pdf> page 3 [accessed 3 June 2007]

⁵ Ad Hoc Group of Experts on International Cooperation in Tax Matters op cit note 4 at 3

costs, infrastructure, tax incentives and systems, skilled labour force just to name but a few.⁶

One of the fundamental tax concepts that have been affected by the technological advancements is transfer pricing. This concept has gained importance because states are increasingly becoming active in protecting their tax base. However, due to the complex nature of the field of transfer pricing, difficulty is experienced in the application of transfer pricing principles and methodology.

Many developed countries in which the MNE groups are located have over the years experienced challenges that come with transfer pricing. The trend has since shifted to developing nations such as South Africa in which local companies have shown increasing global expansion. This trend saw South Africa pass specific transfer pricing legislation. Further South Africa has adopted the OECD guidelines on transfer pricing in its domestic legislation. The extent to which such guidelines are adequately adopted and the relevance to the South African situation are debatable.

1.2 Background

Specific transfer pricing provisions with an international focus were first introduced in United Kingdom and the United States during the First World War (1914-1918). Other countries including France followed. These provisions were introduced as an anti-tax avoidance mechanism to prevent profit shifting by associated companies through under or over-pricing of cross-border transactions.⁷ The result of such transactions was that the eventual prices selected significantly affected the total profits that the concerned companies shared amongst its groups of companies.⁸ For this and other reasons companies effectively used transfer pricing as a means to avoid taxes. This was done bearing in mind that avoiding tax is tolerated as long as a legal method is used to organize ones dealings in such a way that less tax was paid by taking advantage of shortcomings in tax laws within legal boundaries.⁹ Absence of

⁶ Ad Hoc Group of Experts on International Cooperation in Tax Matters Tenth meeting Geneva, 'Transfer Pricing History C State of the Art C' op cite note 4 at 3

⁷ Ad Hoc Group of Experts on International Cooperation in Tax Matters op cit note 4 at 5

⁸ Bernard du Plessis and Michelle Viljoen 'Taxation of e-commerce: Income Tax.' op cit note 3

⁹ Annet Wnyana Oguttu 'Transfer pricing and Tax Avoidance: Is the Arm's Length Principle Still

specific transfer pricing provisions in many countries meant that companies found it relatively easy to reduce their tax burdens at the expense of tax authorities losing their tax base.

Currently these companies are mainly known as multinational enterprise groups (MNE Group) or multinational enterprises (MNE). MNE group is a group of associated companies with business establishments in two or more countries while MNE is a company that is part of an MNE group.¹⁰ The MNEs consist of corporate giants and smaller companies with one or more subsidiaries or permanent establishments usually in countries other than where the parent company head office is located.

In the subsequent years, the anti-avoidance provisions in the United Kingdom, the United States and other countries that followed the trend, presented a risk of double taxation for the taxpayer on the same income or profits. The risk of double taxation could either be, economic double taxation where the same amount is taxed more than once in the hands of different parties or, juridical double taxation where the same income is taxed more than once by way of different taxes or in an international context by different authorities.¹¹

The risk was compounded by an increasing concern by tax authorities to ensure that they get satisfactory tax contribution from the enterprises operating in or from their jurisdictions. The countries did so by enacting transfer pricing legislation which resulted in unilateral solutions to the problem. Further, there was a common conflict of interest among the countries to collect tax at the expense of the companies being doubled taxed hence leading to increased operational costs, decreased profits and uneven competition internationally.

In view of that, the policy, law and practice by different national tax authorities developed to avoid this conflict of interests or double taxation,¹² while

Relevant in the e-Commerce Era' 2006 18 *SA Merc LJ* at 138

¹⁰ OECD Transfer Pricing Guidelines at glossary

¹¹ Oliver L Brinker E, Honiball M 'International Tax A South African Perspective, 2nd Ed, at 336

¹² 'The Tax treatment of transfer Pricing' (1997) Transfer Pricing supplement International bureau of Fiscal Documentation par 8 at 2

satisfactorily collecting tax which is properly due to them from the taxpayer.¹³ Therefore, an international consensus on transfer pricing and cross-border transactions was found to be essential. The purpose of the consensus was to; seek a balance between costly obligations of MNEs to comply with complex laws and administrative requirements in different countries, enable tax authorities avoid double taxation while controlling abuse by the tax payer and avoiding conflict amongst the tax authorities.¹⁴ The Organisation for Economic Co-operation and Development (OECD) has been in the forefront in providing for such a unified global approach. This is pursuant to Article 1 of the Convention signed in Paris on 14 December 1960, which came into force on 30 September 1961.

The OECD predecessor was the Organisation for European Economic Co-operation (OEEC), which was formed to administer American and Canadian aid under the Marshall Plan for reconstruction of Europe after World War II. Since it took over from the OEEC in 1961, the OECD objective has been to build strong economies in its member countries, improve efficiency, sharpen market systems, expand free trade and contribute to development in industrialised as well as developing countries.¹⁵

For tax purposes, the OECD promotes policies designed to ensure appropriate tax base in each jurisdiction and avoiding double taxation.¹⁶ The policies are found in the OECD Model Tax Convention Commentary (2002) and form a basis of most of the international tax treaties between member states and non-member states. The Double tax agreements (DTAs) are examples of such treaties. For transfer pricing purposes, DTAs establish the arm's length principle as the standard for the adjustments of transfer prices by tax authorities in the case of transactions between associated enterprises.¹⁷

¹³ OECD Guidelines chap I par 1.5

¹⁴ Collins M H C 1997 The Tax Treatment of transfer pricing- International Fiscal Documentation, introduction at 2

¹⁵ 'History of the OECD' available at http://www.oecd.org/document/63/0,3343,en_2649_201185_1876671_1_1_1_1,00.html [accessed 3 June 2007]

¹⁶ 'History of the OECD' op cit note 15

¹⁷ Oliver L, op cit note 11 at 330

The specific principles for transfer pricing are provided in the OECD Report, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995) and pursuant reports. These guidelines have been selected by member and non-member countries as serving the dual objectives of securing their tax base, thereby minimizing conflict between tax administrations and promoting international trade and investment. Hence, these guidelines play a central role in the global approach to transfer pricing and must be given notice when dealing with issues of transfer pricing.

1.3 Statement of the problem

As mentioned above, transfer pricing is an important yet problematic aspect of the international tax regime. Therefore, many states endeavor to be part of a unified global approach to transfer pricing. However, the necessity for each state to protect its own tax base makes it difficult to simply apply an internationally acceptable transfer pricing regime. Currently, OECD guidelines constitute a regulatory roadmap and unified global approach to international transfer pricing. Consequently many countries, including non-member states such as South Africa, have adopted the OECD guidelines in their domestic legislation. However, the very need for a country to protect its own tax base means that South Africa even with the adoption of the OECD guidelines has to take caution to ensure that the adopted guidelines are relevant to its economic situation. Therefore, this questions the suitability, adequacy and relevance of the OECD guidelines in South African situation. Hence, the determination of whether and to what extent, the current South African adoption of the OECD guidelines is relevant and credible.

Thus, this study analyses the OECD transfer pricing guidelines with a view of examining the extent to which the methodology, principles and standards are relevant and acceptable in the South African context. South Africa's emphasis on progressive economic growth dictates for an effective and reliable transfer pricing regulatory policy. A critical examination of applicable legislation, regulations and guidelines against the backdrop of the OECD guidelines is essential in achieving the objectives of this study.

1.4 Objectives of the study

Having considered the statement of the problem, the overall goal of this study is to examine OECD guidelines on transfer pricing, with a view of determining the manner and extent to which, South Africa has adopted such guidelines. To achieve this goal, the following specific objectives form the theoretical framework of this study.

- (i) To examine the nature and character of the OECD transfer pricing guidelines.
- (ii) To analyse the manner and extent to which South Africa has adopted the OECD guidelines
- (iii) To examine the relevance of existing transfer pricing legislation in South Africa, with a view of making recommendations for improvement.

1.5 Significance of the study

Considering that South Africa is a non-member state, yet, it has adopted the OECD guidelines, strongly suggests that these guidelines provide the foundation of the approach taken in transfer pricing issues in South African. Therefore, an analysis of the manner and extent to which South Africa has adopted the OECD guidelines of transfer pricing will substantially contribute towards, taxpayers understanding the application of current policy and the improvement of the existing regime. The study makes recommendations which, if acted upon, will contribute to transforming the existing regime and make it more relevant and acceptable. The extent to which the existing regime effectively serves the interests of the stakeholders is a central criterion in determining relevance.

1.6 Outline of the study

This study comprises four chapters. Chapter one is the introduction to the study. Chapter two comprises an overview of OECD approach on transfer pricing. In this section, the arms length principle is analysed in a little more detail. Chapter three focuses on transfer pricing legislation in South Africa. Case law and South Africa Revenue Services Practice Note number seven form an integral part of the discussion in this section. The question as to whether and the extent to which OECD guidelines

are relevant and suitable to the South African situation are attempted. Chapter four concludes this study and makes recommendations where appropriate.

1.7 Methodology

This study is desktop based. The main sources of data are primary and secondary materials. Primary sources included international Conventions, domestic legislation, regulations and guidelines. Secondary sources consulted include journal articles and books. Internet sources are used where they provided information that was otherwise not available in journals and primary sources and where they provide current information and data. Newspaper reports constitute sources with up to date information.

Chapter II

2. TRANSFER PRICING: THE OECD APPROACH

This chapter discusses the OECD approach to transfer pricing and is limited to the standards and principles endorsed by the OECD in determining transfer prices. Hence, the study focuses on; the arm's length principle, guidance for its application and the methodology of applying the principle. Further, the study will outline the OECD suggested approaches to avoiding transfer pricing disputes.

Significant contributions in transfer pricing have been made by international bodies and organizations. At centre stage is the Organisation for economic Co-operation and Development (OECD). Other international organisations that have contributed to transfer pricing are the United Nations (UN), and the International Bureau of fiscal Documentation (IBFD). It is therefore important to have an overview on how these organizations define and view transfer pricing.

In tax and transfer pricing, OECD has held the position of a guiding forum especially since its 1979 Report on *Transfer Pricing and Multinational Enterprises*. This report has been amended over the years to align itself with current developments. Consequently, the 1995 report and subsequent reports are much clearer and use the title '*Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*'.¹⁸ This study is based on the 1997 update to the 1995 report. The 1997 update to the report will herein be referred to as the OECD guidelines.

The 1995 OECD report defined transfer pricing as, 'the transfer prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises'.¹⁹ This report set out methods developed in international practice for determining and evaluating taxpayers transfer prices. In the application of the transfer pricing methods the report endorses the arm's length principle. OECD has encouraged member countries to adopt the guidelines and has

¹⁸ Ad Hoc Group of Experts on International Cooperation in Tax Matters Tenth meeting Geneva, op cit note 4 at 4

¹⁹ OECD Report, '*Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*' 1995 par 11 at 9

pointed out that the failure to adhere to international transfer pricing principles is a contributing factor to the increase of harmful preferential tax regimes.²⁰ .

The above view on the principle and methods to use in determining transfer prices is shared by the United Nation (UN). The UN refers transfer price as the; ‘value attached to transfers of goods, services and technology between related entities such as partner and subsidiary corporations and brother/ sister corporations’. The UN endorses the arm’s length principle in its comment that a transfer price is not set by an independent transferor and transferee in arm’s length negotiations, but is within discretion of a single enterprise.²¹

The International Bureau of Fiscal Documentation (IBFD) has also contributed to transfer pricing. The IBFD view reiterates the OECD position. The IBFD comment on Transfer pricing is that where goods, services or intangibles are overpriced in a transaction between related parties the seller’s profitability is increased and the buyers decreased.²² Further, that on the contrary, where the goods, services or intangibles are under priced the buyer’s profitability is increased and the seller’s decreased. The IBFD agrees that such transactions should be viewed at arm’s length.

The foregoing, demonstrates that the organisations agree that the arm’s length principle is the standard for determining transfer prices. Hence, the arm’s length principle is fundamental to the determination of a transfer price. Therefore a discussion of the arm’s length principle and what it entails is imperative.

2.1 The Arms Length Principle

2.1.1 Definition of arm’s length

The Blacks Law dictionary defines an ‘arm’s length transaction’ as;

²⁰ OECD Report of the Committee on Fiscal Affairs Harmful ‘Tax Competition-An Emerging global Issue’ (1998)

²¹ United Nations Model Double Taxation Convention between developed and developing countries 1979 (ST/SG/AC.8/L.29)- United Nations (1979) at 3

²² ‘International Tax Glossary’ (1996) 3rd ed International Bureau of Fiscal Documentation

*A transaction in good faith in the ordinary course of business by parties with independent interests commonly applied in areas of taxation when there are dealings between related corporations, e.g. parent and subsidiary.*²³

Scholars describe the arm's length principle as the price that would be negotiated by independent, unrelated parties in the same circumstances as the sale between the associated entities. They find that the principle is based on a sound economic principle, namely that the competitive market is the best way to allocate resources and rewards of risks.²⁴

2.1.2 Historical origins of the arm's length principle

There are two historical origins of the arm's length principle. The first origin is found in continental European countries. The term was used as a basis for adjustment of income of shareholders who received extraordinary benefits from a company instead of declaring dividends.²⁵ The adjustments were made by deeming such benefits to be dividends and were called constructive dividends or hidden profit distributions. This concept is applied in Austria, Germany, Luxembourg, the Netherlands, Switzerland and other European countries. It is however important to note when applying the principle, these countries place significance upon its applicability in their domestic laws rather than international or cross-border trading amongst related enterprises.²⁶

The second origin is traced to the United Kingdom and the United States. As already mentioned above, the two countries introduced specific transfer pricing provisions with an international focus during the First World War. The provisions were introduced as an anti-tax avoidance mechanism to prevent profit shifting by associated companies through under or over-pricing of cross-border transactions.²⁷

²³ Black, H C, *Black's Law Dictionary* 6th ed (1990) at 109

²⁴ Miesel VH, Higinbotham HH 'International transfer pricing: Practical solutions for inter company pricing' (2002) *International Tax Journal* at 6

²⁵ Ad Hoc Group of Experts on International Cooperation in Tax Matters Tenth meeting Geneva op cit note 4 at 4

²⁶ Ad Hoc Group of Experts on International Cooperation in Tax Matters Tenth meeting Geneva op cit note 4 at 4

²⁷ Ad Hoc Group of Experts on International Cooperation in Tax Matters Tenth meeting Geneva op cit note 4 at 5

The two situations common aspect was that the principle advocated for the concept of equal treatment or the neutrality principle. For example, neutrality principle places shareholders with a controlling interest in a company in the same position as other shareholders and controlled taxpayers are placed on parity with uncontrolled taxpayers. As a result, the arm's length principle neutralizes the advantage of the former.²⁸

2.1.3 OECD approach to the arm's length principle

The phrase 'arm's length' does not appear in OECD Model Tax Convention (2002). However, Article 9 of the Model Tax Convention (2002) provides a statement that describes arm's length price and reads as;

*[When] conditions are made or imposed between ... two [associated] enterprises in their commercial or 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.*²⁹

This statement provides the approach to be taken in applying the arm's length principle. The approach is that, the members of MNEs should be treated as operating as separate entities rather than as inseparable parts of a single unified business. Focus is placed on the nature of the dealings between members of the group.³⁰ In this respect, the OECD guidelines state that the arm's length principle grants states the right to adjust the profits of associated companies to reflect an arm's length profit and this should be done as if the parties were independent of each other.³¹

In addition, for the purposes of calculating tax par 1 of Art 9 of the Model Tax Convention (2002) authorizes a tax administration to re-write the accounts of associated enterprises if as result of the special relations between the enterprises, their accounts do not show the true taxable profits arising in that state. Therefore, the question for both the taxpayer and the tax authority to address is whether the conditions in the commercial or financial relations of associated enterprises are at

²⁸ Ad Hoc Group of Experts on International Cooperation in Tax Matters Tenth meeting Geneva op cit note 4 at 5

²⁹ OECD Transfer Pricing Guidelines (1997) chap I par 1

³⁰ OECD Transfer Pricing Guidelines (1997) chap I par 1.6

³¹ OECD Transfer Pricing Guidelines (1997) chap I par 17

arm's length or whether non arm's length conditions are present. The importance of this statement is that, it evens out the field for both related and independent enterprises as these transactions are viewed equally.

It follows that, the arms length principle is an international standard for assigning transfer prices because it provides a substantial level playing field for both MNEs and independent enterprises.³² Emphasis is put on the arm's length principle's ability to avoid the creation of tax advantages or disadvantages that would arise if entity type were not to be considered. Consequently entity type does not distort the level commercial competitive position of either kind of enterprises. From the foregoing, surveys done suggest that there is general international consensus that the arm's length principle has become the international transfer pricing standard of most countries and of almost all tax treaties.³³ This means that the principle is now widely applied and well understood by taxpayers and tax authorities. On this point the *Ad Hoc committee of experts on international cooperation in tax matters*, has referred to four distinguishable categories when it comes to implementation of the arm's length principle in domestic tax law, these are:

- (i) Countries which have included a specific reference to the arm's length principle and adjustments in case of deviations, in their tax laws, for example, South Africa and Australia.
- (ii) Countries which permit prices to be adjusted in case of associated enterprises, without explicit reference to the arm's length principle, for example, France.
- (iii) Others like Brazil who set rules for the deductibility of the cost of imported goods and rights and the recognition of revenue arising from exports.
- (iv) Countries with a broad statutory basis, which has been developed for transfer pricing purposes in case law, for example, Germany.³⁴

³² Maxi Steyn 'Foreign Branch Operations in a globalised environment: A South African income tax Perspective' (Part II) (2003) *Southern African Business Review* 7 No. 2 at 60

³³ Maxi Steyn loc cit note 32

³⁴ Ad Hoc Group of Experts on International Cooperation in Tax Matters Tenth meeting Geneva, op cit note 4 at 23

2.1.4 Criticism of the arm's length principle identified by the OECD

Although there is general global acceptance of the arm's length principle as an international transfer pricing standard, it is not without criticism. Firstly, there is a view that the arm's length standard does not reflect the economical reality of the MNEs.³⁵ Those who support this view, argue that the arm's length principle and its separate entity approach poses a problem since MNEs are often integrated enterprises. It is argued that, this very integration is the reason why suitable economic advantages are gained in areas such as logistics, brand development, risk management and technology. The result they say is that,

*...the measures of integration cannot be duplicated in the context of arm's length independent transactions conducted by two non-integrated businesses performing the same or similar functions and selling the same or similar products.*³⁶

They conclude that, applying the arm's length standard in such cases will involve splitting the MNE into separate parts which brings about ambiguity based on the scale of the economies of integration and the relative profitability of the parties involved.³⁷

Further argument is that the arm's length standard cannot be efficiently applied in some circumstances. An example is where MNEs take part in transactions that independent parties would not undertake, such as where a new associated company is maintained at a loss so as to create market share.³⁸ These kinds of transactions among MNEs may differ fundamentally from comparable transactions between independent enterprises. Accordingly, the strict application of the arms' length principle would be inappropriate as it will be extremely difficult to find comparable transactions among independent enterprises.³⁹

There is also argument that applicability of the arm's length principle in transactions conducted electronically (e-commerce) is questionable.⁴⁰ On this issue

³⁵ Borkowski 'Electronic commerce, transnational taxation and transfer pricing: issues and practices' (2002) 7, *International Tax Journal* 1 at 36

³⁶ Miesel, V.H op cit note 24 at 62

³⁷ Miesel, V.H op cit note 24 at 62

³⁸ Miesel, V.H., op cit note 24 at 7

³⁹ Miesel, V.H., op cit note 24 at 7

⁴⁰ Annet Wanyana Oguttu op cit note 9 at 145.

the *OECD Report of the Committee on Fiscal Affairs* found that e-commerce does not pose new essential problems for transfer pricing, because the same challenges have been prevalent in mail or telephone ordering businesses for many years.⁴¹ However, the difficulty of applying the arm's length principle arises due to the increasing transactions in an e-commerce and the advanced technological environment that has resulted in faster and easier cross-border transactions. For examples there is quicker; processing of goods and services, data transmission and increased mobility of goods, services and resources. These factors have made it harder for tax authorities to identify, trace, locate and value transactions on an arm's length.⁴²

Due to the above difficulty, tax authorities find it problematic to rely on the traditional factors that need to be present in order for a taxpayer to be taxable in a specific jurisdiction. This is because applying the arm's length principle in an e-commerce environment challenges these traditional factors. One such factor is that the arm's length principle is based on the separate transaction approach. Contrary to this, e-commerce makes separate transactions so closely linked that they cannot be assessed sufficiently on a separate basis hence making comparison harder.⁴³ In such circumstances, it becomes difficult to find comparables for determining the value of a single electronic contribution in a highly integrated transaction arises.⁴⁴ This puts pressure on the traditional approach used to deal with non-arm's length transfer pricing. Accordingly, the separate transaction analysis becomes practically unattainable since success will require enormous skilled labour. Other shortcomings of the arm's length principle will be addressed in chapter three which looks at the arms' length principle from a South African context.

Although there are practical problems in applying the arm's length principle in certain circumstances, there is a general admission that there has not been any justifiable substitute for the arm's length principle.⁴⁵ The arm's length principle is

⁴¹ OECD and Electronic Commerce: The OECD discussion paper 'Electronic Commerce: A discussion Paper on Taxation Issues' 1998 par 1 available at lists.elistx.com/archives/ietfrade/199812/msg00000.html [accessed 3 August 2007]

⁴² Annet Wanyana Oguttu op cit note 9 at 146

⁴³ Annet Wanyana Oguttu op cit note 9 at 156

⁴⁴ Annet Wanyana Oguttu op cit note 9 at 156

⁴⁵ Maxi Steyn op cit note 32 at 62

hence accepted to create and ensure the most convenient and stable economic environment for enterprises to operate within.

Overall, when a transfer pricing approach that is inconsistent with the arm's length standard is followed; the taxpayers risk exposure to double taxation and potential conflict with tax authorities. The OECD suggests that if other methodology is to be used internationally for attribution of profits to multinationals, it should only be considered and comparison made with the methods proposed by its guidelines. The rationale behind this view is that such consideration should only be made to the extent to which the methodology is consistent with the arm's length principle.⁴⁶

2.2 Application of the Arm's Length Principle: OECD proposed methods

Having established that the arm's length principle is the internationally accepted standard in determining a transfer price, it is important to discuss how it is applied. The OECD Guidelines, in Art 9 of the Model Tax convention (2002) outlines the methods and guidelines that may be used in the application of the Arm's Length Principle. The methods are categorized in the following groups:

- (i) Traditional transactional methods such as; Comparable Uncontrolled Price Method (CUP), Resale Price method (RP) and the Cost Plus Method (CP)
- (ii) Transactions profit methods, including Profit Split Method and Transaction Net Margin Method (TNMM)

However, the OECD guidelines point out that none of the proposed methods is suitable in every possible situation hence; circumstances of each case will determine the applicability of any other method.⁴⁷ Hence, the guideline seems to suggest that MNEs have the freedom to apply methods not described in the OECD guidelines when establishing transfer prices. Despite this, the OECD guidelines warn that prices derived by methods not described by the OECD must satisfy the arm's length principle with the taxpayer having to preserve and provide documentation regarding how its transfer prices were established.⁴⁸

⁴⁶ Maxi Steyn op cit note 32 at 62

⁴⁷ OECD Transfer pricing Guidelines (1997) chap I par 1.68

⁴⁸ OECD Transfer Pricing Guidelines (1997) chap II par 1.68

In addition, the OECD guidelines provide that the arm's length principle does not require the application of more than one method, and that if more than one method was to be used it would be significantly burdensome for taxpayer.⁴⁹ However, the guidelines point out that, where the choice of a method is found not to be clear-cut, more than one method may be considered but it should be possible to selecting one method that can provide the best estimation of an arm's length. In summery, the objective is to select a method that is suitable to provide the best estimation of an arm's length price. Notwithstanding this, although not specifically stated, the guidelines seem to establish a hierarchy of the methods that should be considered.⁵⁰ This point is emphasized by the OECD guidelines where its is stated that the,

*Traditional transactions methods are the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are arm's length. As a result, traditional transactions methods are preferable to other methods.*⁵¹

How the arm's length principle is applied in the methods is discussed below. Before embarking on the discussion, it is necessary to briefly look at the issues identified by the OECD guidelines that must be taken into account by tax authorities in applying the arms' length principle, when faced with transfer pricing issues. They are:

- (i) Comparability analysis
- (ii) Recognition of actual transaction
- (iii) Separate and combined transactions
- (iv) The Arm's length range
- (v) Multiple year data
- (vi) Losses
- (vii) Government policies
- (viii) Intentional set-offs
- (ix) customs valuations and

⁴⁹ OECD Transfer pricing Guidelines (1997) chap I par 1.69

⁵⁰ Dixon, Ernst & Young, Finney M International Corporate Tax Planning (2002) par 20.20

⁵¹ OECD Transfer pricing Guidelines chap (1997) I par 2.5

2.3 Issues taken into account in applying the arm's length principle

2.3.1 Comparability Analysis

Chap I of the OECD guidelines at par 1.15 deals with the comparability analysis. It is provided that a comparability analysis involves a comparison of a controlled transaction with an uncontrolled transaction or transactions. The comparisons are only useful if the economically relevant characteristics of the situations being compared are sufficiently comparable. Hence, controlled and uncontrolled transactions are comparable if none of the differences between the transactions could materially affect the factor such as the cost of goods being examined in the methodology, or if reasonably accurate adjustments can be made to eliminate the material effects of any such differences.⁵²

Par 1.15 gives a good illustration from an independent enterprises point of view why the comparability analysis is important. It says that, before an independent enterprise gets into a transaction it compares it with the other options available to it. The transaction it finally enters into is one that is clearly more attractive in a commercial sense than the available alternatives. Therefore, it is unlikely for an enterprise to accept a price offered for its product if it knows that other potential clients are willing to pay more under similar conditions. The independent enterprises generally take into account any economically relevant differences between the options realistically available to them such as the level of risk when valuing the options available.⁵³

On the same note, when making the comparisons tax administrations are required to take the economic differences into account. This assist in establishing whether there is comparability between the situations being compared and what adjustments may be necessary to achieve comparability.⁵⁴ It is however acceptable if minor adjustments are made to minor differences. In this respect the OECD

⁵² OECD Transfer Pricing Guidelines (1997) chap II Para 1.15

⁵³ OECD Transfer Pricing Guidelines (1997) chap II par 1.15

⁵⁴ OECD Transfer Pricing Guidelines (1997) chap II 11 par 1.15

guidelines encourage a flexible approach in applying a particular method as long as reasonable accuracy is maintained.⁵⁵

2.3.1.1 Factors affecting comparability

The OECD guidelines propose five factors that should be considered when trying to determine comparability. These are;

- (i) a functional analysis
- (ii) analysis of contractual terms
- (iii) analysis of economic circumstances
- (iv) analysis of business strategies
- (v) analysis of the characteristics of property or services

2.3.1.2 Functional analysis

Pars 1.20 to 1.27 gives guidance on how a functional analysis should be conducted as well as its importance. The paragraphs provide that a comparison based on a functional analysis seeks to identify and to compare the economically significant activities and responsibilities undertaken or to be undertaken by the independent and associated enterprises. In particular, attention is paid to the structure and organisation of the group as well as the juridical capacity in which the taxpayer performs its functions.

A functional analysis also seeks to identify the principal functions performed by the MNE in or its affiliate. The examples of functions that tax administrations might need to identify and compare are; design, manufacturing, assembling, research and development, servicing, purchasing, distribution, marketing, advertising, transportation, financing, and management. The paragraphs emphasise that it is also useful to consider the assets that are employed or to be employed. These include; plant and equipment, the use of valuable intangibles and the nature of the assets used (the age, market value, location, property right protections available, etc).

A proper functional analysis enables tax authorities, to establish the risks assumed by the respective parties and the significant differences in the risks assumed

⁵⁵ OECD Transfer Pricing Guidelines (1997) chap II par 1.18

if any for appropriate adjustments to be made. Hence, a functional analysis is incomplete unless the material risk assumed by each party is considered. This is because the assumption or allocation of risks would influence the conditions of transactions between the associated enterprises.⁵⁶

2.3.1.3 Contractual terms

Contractual terms as a factor affecting comparability are dealt with in pars 1.28 to 1.29. According to these paragraphs, the contractual terms of a transaction generally define clearly or unconditionally how the responsibilities, risks and benefits are to be divided between the parties. It follows that; an analysis of contractual terms should be part of a functional analysis. Other than written contracts, the terms of a transaction may also be found in correspondence between the parties. Where no written terms exist, a determination of the contractual relationships of the parties is made from their conduct and the economic principles that generally govern relationships between independent enterprises.⁵⁷

2.3.1.4 Economic circumstances

The varying economic circumstances mean that the arm's length prices may vary across different markets. This could be the case even where the same property or services are in question. Par 1.30 therefore finds it important that in order to achieve comparability the markets in which the independent and associated enterprises operate should be comparable. Furthermore, the differences should not have a material effect on price and appropriate adjustments should be capable of being made.⁵⁸

2.3.1.5 Business strategies

Business strategies must also be examined in determining comparability of controlled and uncontrolled transactions. For example, business strategies are important in the penetration of markets. Business strategies take into account many aspects of an enterprise, such as innovation and new product development, degree of diversification, risk aversion, assessment of political changes, input of existing and

⁵⁶ OECD Transfer Pricing Guidelines (1997) chap II pars. 1.20-1.27

⁵⁷ OECD Transfer Pricing Guidelines (1997) chap II par 1.28-1.29

⁵⁸ OECD Transfer Pricing Guidelines (1997) chap II par 1.30

planned labour laws, and other factors that affect the every day running of business.⁵⁹

2.3.1.6 Characteristics of property or services

The differences in the specific characteristics of property or services often account for differences in their value in the open market. The characteristics that may be important to consider include the following:

- (i) in the case of transfers of tangible property, the physical features of the property, its quality and reliability, and the availability and volume of supply;⁶⁰
- (ii) in the case of the provision of services, the nature and extent of the services; and,⁶¹
- (iii) in the case of intangible property, the form of transaction (for example, licensing or sale), the type of property (for example, patent, trademark, or know-how), the duration and degree of protection, and the anticipated benefits from the use of the property.⁶²

2.3.2 Recognition of the actual transactions undertaken

This is an anti-avoidance guidance provision found in pars 1.36 to 1.42. The guideline authorizes the tax authorities' to re-characterize a sham transaction to reflect what it should be. This guideline is applicable where the economic objective of the transaction does not make economic sense as would be in a transaction between independent parties.⁶³

2.3.3 Evaluation of separate and combined transactions

In pars 1.42 to 1.44 it is provided that in order to achieve the most accurate estimate of a fair market value, the arm's length principle is applied on a transaction by transaction basis. However, there are often situations where separate transactions are

⁵⁹ OECD Transfer Pricing Guidelines (1997) chap II pars. 1.31-1.35

⁶⁰ OECD Transfer Pricing Guidelines (1997) chap II par 1.19

⁶¹ OECD Transfer Pricing Guidelines (1997) chap II par 1.19

⁶² OECD Transfer Pricing Guidelines (1997) chap II par 1.19

⁶³ OECD Transfer Pricing Guidelines (1997) chap II pars 1.36-1.42

so closely linked or continuous that they cannot be evaluated adequately on a separate basis. Examples may include:

- (i) some long-term contracts for the supply of commodities or services,
- (ii) rights to use intangible property,
- (iii) pricing a range of closely-linked products which make it unrealistic to determine pricing for each individual product or transaction and
- (iv) e-commerce transactions

The OECD guidelines in these paragraphs also give a view on package deals. Package deals may be done for a number of benefits such as licenses for patents, the provision of technical and administrative services and the lease of production facilities. Such comprehensive packages would be unlikely to include sales of goods although the price charged for sales of goods may cover some accompanying services. The guideline's view is that although some separately contracted transactions between associated enterprises may need to be evaluated together in order to determine whether the conditions are arm's length, other transactions contracted between such enterprises as a package may need to be evaluated separately. An example is a case where it may not be possible to evaluate the package as a whole. In such cases the elements of the package must be separated and after determining separate transfer pricing for the separate elements, the tax administration should consider whether in its entirety the transfer pricing for the entire package is arm's length.⁶⁴

2.3.4 Arm's length range

In pars 1.49 to 1.51 it is provided that there are instances when the application of the most appropriate method or methods produces a range of figures all of which are relatively equally reliable. In these cases, differences in the figures that comprise the range may be caused by the fact that in general the application of the arm's length principle only produces an approximation of conditions that would have been established between independent enterprises.

⁶⁴ OECD Transfer Pricing Guidelines (1997) chap II pars 1.42-1.44

In these paragraphs it is suggested that if the relevant conditions of the controlled transactions are within the arm's length range, no adjustment should be made. However, if the relevant conditions of the controlled transaction fall outside the arm's length range declared by the tax administration, the taxpayer should have the opportunity to present arguments that the conditions of the transaction satisfy the arm's length principle, and that the arm's length range includes their results.

If the taxpayer is unable to establish this fact, the tax administration will determine how to adjust the conditions of the controlled transaction by taking into account the arm's length range. However, such adjustments should be made to the point within the range that best reflects the facts and circumstances of the particular controlled transaction.⁶⁵

2.3.5 Multiple year data

In pars 1.52 to 1.54 the guidelines provide that in order to obtain a complete understanding of the facts and circumstances surrounding the controlled transaction, it generally might be useful to examine data from both the year under examination and prior years.

The analysis of such information might disclose facts that may or should have influenced the determination of the transfer price. For example, the use of data from past years will show whether:

- (i) a taxpayer's reported loss on a transaction is part of a history of losses on similar transactions,
- (ii) the result of particular economic conditions in a prior year that increased costs in the subsequent year, or
- (iii) a reflection of the fact that a product is at the end of its life cycle.

Such an analysis may be particularly useful where as a last resort a transactional profit method is applied.⁶⁶

Multiple year data will also be useful in providing information about the relevant business and product life cycles of the comparables. Differences in business or

⁶⁵ OECD Transfer Pricing Guidelines (1997) chap II pars 1.49-1.51

⁶⁶ OECD Transfer Pricing Guidelines (1997) chap II pars 1.52-1.54

product life cycles may have a material effect on transfer pricing conditions that needs to be assessed in determining comparability.

2.3.6 Losses

In pars 1.52 to 1.54 the guidelines provide that close scrutiny of transfer pricing should be made when an associated enterprise consistently realizes losses while the multinational group as a whole is profitable. It is possible for associated enterprises, like independent enterprises to sustain genuine losses due legitimate business reasons. However, an independent enterprise would not be prepared to tolerate losses that continue indefinitely and it will eventually cease to undertake business on such terms. In contrast, an associated enterprise that realizes losses may remain in business if the business is beneficial to the multinational group as a whole. The indication may be that the loss enterprise may not be receiving adequate compensation from the multinational group of which it is a part in relation to the benefits derived from its activities.⁶⁷

2.3.7 the effect of government policies

In pars 1.55 to 1.59 the guidance given is that a taxpayer can claim that an arm's length price must be adjusted to account for government interventions. As a general rule, government interventions such as price controls or price cuts, controls over payments for services or management fees, controls over the payment of royalties, subsidies to particular sectors, exchange control, anti-dumping duties, or exchange rate policy are treated as conditions of the market in the particular country. However in the ordinary course they should be taken into account in evaluating the taxpayer's transfer price in that market. Core to this is the question whether in light of these conditions the transactions undertaken by the controlled parties are consistent with transactions between independent enterprises.⁶⁸

2.3.8 Intentional set-offs

An intentional set-off is one that associated enterprises incorporate knowingly into the terms of the controlled transactions. It occurs when one associated enterprise has provided a benefit to another associated enterprise within the group that is balanced

⁶⁷ OECD Transfer Pricing Guidelines (1997) chap II pars 1.52-1.54

⁶⁸ OECD Transfer Pricing Guidelines (1997) chap II pars 1.55-1.59

to some degree by different benefits received from that enterprise in return. For example, an enterprise may license another enterprise to use a patent in return for the provision of know-how in another connection and claim that the transactions result in no profit or loss to either party. Such arrangements may sometimes be encountered between independent enterprises and should be assessed in accordance with the arm's length principle in order to quantify the value of the respective benefits claimed as set-offs.⁶⁹

2.3.9 Use of customs valuations

Finally the guidelines in pars 1.65.1.67 note that the arm's length principle is applied by many customs administrations as a principle of comparison between the value attributable to goods imported by associated enterprises and the value for similar goods imported by independent enterprises. Both customs officials and tax administrations, however, generally seek to determine the value of the products at the time they were transferred or imported. Thus, customs valuations, because they may occur at or about the same time the transfer takes place, may be useful to tax administrations in evaluating the arm's length character of a controlled transaction transfer price. In particular, customs officials may have contemporaneous documentation regarding the transaction that could be relevant for transfer pricing purposes, especially if prepared by the taxpayer.⁷⁰

2.4 OECD methodology of determining the arm's length principle

2.4.1 The traditional transaction methods

Chapter II of the OECD guidelines provides for the traditional transaction methods and how they are used to apply the arm's length principle. These methods are the:

- (i) Comparable uncontrolled price method (CUP) method,
- (ii) The resale price (RP) method, and
- (iii) The cost plus (CP) method

The OECD guidelines in par 2.5 provide that the most direct way to ascertain whether the conditions made between associated enterprises are arm's length is to compare the prices charged in controlled transactions undertaken between those

⁶⁹ OECD Transfer Pricing Guidelines (1997) chap II pars 1.60-1.64

⁷⁰ OECD Transfer Pricing Guideline (1997) chap II pars 1.65.1.67

enterprises, with prices charged in comparable transactions undertaken between independent enterprises.

The reason given is that any difference in the price of a controlled transaction from the price in a comparable uncontrolled transaction can normally be traced directly to the commercial and financial relations made or imposed between the enterprises. Consequently, the arm's length conditions can be established by directly substituting the price in the comparable uncontrolled transaction for the price of the controlled transaction.

However, the paragraph goes on to point out that there will not always be comparable transactions available to allow reliance on this direct approach alone, and so taxpayer or tax authority may find it necessary to compare other less direct indications, such as gross margins from controlled and uncontrolled transactions. These approaches, direct and indirect, are reflected in the discussed below.

2.4.1.1 Comparable uncontrolled price method (CUP)

According to par 2.6, the comparable uncontrolled price (CUP) method compares the price at which a controlled transaction is conducted to the price at which a comparable uncontrolled transaction is conducted. This makes it theoretically the easiest to establish the arm's length. In this case, the arm's length price is determined by the sale price between two unrelated corporations. However, the fact that almost any slight change in the circumstances of trade, for example the billing period, may have a significant effect on the price. This makes it extremely complicated to find a given transaction that is adequately comparable.⁷¹

The transactions as mentioned above fall into two categories, namely external comparables and internal comparables. For example if Company A, in South Africa sells wine to its subsidiary B in Australia then an external comparable transaction would be the sale of wine from South African Company X to an unrelated enterprise in Australia Company Y. The terms should be identical terms as the trade between Company A and its subsidiary B.

⁷¹ OECD Transfer pricing guidelines (1997) chap II Par 2.6

On the other hand, the internal comparable transaction would therefore be either the trade of wine between Company A and Company Y, or the trade of wine between Company X and Subsidiary B. The term internal in this respect refers to the fact that one of the parties involved in the tested transaction is also involved in the comparable uncontrolled transaction.

In summary, a taxpayer when utilizing the method is required to find independent parties performing the same type of transaction. The following must be present: the same terms, same type of goods, services or technology and an independent party with which the multinational group deals with on similar terms as it does with its associated enterprise.⁷² Therefore an uncontrolled transaction is comparable to a controlled transaction for purposes of the CUP method if one of two conditions below is met:

- (i) None of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or⁷³
- (ii) Reasonably accurate adjustments can be made to eliminate the material effects of such differences.⁷⁴

In addition, whether controlled and uncontrolled transactions are comparable, require one to consider the effect on price of broader business functions (other than just product comparability) and the factors relevant to determining comparability.

However, practical considerations dictate a more flexible approach to enable the CUP method to be used. For it to be supplemented by other appropriate methods evaluation should be done at to the relative accuracy of those other methods. Effort should be made to adjust the data so that it may be used appropriately in a CUP method. As for any method, the relative reliability of the CUP Method is affected by the degree of accuracy with which adjustments can be made to achieve comparability.

⁷² OECD Transfer pricing guidelines (1997) chap II pars 2.6-2.31

⁷³ OECD Transfer pricing guidelines (1997) chap II par 2.7

⁷⁴ OECD Transfer pricing guidelines (1997) chap II par 2.7

2.4.1.2 Situations in which the CUP method cannot be used

The OECD guidelines identify situations where the CUP method cannot be applied.

The main situations include:

- (i) where component parts or semi-finished parts used within a group are not available on the open Market.
- (ii) where related entities within a multinational group render to each other a wider range of back-up and technical support as opposed to independent companies, and
- (iii) where production arrangements within a specific multinational group are not replicated by independent companies that are not part of the MNE group.⁷⁵

Other situations identified include; differences in the quality of the products, differences in the geographical markets, differences in the level of the market and differences in the amount and type of intangible property involved in the sale. An example in the level of market is where affiliates sell to a higher level distribution chain as compared to an independent enterprise trading in the same commodity.⁷⁶

2.4.1.3 Cost plus method (CP)

The cost plus (CP) method is used where:

- (i) semi-finished goods are sold between related parties,
- (ii) related parties have concluded joint facility agreements
- (iii) long-term buy-and-supply arrangements, or
- (iv) the controlled transaction is the provision of services.

The CP method is determined by adding an appropriate markup to the costs incurred by the selling party. The markup could be; in manufacturing or purchasing the goods or services provided. The suitable markup is based on the profits of other companies comparable to the tested party.⁷⁷ For example, the arm's length price for a transaction involving the sale of finished motor vehicle spare parts to a related distributor could be determined by adding suitable markup to the cost of materials, labour and manufacturing.

⁷⁵ Schwarz, J 'Draft OECD Transfer Pricing Guidelines, Financial Times' *World Tax Report* at 162

⁷⁶ Coopers and Lybrand 1993 *International Transfer Pricing* at 25.

⁷⁷ OECD Transfer pricing Guidelines (1997) chap II par 2.14

The method calculates transfer price on the cost of the goods or services available as per the cost accounting records of the company. The method is generally accepted by the tax customs authorities, since it provides some indication that the transfer price approximates the real cost of item. However, caution is necessary because a company can easily manipulate its cost accounts to alter the magnitude of the transfer price.⁷⁸

In addition, companies also have to decide on the treatment of fixed cost and research and development cost. For example, companies know that they can recover increased cost simply by raising the transfer price without a reason. For purposes of the cost plus method the same principles as in the CUP method mentioned in par 2.7 of the OECD guidelines apply in determining if an uncontrolled transaction is comparable to a controlled transaction.

2.4.1.4 Situations where the cost plus method cannot be used

The cost plus method presents some difficulties in proper application, particularly in the determination of costs. These may involve the determination of costs over a period of time and their relation to profits of a given specific year. In such instances the costs may not be the determinant of the appropriate profit in a specific case for any one year.

An example is where a company after an initial creation of a certain product for example chemical hair products, goes on to improve and modify that product. The research costs involved in such research leading to the improvement or modification may be relatively small compared to the initial creation. In profit years that follow the initial research, there may be no distinct link between the level of costs incurred and the new market price.⁷⁹

Another problem experienced is in the application of a comparable mark-up to a comparable cost basis. An example is where, an uncontrolled enterprise utilizes a leased business assets; the cost basis might not be comparable without adjustment if the enterprise in a controlled transaction owns its business assets. It therefore

⁷⁸ OECD Transfer pricing guidelines (1997) chap II par 2.33

⁷⁹ OECD Transfer Pricing Guidelines (1997) chap II par 2.36

follows that the differences between the controlled and uncontrolled transactions that have an effect on the size of the mark-up must be analyzed to determine what adjustments should be made to the uncontrolled transactions' respective mark-up.⁸⁰

Another problematic area is the lack of consistency which hinders comparability. It is advised that in such cases the appropriate adjustments between the transaction being compared and other controlled transactions must be made.⁸¹

2.4.1.5 Resale price method

The resale price method (RP) is quite similar to the CP method. It is established by working backwards from transactions taking place at the next stage in the supply chain. It is determined by subtracting an appropriate gross markup from the sale price to an unrelated third party, with the appropriate gross margin being determined by examining the conditions under which the goods or services are sold and comparing said transaction to other, third-party transactions.⁸²

Take an example of MNE group in the motor vehicle industry involved in manufacturing to distribution. The arm's length price would be determined by subtracting an appropriate gross margin from the price at which the distributor sold the products received from the manufacturer to third-party retailers. In this example, both the CP and RP methods can be used to examine the same transaction, the transaction being the one between the manufacturer and the distributor.

The selection of the one to use is dependent on the availability of data and comparable transactions. This flexibility is not available in other transactions, particularly those involving intangible goods. For example it is exceedingly difficult to determine the costs involved in developing technological know-how, and so the arm's length price for the payment of royalties from one company to another is best determined by working backwards from the profits gained based on the usage of the know how in other words, the RP method.

⁸⁰ OECD Transfer Pricing Guidelines (1997) chap II par 2.36

⁸¹ OECD Transfer Pricing Guidelines (1997) chap II par 2.37

⁸² OECD Transfer Pricing Guidelines (1997) chap II par 2.14

2.4.2 Transactional profit methods

There are a number of non-traditional methods available for determining the arm's length price. The most common are the profit split (PS) method and the transactional net margin method (TNMM).

2.4.2.1 Profit split method (PS)

The PS method is applied when the enterprises involved in the examined transaction are too integrated to allow for a separate evaluation. The ultimate profit derived from the venture is split based on the level of contribution of each of the participants in the project.⁸³

A highly simplified example is, where a South African Company A, sends four researchers to its Australia subsidiary B to assist in the improvement of wine quality. The wine is for the Australian market. Subsidiary B also allocates six identically salaried researchers to aid in the same improvement. It would be expected that Subsidiary B would pay Company A 40% of the ultimate profits as a royalty fee for the technical knowledge provided by Company A's researchers.

2.4.2.2 Transactional net margin method (TNMM)

The TNMM method focuses on the arm's length operating profit earned by one of the entities in the transaction. It stipulates that relative operating profit (relative to sales, costs, or assets to allow comparisons between different companies or transactions) may be a more robust measure of an arm's length result when close comparables, as required for the traditional methods, are not available. For example, two distributors may sell different products that require different sales efforts per unit sold.

This may lead to very different gross margins (hence the resale price method may not be easily applicable). However, the operating margins would not be expected to be materially different since the margins reflect a competitive return only.⁸⁴ The margin is measured before interest. This is because the level of interest

⁸³ OECD Transfer pricing Guidelines (1997) chap par II 1:3.5

⁸⁴ OECD Transfer pricing Guidelines (1997) chap II 1:3.26

expense becomes an indicator of how a company decides to finance its operations and is unrelated to the transfer pricing.

2.5 A non-arm's-length approach: Global formulary apportionment

There are those who advocate for the use of other non arm's length approach to transfer pricing. An example of such a method is the global formulary apportionment approach. The OECD guidelines from Para 3.61 to 3.74 discusses the global formulary apportionment which has sometimes been suggested as an alternative to the arm's length principle as a means of determining the proper level of profits across national taxing jurisdictions. This method has not found much application as between states and has been rejected by the OECD.

These paragraphs provide that a global formulary apportionment method would allocate the global profits of a multinational group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined and mechanistic formula. OECD member countries do not consider global formulary apportionment a realistic alternative to the arm's length principle, for the reasons discussed below.

In rejecting the non arm's length approach, the OECD gave several reasons. Two examples of these are; the difficulty of implementing the system in a manner that both protects against double taxation and ensures single taxation, and consequences of exchange rate movements.

Para 3.69 notes that implementing the system would require time consuming substantial international coordination and consensus on the predetermined formulae to be used and on the composition of the group in question. In regard to exchange rate movements, the OECD found that although exchange control movements can complicate application of the arm's length principle they do not have the same impact as the global formulary apportionment approach. In relation to this, the arm's length principle is better equipped to deal with the economic consequences of exchange rate movements because it requires the analysis of the specific facts and circumstances of

the taxpayer.⁸⁵ For example, where the formula relies on costs, the result of applying a global formulary apportionment approach is insufficient because particular currencies may strengthen in one country consistently against another currency. In this case, the latter country would be where the associated enterprise keeps its accounts. Consequently, a greater share of the profit would be attributed to the enterprise in the first country to reflect the costs of its payroll nominally increased by the currency fluctuation.

2.6 Administrative approaches to avoiding transfer pricing disputes

The OECD guidelines in chapter IV gives administrative approaches which may minimize and solve transfer pricing disputes, between taxpayers and tax administrations as well as between different tax administrations. The chapter calls for an understanding of the problems of the taxpayer due to the fact that transfer pricing is not an exact science and an unrealistic precision may not be expected. As a result tax administrations are advised to take the commercial judgment of the taxpayer and business realities as a basis in their examination of the taxpayers transfer price.

The suggested administrative approaches aim at minimising transfer pricing disputes and to resolve them when they arise. The OECD guidelines acknowledge such disputes may arise even though the guidance in the report is followed in a conscientious effort to apply the arm's length principle. Further that, it also acknowledged that given the complexities of some transfer pricing issues it is possible that taxpayers and tax administrations to reach differing determinations of the arm's length conditions.

The administrative approaches deal with transfer pricing compliance practices and cover three aspects:

- (i) examination practices,
- (ii) the burden of proof, and
- (iii) penalty systems.

⁸⁵ OECD Transfer pricing Guidelines (1997) chap II par 3.68

The evaluation of these three aspects will necessarily differ depending on the characteristics of the tax system involved. The guidelines therefore provide general guidance on the types of problems that may arise and reasonable approaches for achieving a balance of the interests of the taxpayers and tax administrations involved in a transfer pricing inquiry. This paper will not dwell on the approaches in detail but an outlook is appropriate.

2.6.1 Burden of proof

The OECD guidelines in chap IV pars 4.11 to 4.17 deals with burden of proof. In summary there are three distinguishable situations:

- (i) the tax administration bears the burden of proof;
- (ii) the burden of proof falls on the taxpayer if he did not produce appropriate documentation or if he filed a false return, etc.; and
- (iii) the burden of proof is on the taxpayer. The taxpayer must prove that the adjustment made by the tax authorities was wrong. These differences may cause problems which are hard to solve through mutual agreement procedures. The starting point of the Guidelines in such a procedure is that the state that has made the primary adjustment bears the burden of proof that the adjustment is justified both in principle and as regards the amount.

2.6.2 Penalties

Par 4.18 of the guidelines raises concern over the design of penalties. The paragraph advocates for tax authorities to promote compliance rather than make tax underpayments and other types of non-compliance more costly.

2.6.3 The mutual agreement procedure

Par 4.29 of the OECD guidelines provides that the mutual agreement procedure as means through which tax administrations consult to resolve disputes regarding the application of double tax conventions. The procedure is described and authorized by Article 25 of the OECD Model Tax Convention. It can be used to eliminate double taxation arising from transfer pricing adjustment.

2.6.4 Concept of safe harbours

Par 4.95 provides that the concept is a formal formally statutory provision that applies to a given category of taxpayers. It aims at relieving qualified taxpayers from certain obligations otherwise imposed by the tax code by substituting exceptional, usually simpler obligations. However, the report acknowledges that the degree of arbitrary decision making will create difficulties such as determining which category of tax payer qualifies to be eligible to benefit from the provisions.

2.6.5 Advance pricing agreements (APA)

Pars 4.124 to 4.167 of the guidelines deal comprehensively with advance pricing agreements. APA is an agreement between the taxpayer and the competent taxation authority that a future transaction will be conducted at the agreed-upon price. This price is recognized as the arm's length price for the period designated. Although retroactive, APAs can be used to reduce tax exposure in past years. APAs are primarily used to avoid the risk of future income assessment adjustments, which could lead to large payments in the future. However, at present, only a few OECD Member Countries have experience with APAs.⁸⁶

APAs can be unilateral, bilateral or multilateral. A unilateral APA is an agreement between a corporation and the authority of the country where it is subject to taxation. Hence, foreign tax authorities will not recognize a unilateral APA. Bilateral or multilateral APAs on the other hand involve an agreement between the corporation and two different authorities for the former and with more than two tax authorities for the later.⁸⁷

2.7 Documentation

Chapter V of the OECD guidelines deals with documentation. It is explicitly stated in the chapter that there is no obligation to present supporting documents at the time the transfer price is determined or the tax return is filed.⁸⁸ Information requirements

⁸⁶ OECD Transfer Pricing Guidelines (1997) chap IV par 4.16

⁸⁷ OECD Transfer Pricing Guidelines (1997) chap IV par 4.124

⁸⁸ OECD Transfer Pricing Guidelines (1997) chap V par 5.2

that should be provided when filing a return should be limited to information which enables the tax administration to select cases for further examination.

The Guidelines also state that it is not reasonable to burden the taxpayer with disproportionately high costs, for example, in order to obtain documents from foreign related enterprises or in an exhaustive search for comparables, if the taxpayer believes that no comparables exist or if obtaining comparables would incur disproportionate costs for the taxpayer. The taxpayer should not be expected to provide more documentation than the minimum required for a reasonable determination by the tax administration that the taxpayer has complied with the arm's length principle.

2.8 Tax treaty position of the OECD guidelines

It is every countries right to impose tax legislation within its jurisdiction. Double tax treaties impact this very sovereignty. This is felt both on the governing rights and obligations of contracting states as well as governing of taxpayers who are resident in the jurisdiction s of the contracting states.

In transfer pricing the treaties define the allocation of income and facilitate agreement on international standards. They also identify the transactions to which the basis of allocation applies. Furthermore they provide a resolution of disputes as well as for mutual assistance between tax authorities. Art 9 of the OECD Model Tax convention grants a signatory state the rights to adjust profits of associated companies to reflect an arm's length price however this should be done in a manner that allows neutrality as envisaged in Article 9 (2).

The next chapter examines the manner and extent to which South Africa has adopted the OECD transfer pricing regulations.

CHAPTER III

3. TRANSFER PRICING: SOUTH AFRICAN APPROACH

This section will focus on South Africa's transfer pricing regime. The discussion will first briefly touch on the history of transfer pricing in South Africa. This will be followed by a discussion of the current legislation and the South Africa Revenue Service (SARS) Practice Note No. 7 extent to which it has adopted the OECD transfer pricing guidelines. Central to the discussion will be the status of the OECD guidelines and Double Tax Agreements (DTA) in relation to transfer pricing and the status of SARS practice Note No.7. SARS view of the arms length principle and guidance to applying the arm's length principle will also be discussed through hypothetical examples on how the proposed methods are applied. Finally shortcomings of the current South Africa transfer pricing regime will be highlighted.

3.1. History of transfer pricing in South Africa

Initially the control of and management of transfer prices was primarily protected by exchange controls with the source of income playing a major role in determination of relevant taxes.⁸⁹ Customs duties were also used to some extent in resolving transfer pricing problems. The provisions under the original s 31 of the Income Tax Act which has now been revised also played a role. These regulatory channels were found to be inadequate.

The inadequacy was generally because the control restrictions applied for purposes of repatriation of profits and capital earned by foreign investors was considerably manipulated by non-resident investors.⁹⁰ Furthermore, South Africa's re-emergence into the international market saw a significant expansion of international trade and commerce which was increasingly being carried on between multinational enterprises.⁹¹ The inadequacy further escalated due to the progressing relaxation of exchange controls regulations. Consequently, South Africa was unable to adequately tap and protect this growing tax base due to multinational transfer

⁸⁹ SARS Practice Note No. 7 1999 par 2.5

⁹⁰ Annet Wanyama Oguttu op cit 9 at 142

⁹¹ Roxanna Nyiri, 'Transfer Laws could Affect SMEs' Economy News Available at <http://business.iafrica.com/news/398104.htm> posted 9 Dec 2004 [accessed July 2007]

pricing schemes. To steer clear from these state of affairs our legislature passed comprehensive domestic legislation that addressed transfer pricing issues. This was done in 19 July 1995 in the form of revised Section 31 of the Income Tax Act No.58 of 1962.⁹²

The provisions in the revised section 31 were introduced following the recommendations of the *Katz Commission: First and Second Interim Reports of the inquiry into certain aspects of the Tax Structure of South Africa (1995)*. The commission was of the opinion that the OECD pronouncements were relevant due to their significant influence in international trade and investment.

The commission further noted that the OECD pronouncements had grown to a common language amongst a much greater group of trading and investment nations hence were useful in assisting South Africa to integrate its national tax, trade and investment system into the international arena.⁹³ The commission also found that the transfer pricing rules adopted in most countries of the prominent developed countries correspond with the transfer pricing measures recommended by the OECD. Accordingly, the commission recommended that it was essential for South Africa to follow the international consensus in the application of the OECD transfer pricing rules as it was paramount to the wealth and development of South Africa.⁹⁴

3.2 Statutory position in respect of transfer pricing in South Africa before 19 July 1995: Original section 31 (now repealed)

Prior to 19 July 1995 transfer pricing provisions was dealt with under the now revised section 31 of the Income Tax Act. In its application, this section was limited to the purchase and sale of commodities where one of the related enterprises was a foreign enterprise resident in a country which South Africa had concluded a DTA.⁹⁵ The section provided that the commissioner could determine the taxable income of the South African importer or exporter as if the commodity had been purchased or sold at a price determined in accordance with the associated enterprises article of the

⁹² Annet Wnyana Oguttu op cit note 9 at 143

⁹³ Katz Commission: First and Second Interim Reports of the inquiry into certain aspects of the Tax Structure of South Africa (1995) 3 at Par 4

⁹⁴ Katz Commission: First and Second Interim Reports of the inquiry into certain aspects of the Tax Structure of South Africa (1995) 3 at par 5

⁹⁵ Original s 31 (a) Income Tax Act 58 of 1962

relevant DTA.⁹⁶ The provisions gave South Africa as a contracting state the right to determine taxable income of a taxpayer as if the commodity had been bought or sold at an arm's length price. The arm's length price was determined according to the provisions of the particular double taxation agreement.⁹⁷ Furthermore, the section provided that the general deduction formula or the terms of the general anti-avoidance Section 103 (1) of the Income Tax Act would apply where expenditure incurred for the commodity was grossly excessive.⁹⁸

The reference to section 103 (1) limited the application of section 31. Illustrations of such limitations are evident in the way our courts interpreted expenditure in view to tax evasion. The court in *ITC 735 18 SATC 204* found that expenditure which is extravagant or inefficient is deductible. In this case the commissioner was of the opinion that a deduction in connection to payment of salary to the son of the appellant farmer was excessive. On appeal the court stated that in such matters every case was to be decided in the light of its own circumstances and the following considerations had to be made;

- (i) Whether the remuneration was so grossly excessive that it could not possibly be regarded in its total amount as producing income; and⁹⁹
- (ii) Whether it had it been awarded from some ulterior motive such as tax evasion, or favouritism; or the like¹⁰⁰

On this basis the court held that despite his youth, the son had considerable farming experience coupled with farming diplomas and certificates hence that amount was in fact reasonable in all circumstances of the case. Consequently, the court ruled that an amount is deductible even if it was extravagant. Therefore on this basis the courts, would find over-priced or under-priced goods or services in transfer pricing circumstances if extravagant or inefficient to be deductible.

Furthermore, in circumstances involving expenditure which is grossly excessive, the court in *ITC 569 13 SATC 447* held that such expenditure is not

⁹⁶ Danziger E, *International Income Tax, The South African Perspective* (1991) par 19.101

⁹⁷ Original S 31 (c) Income Tax Act 58 of 1962

⁹⁸ Original S 31 Income Tax Act 58 of 1962

⁹⁹ At 205

¹⁰⁰ At 205

deductible.¹⁰¹ The case also involved salary paid to the appellants' son for services rendered which the commissioner found to be grossly excessive. On appeal, the court held that expenditure which was grossly excessive is not deductible but it allowed the appeal in part because from the facts established by evidence it was impossible to hold that the remuneration paid was so grossly excessive to render it not deductible. The court could not possibly regard the amount in its total as having been incurred in the production of income or that it had been awarded from some ulterior motive such as tax evasion favouritism or the like. The court further held that the appellant had established his right to the deduction to a given sum and the evidence supported that.¹⁰² Consequently the commissioners' assessment was ordered to be amended accordingly. On this basis it follows that the courts would only find over-priced or under-priced goods or services in transfer pricing circumstances not deductible where such prices were grossly excessive.

Although this was the position, the determination of grossly excessive expenditure was made more difficult because the court in *Tobacco Father v Commissioner of Taxes* 17 SATC 395, found that, in certain circumstances a court or the commissioner is not at liberty to consider the open market price and each industry must decide for itself a fair market rate.¹⁰³ The result was that there were no general guidelines in determination of a grossly excessive expenditure. In a transfer pricing circumstance, the above pronouncements would suggest that the courts would have been inclined to consider the taxpayers selected prices and not embark on finding what a true market price would be in given circumstances hence make the application of the section difficult in the commissioner's hands.

The above illustrations show that the general deduction formula had limited application. Firstly it only relates to deduction and secondly it is inadequate as a price adjusting mechanism even where expenditure is grossly excessive.¹⁰⁴ The original wording of s 31 further restricted the commissioner's adjusting powers to the import and export of commodities within a DTA context.

¹⁰¹ At 449

¹⁰² At 450

¹⁰³ At 399

¹⁰⁴ Oliver L, op cit note 11 at 232

3.3 Statutory position in respect of transfer pricing in South Africa after

19 July 1995: Revised section 31 of the Income Tax Act

The revised section 31 (1) seeks to remedy the above shortcomings of its predecessor. The section contains anti-avoidance measures whose objective is to prevent the artificial removal of what would be South African taxable profit into other jurisdictions. The artificial removal of taxable profits as already mentioned in chapter two occurs when MNEs overstate certain deductions allowable in the determination of taxable income or understate the amount which is received by or accrues to them.¹⁰⁵ The provisions of the section were therefore necessary to prevent taxpayers from manipulating transfer pricing by transferring profits from South Africa to tax jurisdictions with lower tax rates.

The section provides for definition of terminology that is relevant to its application. These include; goods, services and international agreement. Section 31(2) specifically contains transfer pricing mechanism and regulations that apply to associated enterprises that have cross-border dealings. It aims at regulating the pricing of goods and services in cases where an international agreement between connected persons takes place. The section reads as follows;

- 2) *Where any goods or services are supplied or acquired in terms of an international agreement and--*
- a) *the acquirer is a connected person in relation to the supplier; and*
 - b) *b) the goods or services are supplied or acquired at a price which is either--*
 - (i) *less than the price which such goods or services might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's length (such price being the arm's length price); or*
 - (ii) *ii) greater than the arm's length price,*
- then, for the purposes of [this Act](#) in relation to either the acquirer or supplier, the Commissioner may, in the determination of the taxable income of either the acquirer or supplier, adjust the consideration in respect of the transaction to reflect an arm's length price for the goods or services.*

Section 31(3) contains specific Thin Capitalization rules but these will not be dealt with in this discussion.

¹⁰⁵ DJM Clegg ' Deemed Source and Transfer Pricing' Sept 1997 *The Tax Payer* at 163-4

The provisions in section 31 are worded with wide application. Consequently, SARS in its practice note number 7 of 6 August 1999 seeks to provide explanation on the application of the section specifically section 31 (2) that deals with cross border transaction among associated enterprises.¹⁰⁶

An important aspect of section 31 is that it empowers the Commissioner to adjust the non arm's length consideration for goods or services and focuses on international agreements between connected persons.¹⁰⁷ The adjustment is made where the selected price is either less or greater than the price selected between independent parties dealing on an arm's length. The adjusted price is then used in the determination of the taxable income of either of the parties to the transaction.¹⁰⁸

3.4 Section 31 (1) definitions

3.4.1 Goods

Goods are defined to include any corporeal movable things, fixed property and any real right in any such thing or fixed property.

3.4.2 International agreement

International agreement is defined as a transaction, operation or scheme entered into between a resident or non resident for the supply of goods or services to or by a permanent establishment of either of such persons outside the Republic.

3.4.3 Services

The definition of services is wide and includes anything done or to be done for example:

- (i) the granting, assignment, cession or surrender of any right, benefit or privilege
- (ii) the making available of any facility or advantage
- (iii) the granting of financial assistance, including a loan, advance or debt, and the provision of any security or guarantee
- (iv) the performance of any work

¹⁰⁶ SARS Practice Note No 7 of 1999. Section 31 of the Income Tax Act 1962: Determination of the taxable income of certain persons from international transactions.

¹⁰⁷ S 32(2) (b) (ii)

¹⁰⁸ SARS Practice Note No 7 par 4.4

- (v) an agreement of insurance or
- (vi) the conferring of rights to incorporeal property.

The section also mentions terms such as a 'connected person' and 'permanent establishment' but the definitions of these terms are found in s1 of the Income Tax Act.

3.5 Relevant section 1 definitions (Income Tax Act 58 of 1962)

3.5.1 Permanent establishment

A Permanent establishment is defined in Section 1 of the Income Tax Act to mean a;

...permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development.

3.5.2 Connected Person

Section 1 of the income Tax Act definition of a connected person is wide and the section provides that a connected person means-

- a) *in relation to a natural person-*
 - (i) *any relative; and*
 - (ii) *any trust of which such natural person or such relative is a beneficiary;*
- b) *in relation to a trust-*
 - (i) *any beneficiary of such trust; and*
 - (ii) *any connected person in relation to such beneficiary;*
- bA) *in relation to a connected person in relation to a trust (other than a collective investment scheme in property shares managed or carried on by any company registered as a manager under section 42 of the Collective Investment Schemes Control Act, 2002, for purposes of Part V of that Act), includes any other person who is a connected person in relation to such trust;*
- c) *in relation to a member of any partnership-*
 - (i) *any other member; and*
 - (ii) *any connected person in relation to any member of such partnership;*
- d) *in relation to a company-*
 - (i) *its holding company as defined in section 1 of the Companies Act, 1973(Act No. 61 of 1973)*
 - (ii) *its subsidiary as so defined;*
 - (iii) *any other company where both such companies are subsidiaries (as so defined) of the same holding company;*
 - (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); and*
 - vi) *where such company is a close corporation-*
 - aa) *any member;*
 - bb) *any relative of such member or any trust which is a connected person in relation to such member; and*
 - cc) *any other close corporation or company which is a connected person in relation to-*
 - (i) *any member contemplated in item (aa); or*
 - (ii) *the relative or trust contemplated in item (bb); and*
 - e) *in relation to any person who is a connected person in relation to any other person in terms of the foregoing provisions of this definition, such other person; and in this definition the expression "beneficiary" means any person who has been named in the will or deed of trust concerned-*
 - (i) *as a beneficiary; or*
 - (ii) *as a person upon whom the trustee of the trust has the power to confer a benefit from such trust;*

3.6 Relevant SARS Practice Note No. 7 definitions

3.6.1 OECD Guidelines

The Organisation for Economic Co-operation and Development (OECD) Report on Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations published in July 1995 and supplemented with additional chapters and revisions to the contents thereof.¹⁰⁹

3.6.2 Transfer prices

The term transfer pricing describes the process by which entities set the prices at which they transfer goods or services between each other.¹¹⁰

¹⁰⁹ SARS Practice Note No. 7 Par 1.2.4

¹¹⁰ SARS Practice Note No. 7 Par 1.2.5

3.6.3 Controlled transaction

Controlled transaction is defined as 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 Income Tax Act.¹¹¹

3.6.4 Uncontrolled transaction

Uncontrolled transaction on the other hand is defined as a transaction which is concluded at arm's length between enterprises that are not connected persons in relation to each other. An example is 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.¹¹²

3.6.5 Multinational

The term Multinational is used to refer to any group of connected persons with members or business activities in more than one country where as the term members refers to constituent parts (including natural persons) of that multinational, each having a separate legal existence.¹¹³

3.6.6 Managed or controlled

The concept of "managed or controlled" is used a number of times in the definition and the scope is intended to be wider than the term "managed and controlled", as used in other sections of the Income Tax Act. The practice note provides that, in order to determine the place where an entity is managed or controlled, regard will be had to the business activities of the entity and business activities of connected persons, as well as the degree of autonomy under which the entity operates. SARS view is that the control of an entity is to be found at the meeting place of the persons

¹¹¹ SARS Practice Note No. 7 Par 1.2.1

¹¹² SARS Practice Note No. 7 Par 1.2.2

¹¹³ SARS Practice Note No. 7 Par 1.2.3

who exercise authority over and control direction of the entity's business operations.¹¹⁴

3.7 Manner in which South Africa adopts the OECD transfer pricing guidelines

The manner in which South Africa adopts the OECD guidelines is through, section 31 of the Income Tax reference to the arms length principle and SARS Practice Note No. 7 statement in par 3.2.2 that it is based on the OECD guidelines. The practice note's view is that the best way to address the issues of, international double taxation and different rules for transfer pricing methodologies is by the adopting a global transfer pricing policy recorded in global transfer pricing document such as the OECD guidelines.¹¹⁵ SARS reason for following the OECD guidelines is found in the following statement;

*...the OECD Guidelines are acknowledged as an important, influential document that reflects unanimous agreement amongst the member countries, reached after an extensive process of consultation with industry and tax practitioners in many countries.*¹¹⁶

It follows that by adopting the OECD guidelines, the separate accounting or arm's length method in relation to transfer pricing is favoured in South Africa. Therefore By utilizing the arms' length method in section 31 and in SARS practice note No. 7, South Africa is effectively conforming to art 9 of the OECD Model Tax Treaty.¹¹⁷

Another manner in which South Africa adopts the OECD guidelines is through the Double Tax Agreements (DTA) it has entered with other countries. These DTAs are based on the OECD Model Tax Convention. The scope of such DTAs is limited to taxes as covered in the Income Tax Act. For transfer pricing purposes the object of a DTA is to establish an arm's length principle as the standard for the adjustments of transfer prices by tax authorities in the case of transactions between associated enterprises.

¹¹⁴ SARS Practice Note No. 7 Par 1.1.3

¹¹⁵ Bale, D 'One size does not fit all' (2001) *CA Magazine* at 52

¹¹⁶ SARS Practice Note No. 7 par 3.2.1

¹¹⁷ Maxi Steyn op cit note 39 at 58

Having established the manner in which South Africa adopts the OECD guidelines in relation to transfer pricing, it is important to discuss the extent to which South Africa has adopted the guidelines. This is achieved by an outlook of the status of the DTAs in South Africa and a more detailed look at SARS Practice Note No. 7.

3.8 Tax treaty position

3.8.1 Status of OECD Model Tax Convention in South Africa

South Africa has entered into to a number of DTAs with other countries. The DTAs are based on the OECD Model Tax Convention. The origin of South African DTAs is found in the provisions of s 108 of the Income Tax Act. Section 108 indicates that it is the government of South Africa that enters the DTA with the government of the foreign country concerned. The agreement is therefore not made with an individual of either of the countries.

The section aims at preventing or providing relief from double taxation. Hence, a DTA is concluded with a view to prevent, mitigate or discontinue the levying of taxes in respect of the same income, profit or gains or tax imposed in respect of the same donation under the laws of both contracting countries.¹¹⁸ Section 108 (2) clearly indicates that that a DTA will have effect as if enacted in the Income Tax Act. It is therefore possible for the DTA to override the provisions of the Income Tax Act. However, section 108 does not provide much assistance on this matter. It has been left for the courts to determine this matter and this is discussed below.

Generally the a tax treaty does not give the state any right to income tax where its treaty partner state does not tax even where the right has been allocated by the treaty.¹¹⁹ However specific scenarios of a DTA may result in instances where taxes can be imposed, such as where arm's length prices are to be imposed. These provisions would be similar to transfer pricing provisions contained in s 31 of the Income Tax Act, however, these provisions do not necessarily impose tax but merely

¹¹⁸ Oliver L, op cit note 11 at 328

¹¹⁹ Oliver L, op cit note 11 at 358

allocate reciprocal rights to tax and limit a states right to tax within those allocated parameters.¹²⁰

The interaction between the relevant provisions of conventions and those of domestic legislation such DTAs, the OECD Model Tax Convention and the Income tax have been debated upon. This stems from the fact that the procedure to incorporate international agreements into domestic law is not by means of specific adoption. In *Pan American World Airways Inc v SA Fire and Accident Insurance Co Limited 1965 (3) SA 150* the court stated that;

*as a general rule, the provisos of an international instrument so concluded are not embodied in our municipal law except by legislative process...in the absence of any enactment giving their relevant provisions the force of law, They cannot affect the rights of a subject.*¹²¹

In *Swiss-Borough Mines (Proprietary) Limited and others v The Government of The Republic of South Africa and Others 1999 (2) 279 (T)* the court indicated that, to the extent that a treaty is not incorporated into domestic law, the court can only take cognisance of the treaty as well as the contents thereof, as facts, just as it can take cognisance of any facts properly proved before it.¹²² The court further held that it is not entitled to neither interpret or construe the treaty in such circumstances, nor determine the legal consequences arising from the treaty or the true agreement so concluded between the two countries.¹²³

The indication from these judgements is that a convention or treaty can only be incorporated into our law through specific legislative provisions. As mentioned above section 108 (2) of the Income Tax Act indicates that a DTA will have effect as if enacted in the Income Tax Act. It follows that, in the absence of s 108 (2) of the Income Act, a DTA would not have the force of law in South Africa and would therefore not be enforceable by a South African court.

The interpretation as to the co-existence of OECD Model Tax Convention, DTAs and the income Tax Act may be firstly that they will override the provisions of the Income Tax Act. Secondly, their provisions should as far as possible be

¹²⁰ Oliver L, op cit note 11 at 359

¹²¹ at 161

¹²² At 329 J-330 A- B

¹²³ At 330 C

reconciled with the provisions of domestic law. Thirdly, to the extent that domestic law is specifically worded, it should take preference.

It is proposed *in ITC 789 19 SATC 434* that the terms of a DTA should be considered to establish the extent to which they conflict with the provisions of domestic statute.¹²⁴ It follows that, the OECD Model Tax Convention or DTAs and the Income Tax Act provisions should be interpreted in as much a way as possible as to be consistent with each other. Further it is propped that as long as OECD Model Tax Convention and the DTAs embody the arm's length principle there would be no inconsistency between domestic law and the tax treaties. Hence, the principles on the OECD Model Tax Convention do not restrict or limit the application of Section 31 of the Act regardless of the methods a tax payer may choose to select to determine an arm's length consideration.¹²⁵

3.9 SARS Practice Note No. 7

3.9.1 Status of SARS Practice Note No. 7

Generally, the interpretation of tax legislation may be complicated on the taxpayers' point of view. To avoid uncertainty and to ensure efficiency, SARS provides for the interpretation and how the legislation which it administers might be applied. SARS does this through practice notes or manuals, interpretation notes, guides and brochures. The question that arises is whether there is statutory basis to hold SARS for either of these forms of communication with specific reference to SARS Practice Notes.

SARS practice note number 7 states that its objective is to provide taxpayers with guidelines about the procedures to be followed in the determination of arm's length prices, taking into account the South African business environment.¹²⁶ On this account the commissioner's approach is that it has been drafted as a practical guide and is not intended to be a prescriptive or an exhaustive discussion of every transfer pricing issue that might arise.¹²⁷

¹²⁴ At 461

¹²⁵ SARS Practice Note No. 7 par 6.2

¹²⁶ SARS Practice Note No. 7 par 2.8

¹²⁷ SARS Practice Note No. 7 pars 3.1

In *ITC 1675 62 SATC 219* Wunsh J gave a warning on the status of SARS practice notes by saying that it cannot be safely assumed that the commissioner will consider himself bound by his own practice notes. The court found that practice notes or interpretation notes are not law, hence cannot override the provisions of the Income Tax Act when properly interpreted.¹²⁸ In the case of transfer pricing, SARS Practice Note No. 7 sets out the circumstances where the commissioner will regard a price as an arm's length based on internationally accepted principles. On this basis there is argument that this particular practice note would carry more weight in a court of law than other practice notes hence taxpayers can hold SARS to its representations in the practice note.

In this regard the proposed avenues for such argument are the administrative law doctrine of 'estoppel' and the doctrine of 'legitimate expectation'. A brief examination of case law that deals with application of these doctrines and how they may impact SARS being held accountable for its representations in Practice Note 7 would serve as good illustrations in resolving this issue.

3.9.2 Doctrine of estoppel

According to the doctrine of estoppel, an administrative authority, is precluded or estopped from denying the truth of a representation previously made by such a body to another party if the former, believing in the truth of the representation, acted thereon to the party's prejudice.¹²⁹ In our circumstance, the question is whether SARS in its Practice Note No. 7 presentations can be held accountable for such presentations when a tax payer acts in good faith and in line with the practice notes but ends up being prejudiced thereof through an adjustment.

In *ITC 1675 (1998) 62 SATC 219 (G)* the appellant sought to deduct the accumulated interest paid by him in respect of a loan which he had taken out in order to finance an investment. SARS had issued a practice note number 31 of October 1994 in which it stated that it was its practice to allow expenditure incurred in the production of interest to the extent that it does not exceed such income. The practice note in par 2 indicated that,

¹²⁸ *ITC 1675 62 SATC 219* at 227 D

¹²⁹ Baxter, L *Administrative Law* (1984) at 400

...Although, strictly in terms of the law, there is no justification for the deduction, this practice has developed over the years and will be followed by Inland Revenue...

The court found that the application of the estoppel principle cannot be upheld if the effect would be the validation of an *ultra vires* act. Hence, SARS could clearly not be held to this practice note.¹³⁰ The decision suggests that on the given circumstances the plea of estoppel could not apply where the SARS practice note provisions a taxpayer relied on were *ultra vires*.

Despite this, the courts have widened the scope of the application of the doctrine. In *Eastern Metropolitan Substructure v Peter Klein Investments (Pty) Ltd* 2001 (4) SA 661 (W), the court considered Section 39(2) of the Constitution which reads that;

When interpreting any legislation, and when developing the common law or customary law, every court, tribunal or forum must promote the spirit, purport and objects of the Bill of Rights.

The court then held that the common law rule that estoppel cannot be raised to prevent or excuse the performance of a statutory duty or discretion, should be developed in line with section 39(2) of the Constitution of the Republic of South Africa 108 of 1996.¹³¹ The court was of the view that the doctrine of estoppel on its own does not infringe any provision of the Bill of Rights, and is in conformity with the doctrine of legality implied in the Constitution. However, the court found that blanket application of the rule may in certain instances run counter to a fundamental rights provision or values which underpin our Constitution.¹³²

The court further held that the common law should be developed to emphasise the equitable nature of estoppel and its function as a rule allocating the incidence of loss. The court concluded that the proper approach is for the Court to balance the individual and public interests at stake and decide whether the operation of estoppel should be allowed in a specific case.¹³³ It follows that the courts will deal with a matter where a taxpayer relies on this doctrine to holding the commissioner to the provisions of SARS Practice Note No. 7 by balancing the taxpayer's individual interest and that of the public. Emphasis will be on the proper

¹³⁰ At 229 B

¹³¹ At par 32

¹³² At par 34

¹³³ At par 53-55

collection of tax by SARS as empowered by the Income Tax Act as compared to the taxpayer's objective to pay minimum taxes. The court will therefore seek to ensure that the application of the doctrine is not violated if the effect of its application will be *ultra vires* the provisions of the income Tax Act.

Overall, the approach taken by the court in *South African Railways and Harbours v Transvaal Consolidated Land and Exploration Co Ltd* 1961 (2) SA 467 (A) should be given consideration when dealing with estoppel in the legitimacy of SARS Practice Note No. 7 provisions. Although dealing with another matter, the principle set by the court serves as a good approach which answers the question whether and in what circumstances SARS should be held to representations made by it to members of the public and individual members. The court dealt with a notice of expropriation on acceptance constituting a voluntary agreement for compensation under the Transvaal ordinance 20 of 1903. The principle set by the court is that

*...an executive authority cannot renounce a peremptory statutory obligation imposed upon it by the legislature for the conservation of public monies.*¹³⁴

It therefore follows that if this view was to be followed, the plea of estoppel will not succeed where the provisions of SARS practice notes renounce the statutory obligations imposed by the Income Tax Act which is to collect Tax.

3.9.3 Doctrine of legitimate expectation

Another argument that a taxpayer may raise to hold SARS to its practice notes is the doctrine of legitimate expectation. The courts seem to be reluctant to enforce the protection of substantive legitimate expectations for tax purposes, but they recognize that the principle needs to be developed. The question that needs to be addressed in this context is whether or not the doctrine of legitimate expectation will provide any kind of relief for a taxpayer when he relies on the provisions of SARS Practice Note No. 7 to select a transfer price which is later by SARS rejected as not being at arm's length.

The doctrine of legitimate expectation is entrenched in s 33(1) and (2) of the Constitution read with s 23(2) (b) of the sixth schedule thereto. For transfer pricing

¹³⁴ at 481 C

purposes, a taxpayer would need to identify the grounds on which the courts will give protection on the grounds of legitimate expectations where the taxpayer relies on SARS practice note number 7 provisions.¹³⁵

Our courts have had the opportunities to deal with issues pertaining to the doctrine of legitimate expectation. The court in *Administrator Transvaal and Others v Traub and Others 1989 (4) SA 731 (A)*, approved the doctrine of legitimate expectation by finding it necessary to extend the scope of judicial review to include cases of legitimate expectation.¹³⁶

It follows that in transfer pricing a taxpayer could have an expectation that if by following SARS Practice Note No.7 guidelines in good faith when determining a transfer price; adjustments of the taxpayers price by commissioner will not occur. The question would be whether the taxpayer can actually hold SARS to the provisions of the practice note.

Useful direction can be drawn from cases that considered the doctrine of Legitimate Expectation. Corbett CJ, in *Administrator, Transvaal and Others v Traub and Others (1989(4) SA 731(A))* found that there are two instances in which the Doctrine can be relied. Firstly, where someone has an expectation of a privilege or benefit of which it would not be fair to deprive him or her without a fair hearing.¹³⁷ Secondly, where the previous conduct of an official has given rise to the expectation that a particular procedure will be followed before a decision is made.¹³⁸

In this respect, Davis J, in *ITC 1682 (62 SATC 380)*, stated that there is merit in recognising the doctrine where the taxpayer applies principles in given circumstances that are similar in nature and where equivocal statement appears in the respondents (SARS) own practice manual.¹³⁹ Further more Davis J stated that, the doctrine will only apply if there is:

...A specific representation addressed to a particular individual which may

¹³⁵ Saber Ahmed Jazbhay 'Legitimate Expectation' (2004) *Derebus*

¹³⁶ At 761 D

¹³⁷ At 758 F

¹³⁸ At 758 F

¹³⁹ ITC 1682 (62 SATC 380) at 403 F

take the form of a letter or another considered assurance or undertaking and to be binding the representation must fulfil the following conditions:

- a) the representation must be based upon full disclosure;*
- b) the representation must be made by a person with actual or ostensible authority to make the representation;*
- c) the representation must be 'clear and unambiguous and devoid of relevant qualification.'¹⁴⁰*

Davis J then concluded that the taxpayer in this case did not meet any of these requirements. Further amongst other reasons that the taxpayer did not discharge the burden of proof imposed by section 82 of the Income Tax Act to establish a representation sufficient to create a legitimate expectation. Consequently, the taxpayer could not rely on the doctrine as a ground of objection to the revised assessments.¹⁴¹

In *ITC 1751 2002(65 SATC 294)* the issue was whether the tax payer had a legitimate expectation based on agreements reached between the parties and the commissioners conduct. Although the court found that it was not necessary to decide the matter on the basis of legitimate expectation, it found that there was substantial merit in the appellant's contention regarding substantive legitimate expectation.

The court noted that; the commissioner was not entitled to simply change his mind where there was no factual justification for the change, by making assumptions that could not be sustained after a vigorous examination of the facts before the court. Further that,

...the doctrine of fairness suggest that unless the commissioner has given an undertaking which is mistaken on the basis of law, he should be obliged, where he took the initial decision after he had applied his mind carefully to the issuing of the letter to the taxpayer, to follow that ruling.¹⁴²

It follows that taxpayers will need substantial, merit before the court can consider their contention on the grounds of legitimate expectation. It is clear that the circumstances of each case will play a pivotal role for the court to consider the doctrine.

¹⁴⁰ Smith, Woolf and Jowell *Judicial Review of Administrative Action* at 57 in *ITC 1682 (62 SATC 380)* at 402 F

¹⁴¹ at 404

¹⁴² At 303 par I to 304 A-G

In *COT v Astra Holdings (Private) Ltd t/a Puzey & Payne 66 SATC, 2003 (ZS)*, on a question whether or not the principle of legitimate expectation is applicable to a decision of a public body, the court found this depends upon the particular legislation in terms of which the decision was taken. In this case the legislation in question required that sales tax be charged and collected by the motor dealer on all motor vehicles sold by him locally. The court held that legitimate expectation created in taxpayer as a motor dealer would be that the taxpayer should be taxed according to the law and therefore legitimate expectation could not arise out of an error of law to the effect that a tax which is due to Revenue should be collected.¹⁴³

It is however conceivable for a tax payer to succeed in a pleading legitimate expectation in reference to SARS Practice Note No.7. However, the cases sound a warning to taxpayers that although the courts recognize the principle of legitimate expectation in relation to holding SARS to its practice notes there is reluctance to uphold the principle in the taxpayers favour. The overriding factor is that the taxpayer must ensure that he is not relying on a provision of SARS Practice Note No. 7 that is an error of law that or that has an effect of the revenue not collecting tax as empowered by the Income Tax Act. Further the requirements mentioned above in *ITC 1682 (62 SATC 380)*¹⁴⁴ should be present for the taxpayers' plea to succeed.

3.10 SARS Practice Note No. 7 transfer pricing guidelines

As already mentioned the practice note is fundamentally based on the OECD transfer pricing guidelines and enshrines the internationally accepted arms length principle. The enquiry that will follow is the extent to which the practice note is in line with the OECD guidelines in its guidance for the application of the arm's length principle.

The practice note in par 4.3 provides for the circumstances under which the commissioner may exercise his discretion in relation to cross-border transactions.¹⁴⁵ These are:

¹⁴³ At 92 E-H

¹⁴⁴ At 402

¹⁴⁵ s 3(4) Income Tax Act 58 of 1962

- (i) where the acquirer of the goods or services is a connected person in relation to the supplier of those goods or services¹⁴⁶ and
- (ii) where the goods or services are supplied at a price other than the arm's length price.¹⁴⁷

The price could either be greater or less than the arm's length price. The transactions in question may involve interest free loans or guarantees, services (management fees, admin fees and technical fees), royalties or license fees and the transfer of goods in or out of South Africa.¹⁴⁸ The transaction should have the substantive financial characteristics of a transaction between independent parties, with each party aspiring at getting maximum benefit from the transaction.

The practice note concurs with the OECD view that the determination of an arm's length consideration is not an exact science.¹⁴⁹ As a result, the practice note advises the taxpayers and the commissioner to approach each case, having due regard for the unique business and market realities applicable to each individual case. This particular notion is what has made transfer pricing rather complex. This is because of the current economic environment is very dynamic and as noted in chapter II many factors come into play when a taxpayer determines a transfer price. Hence, is experts sin the field and novices agree with a genius like Albert Einstein when he said that preparing tax return is too difficult even for a mathematician.¹⁵⁰

The complexity is evident in the broad guidelines provided by the practice note in par 7.7 about the business and economic concepts which serve to indicate what information, data and other evidence that would support a contention that a transaction has occurred at arm's length. The implication is that the arm's length price does not necessarily constitute a single price, but a range of prices and the facts of each case will determine where and within what range, a specific arm's length price will lie.¹⁵¹

¹⁴⁶ SARS Practice Note No. 7 Par 4.3.1

¹⁴⁷ SARS Practice Note No. 7 Par 4.3.2

¹⁴⁸ SARS Practice Note No. 7 Par 7.1

¹⁴⁹ SARS Practice Note No. 7 Par 7.6

¹⁵⁰ *Famous quotes* available at <http://www.famous-quote.net/quotes-taxes.shtml> [accessed 15 August 2007]

¹⁵¹ SARS Practice Note No. 7 Par 7.7

The challenging aspect is how to arrive at the actual arm's length transfer price where associated enterprises carry transactions amongst its members in which various market, economic and geographical factors are be present. The practice note accepts that the methods of applying the arm's length principle documented by the OECD guidelines should apply. Therefore, a comparable transaction between independent parties (an uncontrolled transaction) should be used as a benchmark against which to evaluate the transfer prices between MNEs (the controlled transaction). It follows that where there is a difference between the two transactions the price should be adjusted to show an arm's length price which reflects the economic contribution made by the parties to the controlled transaction.¹⁵²

The practice note goes further to advice taxpayers to support their arm's length prices by applying more than one method.¹⁵³ SARS support for this view is that there are conceptual links between each of the transfer pricing methods and likewise a general consistency between transfer prices determined under each of the methods.¹⁵⁴ In addition such transfer pricing practices are considered more credible if supported by analyses under one or more secondary methods. However, the practice note acknowledges that this could be significantly burdensome on taxpayers. Although not explicit this seems to be an agreement with the OECD guidelines that the commissioner does not as a rule require the application of more than one method.¹⁵⁵ It is however questionable whether the practice note actually concurs with the OECD on this view. This paper considers this question in the section dealing with shortcomings of the practice note below.

3.11 SARS guidance to the application of the arm's length principle

Just like the OECD guidelines, the Income Tax Act does not define the term arm's length. However, section 31 (2) of the Act provides a mechanism by which the commissioner adopts the internationally accepted arm's length principle for taxation purposes as the basis for ensuring that the SARS receive and fairly collects a fair share of tax.

¹⁵² SARS Practice Note No. 7 Para 7.3

¹⁵³ SARS Practice Note No. 7 Para 11.6.4

¹⁵⁴ SARS Practice Note No. 7 Para 11.6.2

¹⁵⁵ OECD transfer Pricing Guidelines chap I par 1.69

The practice note identifies the considerations for a tax authority to take into account when determining the arm's length principle proposed by the OECD guidelines discussed in chapter II. The practice note is therefore inline with the OECD guidelines in this respect. In addition to these, the practice note addresses other practical considerations that must be considered. Some of the important practical considerations are addressed below.

The practice note recognizes that there may be difficulties encountered in obtaining information on uncontrolled transactions in South Africa. In such instances the practice note provides that the commissioner may accept foreign comparables in taxpayers transfer pricing analyses but an assessment of expected geographical differences and other factor must be made¹⁵⁶ The Examples given in par 11.2.2 are;

- a) *Consumer preferences may result in different retail prices for a product in the two countries. This raises the question of which party to the transaction should capture any premium in price.*
- b) *Higher transport costs may be associated with one of the markets. The relative gross margins may be affected by who bears this cost.*
- c) *The relative competitiveness of the distribution industries in South Africa and the United Kingdom may differ. This could result in lower gross margins being paid in the more competitive market.*
- d) *There may be differences in accounting standards that, if not adjusted for, could distort the relative margins of the parties being compared¹⁵⁷*

It should be noted that while foreign comparables may be useful, caution needs to be exercised to ensure that appropriate adjustments reflect differences between the South African and foreign markets.

Another practical consideration is the determination of the party to be evaluated in a controlled transaction. The practice note provides that from a South African perspective, the basis for determining and applying an appropriate pricing method should focus primarily on functions performed by the South African member. The commissioner would therefore generally prefer using the South African party as the party to be evaluated. A practical approach by the taxpayer is essential for a practical solution that provides a dependable determination of an arm's length price.¹⁵⁸

¹⁵⁶ SARS Practice Note No. 7 par 11.2.1

¹⁵⁷ SARS Practice Note No.7 par 11.2.2

¹⁵⁸ SARS Practice Note No 7 Pars 11.3.1-11.3.4

Pars 11.7.1 to 11.7.4 provide that the determination of an arm's length price should not deal with immaterial differences. It is proposed that a functional analysis should be done whose purpose is to understand the nature of the functions, assets and risks, for an easy comparison with other enterprises with similar functions, assets and risks. Accordingly, assigning actual income to specific functions, assets and risks may lead to needless difficulty in analysis. In that sense some factors that cannot be quantified may need to be addressed indirectly instead.

It is also noted that the mere fact that certain arrangements are common between members of a multinational, is not an indication that the arrangement was at arm's length. Similar arrangements by independent companies under similar circumstances must be considered must be compared with the one in question. Where independent parties would not enter into such an arrangement will show that the arrangement was not made at an arm's length.¹⁵⁹

Pars 11.13.2 to 11.14.2 address the issues of real bargaining and provide that in such cases the bargaining conditions must be similar to those of independent parties dealing at arms length. Lack of such conditions is a clear indication that the bargaining was not at arm's length.

Par 11.15.1 provides that events occurring after a taxpayer has selected its prices would not affect the determination of already selected transfer prices. The exception is if the events could be reasonably predicted at the time those prices were set.¹⁶⁰ Further that looking at retrospective events is inconsistent with the arm's length principle in setting or reviewing a transfer price.

Par 11.8 provides that for purposes of South Africa residents making loans to non-residents at no interest and at no agreed repayment conditions, the commissioner may adjust the consideration in respect of the granting of financial assistance. The commissioner takes into account the following;

- (i) the amount of income of the non-resident which is taxed in the South Africa in terms of the provisions of Section 9D of the Income Tax Act,

¹⁵⁹ SARS Practice Note No 7 at Para 11.13.2

¹⁶⁰ SARS Practice Note No 7 at par 11.15.1

- (ii) the impact of the transaction on the tax base of any of the taxes imposed under any of the Acts,
- (iii) the business activities of the non-resident and
- (iv) the ruling interest rates in South Africa as well as the country of residence of the non-resident that borrowed the funds.

From the above mentioned considerations, the impact of section 9 D requires more elaboration. The section deals with taxation of controlled foreign companies (CFC). For transfer pricing purposes, section 31 applies to a CFC when calculating its net income as per the specific provisions referring to transfer pricing in section 9D (2A) (c) (i) of the Income Tax Act. The taxable income for this purpose is the net income. It includes capital gains tax (CGT) but excludes secondary tax on Companies (STC) and donations tax.

CGT is specifically included into taxable income by section 26A of the Income Tax Act. Section 26A provides that for transfer pricing purposes transactions, operations, or schemes entered into between a CFC and a person connected to the CFC are deemed to be an international agreement and the CFC is deemed to be a resident. The result is that an agreement entered into between a CFC and a person who is not a South African resident, but a connected person in relation to the CFC is subject to transfer pricing.

Further, an international agreement entered into by a CFC and its South African resident shareholder is also subject to transfer pricing from the point of view of calculating the taxable income of the CFC as well as of the South African resident share holder. The transfer pricing provisions apply irrespective of whether the transaction is entered into between a CFC which is a business establishment with fully fledged operations outside South Africa and another CFC which is also a business establishment with similar substance. SARS may override transfer pricing and thin capitalization provisions imposed by jurisdictions where such CFCs are incorporated or resident.¹⁶¹

¹⁶¹ Oliver L, op cit 11 at 246

3.12 SARS transfer pricing review process and approach

It is important for the taxpayer to be fully aware of SARS transfer pricing review process so as to avoid the taxpayer's selected prices from being subject to adjustment. When examining a transfer price SARS will review the relevant global and local industry and how the business of the relevant group companies being tested are conducted. The global group structure is analyzed and recorded and thereafter functional and risk analyses are conducted. Included is a global functional analysis of the industry in question. This is in line with the OECD guidelines that advocate for a comparability analysis.

The practice note in Annexure A sets out SARS views on the role and characteristics of a functional analysis; it requires that an outline of the multinational's operations and group structure be part of such analysis. The risk analysis involves risk profiling by the SARS transfer pricing unit.

SARS considers whether there is substance over form concerning the taxpayer that provides its transfer price.¹⁶² The questions addressed are whether there is substance to the offshore entities or whether they are post box companies, that is are, there premises, equipment or employees in the offshore companies. SARS then determines whether the offshore company is a residence in a South African context and the source or deemed source of the income. The rationale here is to establish if section 9D applies especially in transactions invoicing loans issued amongst the associated enterprises. Once the above have been established, SARS then will determine the applicability of the section 31 general anti-avoidance provision in terms of transfer pricing.

The transfer pricing risk analysis is tested in two ways, firstly where no contemporaneous documentation is provided SARS requests for such documentation. Secondly, the testing of contemporaneous documentation information provided. The procedure is provided in parts 12.1 to 12.6. The tests are done through desk audits procedures by SARS transfer pricing unit through a database called 'Amadeus' used

¹⁶² Roxanna Nyiri, 'Examining Inter-company Cross border Transactions' Available at https://www.saica.co.za/documents/SAICA_Transfer_Pricing_Presentation.pdf [accessed 14 August 2007]

to conduct comparable searches. SARS also uses audit programs for different industry segments and transactions.¹⁶³ Further, field audits using audit methodologies may follow with an emphasis on the functional and risk analyses. Depending on the circumstances, further investigation may be required.

Having completed the risk analysis, the most appropriate method of determining an arm's length price is then selected based on the specific functions and risks relevant to the circumstances. A quantitative screening is then undertaken to determine relevant comparable companies for a pricing analysis, including a record of each of the search process and a determination of the relevant comparable pricing range. Depending on the outcome, SARS may or may not raise a transfer pricing adjustment.

Where an adjustment is raised, it may be applied retrospectively depending on whether; prescription is applicable, fraud was involved in determining a transfer price by the taxpayer, or where the taxpayer misrepresented or did not disclose important information. The taxpayer may find itself liable for penalties or interest depending on the circumstances of the case.

Furthermore, where SARS raises a transfer pricing adjustment a letter of intent allowing the taxpayer to comment is required. Once a transfer pricing adjustment has been made following an assessment, there is a dispute resolution process available to the taxpayer to raise an objection. It is called the alternate dispute resolution process (ADR) done through the ADR1 form. This process concurs with the OECD view that proposes for administrative approaches which aim at settling disputes between tax authorities and taxpayers.

If the commissioner disallows the objection, the tax payer may appeal through the Notice of appeal ADR 2 form. The notice of appeal request must reach the Commissioner within thirty days of disallowance of objection. The Commissioner

¹⁶³ Amadeus database: Pan European database containing financial information on 1.1 million companies. There is currently a lack of publicly available information regarding independent South African companies. SARS accepts the use of foreign country comparables in the transfer pricing analysis.

has discretion to accept or reject the appeal but must let the taxpayer know within twenty days. Where the appeal is accepted a facilitator is appointed and his or her objective is to seek that the taxpayer and the Commissioner reach a fair, equitable and legal resolution of the dispute. However, the facilitator cannot make a ruling or decision that binds the commissioner or the taxpayer, nor compel either party to settle the dispute. On conclusion of the process, the facilitator will record the terms of any agreement reached by the parties. In case of a failure to reach agreement the facilitator delivers a report to both parties in ten days. Most transfer pricing disputes are settled by ADR.

In summary the functional analysis identifies the function performed by each member of the multinational group and assesses the relative importance of each function to the overall operations of the multinational. The practice note in a functional analysis utilizes the same factors considered by the OECD guidelines in determining comparability. The practice note in Annexure A lists the risk reviewed as follows:

- (i) Market risks
- (ii) Financial risks
- (iii) Credit and collection risks
- (iv) Product or manufacturing liability risks
- (v) Risk related to the success or failure of research and development activities
- (vi) Business risk related to ownership of assets or facilities and,

These procedures are documented in a transfer pricing policy document, including reasons why specific arm's length pricing methods were rejected and reasons why certain prices are regarded as not comparable.

Overall, Annexure A adopts the OECD guidelines on what information would be relevant to a functional analysis and examples of relevant functions and discusses the relative contribution of various functions and the treatment of risk. However, while not specifically stated, when read with Annexure B which outlines the four-step approach, it would appear that most of the functional analysis needs to be documented by the taxpayer.

3.12.1 SARS four-step approach

A summary of the four-step approach contained in Annexure B of SARS practice note no. 7 and was designed by the Australian Tax Office (Taxation Ruling 98/11, Chapter 5).

- (i) The first step seeks an understanding of the cross border dealings between connected parties in the context of the business.
- (ii) The second step entails selecting the pricing method or methods.
- (iii) The third step entails applying the pricing method or methods and
- (iv) The fourth step entails arriving at an arm's length amount and includes support for the selected method.

SARS found the approach suitable for compiling a transfer pricing report for South Africa; hence the approach would not necessarily be a suitable process to adopt in compiling a global transfer pricing report. The taxpayer should therefore take caution when compiling global transfer pricing, hence should follow the OECD guidelines in this respect.

The SARS Practice Note no. 7 acknowledges that neither section 31 nor any tax treaty entered into by South Africa prescribes any particular methodology for the purposes of ascertaining an arm's length consideration. It allows the taxpayer to use any one of the principle methods referred to in the OECD guidelines, as discussed in chapter two above¹⁶⁴ The choice of a method is based on a practical weighting of the evidence, having regard to:

- (i) the nature of the activities being examined,
- (ii) the availability, quality and reliability of the data,
- (iii) the nature and extent of any assumptions, and
- (iv) the degree of comparability that exists between the controlled and uncontrolled transactions where the difference would affect conditions in the arm's length dealings being examined.

As noted in chapter II the principle of comparability is fundamental to the application of the arm's length principle internationally and likewise in the South

¹⁶⁴ SARS Practice Note No. 7 Par 9.2.2

Africa.¹⁶⁵ Hence, the practice note advises the taxpayers to always seek the highest practical degree of comparability while still recognizing the unique situation.¹⁶⁶

The practice note provides that in cases where there are no comparables or insufficient information to determine an arm's length outcome, the method selected should produce a reasonable estimate of an arm's length outcome based on the facts in hand.¹⁶⁷ The practice note agrees with the OECD view that comparable data may have to be adjusted to more accurately match the circumstances and risk profile of the tested taxpayer.

As a general rule, the most reliable method will be the one that requires fewer and more reliable adjustments to be made.¹⁶⁸ Therefore the taxpayer is not expected to carry out an elaborate analysis of all the methodologies. What is required is a good basis for using the selected methodology coupled with reasons why secondary methods were not appropriate.¹⁶⁹ It follows that the most appropriate method will depend on the particular circumstances available and the reliability of data.

Although, the practice note requires accurate matches, there is acknowledgement that there is a deficiency of freely available financial information concerning private companies in South Africa. Subsequently, SARS has indicated that it will accept the use of foreign financial databases on condition that the comparables are adjusted for the South African market.¹⁷⁰ The practice note also recognises unique situations and cases involving unique intangibles where it is not practicable to apply methods based on a high degree of direct comparability.¹⁷¹

On the issue of selecting a method, par 9.3.1 of the practice note, provides that section 31 does not impose a hierarchy for the transfer pricing methods. The reason being that certain methods may provide a more reliable result than others and

¹⁶⁵ SARS Practice Note No. 7 par 8.11

¹⁶⁶ SARS Practice Note No. 7 par 8.1.4

¹⁶⁷ SARS Practice Note No. 7 par 9.2.2

¹⁶⁸ SARS Practice Note No. 7 par 9.1.6

¹⁶⁹ SARS Practice Note No. 7 par 9.1.6

¹⁷⁰ Rolfe (Ed) *International Transfer Pricing* 2003/2004 PricewaterhouseCoopers Par 4309

¹⁷¹ SARS Practice Note No.7 par 8.1.4

that a preferred method highly depends on the quality of available data and the taxpayer's circumstances.

The practice note as a general rule accepts the OECD guidelines' view that the traditional transaction methods are preferred. First is the CUP method which looks directly to the product or service transferred and was noted in chapter II it is relatively insensitive to the specific functions which are performed by the entities being compared. Second are the RP and CP methods which look at valuing the functions performed. These methods examine gross margins hence, operating expenses are excluded and the impact of relative cost structures are material.¹⁷²

Notwithstanding this, the practice note acknowledges that there are instances where the traditional transactional methods are not applicable mainly due to information constraints. This is particularly due to the lack of comparable uncontrolled transactions or published data on gross margins. Therefore, there is need to resort to the transactional profits methods.¹⁷³ In this regard, the practice note proposes that the transactional net margin method (TNMM) or the profit split (PS) could apply. The TNMM is reasonably objective because comparables are applied and varying levels of operating expenses will be incorporated into the calculations.¹⁷⁴ In theory the TNMM methods is inferior to the RP or CP methods where sufficient information is available to apply all three methods, because comparing operating expenses requires a similar structure of business to be truly reliable.

In summary, the practice note has satisfactorily adopted the OECD guidelines on the application of the arm's length principle and the methodology of selecting a transfer price. This has been done in a manner that is relevant to the South African economic situations. However, the challenge of applying the methodology as shown below is their application within a domestic context especially when it comes to the documentation process.

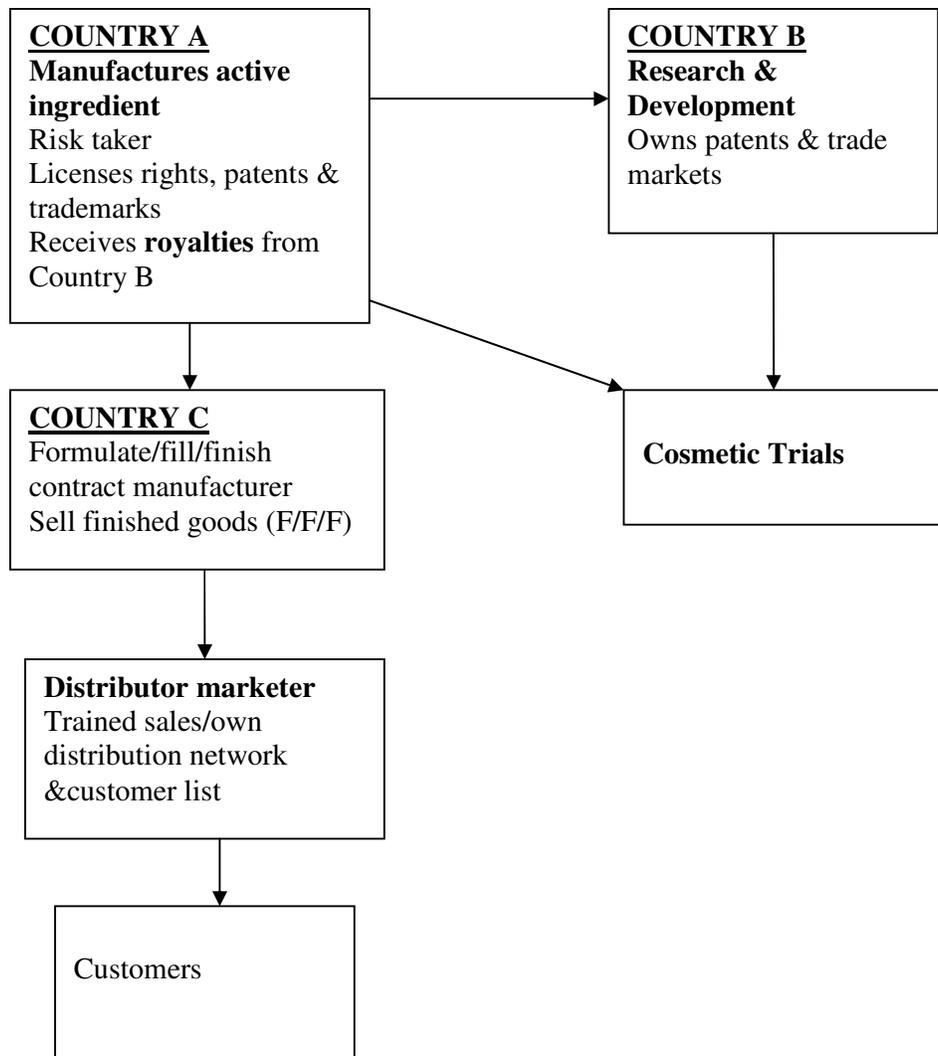
¹⁷² SARS Practice Note No. 7 par 9.3.5

¹⁷³ SARS Practice Note No. 7 par 9.3.6

¹⁷⁴ SARS Practice Note No. 7 par 9.3.7

3.12.2 Hypothetical illustration of SARS review process: Cosmetic MNE dealing with tangibles and intangibles

The flow chart below gives an outline of transactions between a cosmetic MNE dealing with. The MNE groups are situated in Countries A, B and C.



Adopted from: Roxanna Nyiri, 'Examining Inter-company Cross border Transactions'

Available at

https://www.saica.co.za/documents/SAICA_Transfer_Pricing_Presentation.pdf

[accessed 14 August 2007]

Implications for consideration in the cosmetic industry MNE include; evidence of significant MNE trade, evidence of wide range of transactions, tangible and intangible goods, intra-group services, potential involvement of a number of revenue administrations, range of potential transfer pricing issues between tax jurisdictions, documentation requirements and the differences in approach by different tax authorities as well as MNE.

SARS in assessing the taxpayers' selected prices:

- (i) Identifies cross border dealings between the cosmetic MNE.
 - Done in the context of the cosmetic industry
 - Involves identifying commodities the group trades in, i.e., tangible goods (finished and semi-finished), transfers of intangible property and intra-group services.

- (ii) A functional and risk analysis follows.
 - Aim is to assist in identifying the pricing method that can be used.
 - Global functional analysis is also essential to identify the cosmetic industry value chain that comprises several steps as illustrated in the diagram above.
 - Global functional analysis does not involve the ownership of process or product-related intangibles.
 - Functional and risk analysis; identifies the legal entities, their location, economically significant transactions and activities, inter-company license agreements, and the intangibles.
 - key questions addressed :
 - (i) What is done by which entity in the value chain?
 - (ii) What risks are borne by which entity in the value chain?
 - (iii) What intangibles exist and how important are they?
 - (iv) What is the form of the intra-group service?
 - SARS expected result;
 - (i) Understand the value chain hence perform functional and risk analysis
 - (ii) Identify the intangibles

- (iii) Clarify ownership of intangibles, hence establish; the economically significant activities and the transfer pricing issues.

The importance of establishing the risk borne by which entity in the value chain is important, because improper risk analysis may lead revenue authorities on assessment to find selected price not to be at arm's length. An example is *Westreco Inc v Comr 64 TMC (CCH) 849(1992)*.¹⁷⁵ In this case, WESTRECO USA was a US subsidiary of a holding company NESTEC resident in Switzerland. WESTRECO provided NESTEC Research and Development services. The bulk of the risk of research and development was borne by NESTEC. The costs were determined by direct and indirect plus a mark-up price. These included a 7.5% of first USD 350 000, 5% of the next USD 1,150,000 and 3.5% thereafter. The revenue authority found the mark-up prices to be unreasonable and not at arms' length. The court held in favour of taxpayer because the risk borne by NESTEC for research and development was unsuccessful. Further, the rights stemming from the research and development lay with NESTEC. The comparable research and development service companies had higher margins with the risk level being greater than WESTRECO. Hence, the mark-up adopted by taxpayer was found to be reasonable.¹⁷⁶

- (iii) SARS selects the appropriate transfer pricing method.
- Process of characterization of the dealings is important.
 - Method selected and applied varies depending on whether the taxpayer in question is; a fully-fledged manufacturer, service provider for example; contract manufacturer, distributor-marketer, distributor or sales agent.
 - the appropriate method to select and apply either the traditional transactional methods or transactional profit method

¹⁷⁵ Adopted from: Roxanna Nyiri, 'Examining Inter-company Cross border Transactions' Available at https://www.saica.co.za/documents/SAICA_Transfer_Pricing_Presentation.pdf [accessed 14 August 2007]

¹⁷⁶ Roxanna Nyiri, 'Examining Inter-company Cross border Transactions' Available at https://www.saica.co.za/documents/SAICA_Transfer_Pricing_Presentation.pdf [accessed 14 August 2007]

- The CUP method compares the price charged in a controlled transaction with price charged in an uncontrolled transaction.
- The RP method tests arm's length outcomes with reference to the gross profit margin observed in a comparable uncontrolled transaction
- CP method tests arm's length outcomes with reference to the profit markup on 'value adding costs'.
- As for transactional profit methods, profit split method compares the division of profits that would have occurred if the parties were at arm's length. The Transactional net margin compares the net margin the taxpayer established with reference to uncontrolled net margin outcomes.

(iv) Challenging part is how to do the pricing actual pricing.

- Starting point should be the distributor; the rationale is to value the simpler bits first.¹⁷⁷
- The distributor's rate of return and the marketing function is made which will ordinarily be in the percentages of net sales.
- Next establish the F/F/F rate of return the residual going to the owner of the any of the intangible.¹⁷⁸
- To determine arm's length concerning royalties one has to look at the industry literature. CUP will focus on residual profit split. A comparable profit split, the market approach, cost approach and a regression analysis, follows.

3.13 SARS transfer pricing documentation and reporting

Thus far, it is evident that transfer pricing is complex and involves multiple international transactions methodologies and comparisons. This is amplified further by the preparation of transfer pricing documentation. Transfer Pricing documentation and reporting can be time consuming and expensive for the tax payer.

¹⁷⁷ Roxanna Nyiri, 'Examining Inter-company Cross border Transactions' Available at https://www.saica.co.za/documents/SAICA_Transfer_Pricing_Presentation.pdf [accessed 14 August 2007]

¹⁷⁸ Roxanna Nyiri, 'Examining Inter-company Cross border Transactions' Available at https://www.saica.co.za/documents/SAICA_Transfer_Pricing_Presentation.pdf [accessed 14 August 2007]

This is because the documentation not only indicates *prima facie* compliance to tax authorities, but may also discharge the taxpayer's burden of proof in litigation circumstances. Bearing this in mind, the practice note in paragraph 10.2.6 indicates that;

...it will not be expected of the taxpayer to go to such lengths that the compliance costs related to the preparation of the documentation are disproportionate to the nature, scope and complexity of the international agreement entered into by taxpayers with connected persons.

This is a general agreement with the OECD view on the same matter. However SARS does not give further guidance in this regard but it has been suggested that it could make use of tax treaty provisions that permit information exchanges between contracting states to determine consistency of pricing. This would save costs on the tax payer's hands.¹⁷⁹

3.13.1 SARS general documentation and reporting requirements

Par 10 of the practice note sets out the general disclosure and documentation provisions which are contained in the Income Tax Act and states that these provisions are also applicable to transfer pricing investigations.¹⁸⁰ Section 69 requires the commissioner to request for information. Furthermore, the power to access information by SARS is contained in Sections 74 to 74D. Par 10 of the practice note advises based that there is no explicit statutory requirement to prepare and maintain transfer pricing documentation. This is in agreement with the OECD guidelines. However a taxpayer must bear in mind that a request for documentation in terms of section 65 of the income Tax Act is a statutory requirement. In this regard it seems that there is deviation from the OECD guidelines.

Comprehensive documentation guidelines are provided in par 10.3, which sets out the factors that should be considered by tax payers in determining the appropriate level of documentation for their specific circumstances. The documentation guidelines are based on the Chapter V of the OECD Guidelines.

The documentation of policies and procedure for the determination of arm's length prices is likely to cause the commissioner to conclude that a taxpayer's

¹⁷⁹ Ernst & Young 'Transfer Pricing 2001 Global Survey' (2001)17

¹⁸⁰ SARS Practice Note No. 7 par 10.2.4

practices are acceptable and the risk of possible adjustments will be diminished. The Practice Note in this regard states that,

... if a taxpayer can demonstrate that it has developed a sound transfer pricing policy in terms of which transfer prices are determined in accordance with the arm's length principle by documenting the policies and procedures for determining those prices, the Commissioner is more likely to conclude that its transfer pricing practices are acceptable and the risk of possible adjustments will be diminished.¹⁸¹

3.13.2 Other documentation requirements that should be met

The information sought includes the identification of comparable international transactions, copies of the relevant agreements, descriptions of their nature, the terms of the transactions and prices of the transactions. It is important that the method used to arrive at the nature and terms of the transaction should be presented, together with proof that alternatives were considered. Included should be the reasons why a particular choice of the method used and explanations why the method provides an arm's length result. Failure to provide such documentation is a good reason for SARS to examine the taxpayer's transfer pricing in detail.¹⁸² In addition, lack of documentary support may mean that the taxpayer might be incapable of refuting SARS a decision.

Other important requirements include the details of international transactions by group companies for the previous five years and the debtor repayment policies for both connected parties and outsiders must be included. Furthermore, an analysis of turnover and gross profits; details of management fees, licence fees and royalty agreements must be included. Financial information of controlled foreign entities (as defined in section 9D) and details of foreign dividends received should also be included.

3.13.3 Documentation in relation to subsidiaries in tax havens

SARS pays closer attention to transactions involving subsidiaries in tax havens.¹⁸³ SARS seeks to establish whether subsidiaries have permanent establishments in the countries where they are incorporated, where they are managed and controlled, where

¹⁸¹ SARS Practice Note No. 7 par 10.2.5

¹⁸² SARS Practice Note No. 7 par 10.2.2

¹⁸³ SARS Practice Note No. 7 par 12.6

the day to day decisions are made, how many employees they have, and whether the subsidiaries act as agents as opposed to operating for their own profit.

The information required should establish whether such subsidiaries are independent operating entities or merely shells used for manipulating funds transfers. The necessary information in this respect includes details of; contracts, connections with the multinational enterprise, management autonomy and the financial statements for the previous five years. Particular reference will be on gross margins of the sales.¹⁸⁴ Other required details relate to the physical addresses, descriptions of premises and copies of rental agreements. Even such matters as floor plans, staffing and floor space are included in the details required. Furthermore, enquiries relating to the employees of subsidiaries in tax havens are made. The object is to establishing whether the employees genuinely live there or whether they are South African residents who work in the tax havens for short periods to create the impression that the subsidiaries are genuine operating entities. The enquiry also seeks to establish whether the employment is full time or not and the degree of autonomy the employee.¹⁸⁵

3.13.4 Documentation in relation to foreign branches in tax havens

SARS takes more scrutiny on foreign branches in tax havens as opposed to subsidiaries.¹⁸⁶ It requires details of their location and how head office expenses are allocated to them. This information enables SARS to identify the use of common commercial transactions and the internal administrative arrangements engaged in transfer pricing.

In the face of this focus, taxpayers should take urgent steps to ensure that adequate documentation is available. The very fact that the documentation is not

¹⁸⁴‘Transfer pricing: the next SARS target’ July 2002 Available at www.deneysreitz.co.za/news/item/transfer_pricing_the_next_sars_target,44.html - 14k – [accessed July 4 2007]

¹⁸⁵‘Transfer pricing: the next SARS target’ July 2002 Available at www.deneysreitz.co.za/news/item/transfer_pricing_the_next_sars_target,44.html - 14k – [accessed July 4 2007]

¹⁸⁶‘Transfer pricing: the next SARS target’ July 2002 Available at www.deneysreitz.co.za/news/item/transfer_pricing_the_next_sars_target,44.html - 14k – [accessed July 4 2007]

readily accessible in a form that shows that the taxpayer is concerned about transfer pricing will tend to arouse the suspicions of SARS.

3.13.5 Tax returns documentation and disclosure and the relation to transfer pricing

As mentioned above section 65 entitles the commissioner to prescribe that the taxpayer must submit any information necessary for an assessment of tax due. According to the 2001 income tax return form IT 14 read in conjunction with the SARS accompanying brochure IT 14B, SARS requires disclosure of the following information in respect of any cross-border transactions with connected parties:

- (i) names of the contracting parties and relationship with the company
- (ii) details of the basis for determining the prices used
- (iii) details of the prices which would have been used had the transaction been between independent parties dealing at arm's length
- (iv) copies of the agreement between the contracting parties
- (v) a copy of the transfer pricing policy document when SARS specifically requested it to do so.

It is now obligatory to attach a transfer pricing policy document to a company's tax return form. The 2004 IT 14 form in part 15 specifically requires the company to furnish the information stipulated in the accompanying brochure. The public officer of the company is required to make a declaration that all information is attached to the tax return form.

The result is that, the relevant information requested in the accompanying brochure must be submitted together with the company's tax return. However, SARS does not state in the IT 14B what is meant by a transfer pricing policy document or what the contents of the transfer pricing policy document should be.¹⁸⁷

This lack of specification of the contents of the transfer pricing policy document should have is problematic for the taxpayer. This is because not all companies are in a position to obtain all the required information from affiliates. Some taxpayers may argue that in such circumstances they may not have to provide this information. An

¹⁸⁷ For detail see SARS Practice Note No. 7 par 10

illustration of the problem is evident in *Meditor Capital Management Ltd v Feighan (HMIT) [2004] STC (SCD) 273*.¹⁸⁸ In this case Meditor Capital Management (MCM) a UK Subsidiary of its holding company resident in Bermuda provided its holding company services. MCM did not give the revenue authority contemporaneous documentation to support the transfer pricing of the services. MCM however, provided a wealth of information on its profits and risk as well as contractual evidence. The evidence given was not factual. The revenue authority asked for inter alia the nature of activities in Bermuda, role and number of employees and interest in the funds under management. MCM resisted these demands. MCM aimed as a taxpayer to assert its right to limit the revenue authority investigation. MCM argued that the Bermuda activities were irrelevant to MCM liability to tax.

The special commissioner of the revenue authority argued that the provision of services by one party to another is not at arms length if the other party has no use for the services. The special commissioner's view was that an analysis of the functions of the service provider alone would not be sufficient. MCM argued that the information on the activities in the Bermuda Holding company was irrelevant, and that the information request was unreasonable. Further, MCM argued that some of the documents requested were not in its power or possession.

The court ruled in favour of the revenue authority and found that if something might be relevant to the tax liability the revenue authority is entitled to ask for it. The court further held that MCM did not provide contemporaneous documentation that is important for a functional and industry analysis and that. On the issue that the information requested was wide, unreasonable and irrelevant, the court found that the taxpayer had to provide proper factual evidence to demonstrate that it had no power to produce the documents.

In this respect, the lesson is that taxpayers should pay attention to the adequacy of the evidence that the OECD and revenue authority consider relevant. Consequently, the taxpayer must have a clear strategy on the provision of information

¹⁸⁸ Roxanna Nyiri, 'Examining Inter-company Cross border Transactions' Available at https://www.saica.co.za/documents/SAICA_Transfer_Pricing_Presentation.pdf [accessed 14 August 2007]

and on what is going to be relevant. Further, if documents from foreign affiliates are demanded, awareness as to what to provide coupled with the power of possession of such documentation requires a proper understanding of the documentation process.

3.14 NON compliance: Transfer pricing penalties

Before discussing the penalties it is noteworthy that section 31 gives the commissioner the discretion to adjust the consideration in respect of a transaction. Consequently, the burden of proof rests on the taxpayer in terms of par 15.1. The taxpayer in discharging its burden of proof has to

- (i) develop an appropriate transfer pricing policy;
- (ii) determine the arm's length amount, as required by section 31; and
- (iii) voluntarily produce documentation to evidence their analysis.

Furthermore, par 15.2 provides that section 82 of the Income Tax Act places the burden of proof regarding exemptions, non-liability for tax, deductions or set-offs on the taxpayer.

Internationally, there is inconsistency in the approach to transfer pricing penalties. Some countries like the United Kingdom have specific transfer pricing penalties. Others like; India and France have specific transfer pricing adjustment penalties as well as specific penalties for inadequate or late submission of transfer pricing documentation.¹⁸⁹

In most countries however the general income tax penalties apply. South Africa falls in this category. It seems that in South Africa focus is on the actual penalty rather than devising ways that encourage compliance but as was noted by the OECD this is a matter sovereign to each state.

Non compliance in many instances raises a question as to the consequences that may arise when the commissioner does the adjustment and when the tax payer voluntarily does the adjustment. These situations will be addressed below.

¹⁸⁹ Dixon, Ernst & Young, Finney M *International Corporate Tax Planning* (2002)

Section 65 of the Income tax Act provides for a statutory requirement for a tax payer to prepare and maintain transfer pricing documentation. As mentioned above, the documentation includes a transfer pricing policy document which is required to be submitted together with the corporate income tax return form (2004 IT 14 form). Failure to abide by section 65 provisions calls for the penalties found in Sections 75 and 76.

Section 75 (1) (b) (i) calls for a penalty of conviction to a fine or to imprisonment for a period not exceeding 24 months, where, a taxpayer without just cause shown by him, refuses or neglects to furnish, produce or make available any information or documents. The same penalty applies where firstly the taxpayer fails to show in any return prepared or rendered by him on behalf of any other person any portion of the gross income received by or accrued to or in favour of such other person. The taxpayer may also incur increased taxation as provided in section 75 (1) (d) where the taxpayer fails to disclose to the commissioner when preparing or making such return, any facts which, if so disclosed.

Further section, 76 provides that in instances of non compliance; a taxpayer will pay an amount in addition to the tax that would have been charged as regards the taxpayer taxable income. This amount will be double the tax chargeable for that year of assessment if the taxpayer fails to submit a tax return.¹⁹⁰ The double amount would apply if the tax payer made an incorrect statement in any return.¹⁹¹ The amount may also be in respect of the difference between the tax returned by him and the tax properly due if he omits income which should have been included.¹⁹²

A synopsis of Section 76 is therefore that, section 76 (1) (a) and (c) apply to any transfer pricing related to incorrect statement while section 76 (1) (a) could arguably apply if a transfers pricing policy document is not attached to a tax return with the result that the return could be regarded as not having been fully submitted.

¹⁹⁰ Income Tax Act 58 of 1962 s 76 1 (a)

¹⁹¹ Income Tax Act 58 of 1962 s 76 1 (b)

¹⁹² Income Tax Act 58 of 1962 s 76 1 (c)

Indirect penalties could also apply. They include the tax cost arising from the re-characterisation of income. In South Africa the Secondary Tax on Companies (STC) payable when the adjusted amount becomes a deemed dividend is such an indirect penalty.¹⁹³ Generally STC is of relevance to thin capitalization. Section 64 C of the Income Tax Act provides that certain amounts which are distributed in the wider sense are deemed to be dividends for STC purposes. According to section 64C (2) (e) an amount is deemed to have been distributed by a company to a recipient if;

that amount represents additional taxable income or reduced assessed loss of that company by virtue of any transaction with the shareholder or connected person in relation to such a shareholder, the consideration of which is adjusted or any amount of interest, finance charge or other consideration is disallowed as a deduction in accordance with the provisions of section 31;

The definition of a recipient in section 64C (1) is wide and now matches the connected person requirement in section 31.¹⁹⁴ It includes any shareholder of a company or any connected person in relation to a share holder.¹⁹⁵ This deeming provision is an indirect penalty that applies to both section 31 (2) and section 31 (3) thin capitalization allowances. There are no exclusions relevant to transfer pricing deeming provision. The OECD guidelines seem to indicate that it is permitted, but not compulsory to re-characterise as dividends interest that is disallowed under thin capitalization rules.¹⁹⁶

It is necessary to determine whether this deeming provision applies when the taxpayer voluntarily makes an adjustment in terms of section 31 (2). Section 64C (2) (e) provides for a deemed distribution of an amount which has been adjusted or disallowed in accordance with the provisions of section 31 which also provides for the adjustment or disallowance to be made by the commissioner. SARS Practice Note No. 2 provides that the determination of the thin capitalization adjustment is made by the commissioner either on assessment or by notice prior to assessment.¹⁹⁷ It follows that the taxpayer may voluntarily make adjustments.

¹⁹³ Oliver L, op cit 11 at 250-1

¹⁹⁴ Oliver L, op cit 11 at 261

¹⁹⁵ Oliver L, op cit 11 at 261

¹⁹⁶ Oliver L, op cit 11 at 261

¹⁹⁷ SARS Practice Note No. 2 par 9

There is no similar provision relating to transfer pricing in SARS Practice Note No. 7. It is suggested that where the taxpayer has completed his return, having made the adjustment himself, section 31 cannot apply.¹⁹⁸ The section specifically provides that the adjustment or disallowance has to be made by the commissioner. Nonetheless, where the taxpayer has voluntarily furnished information to SARS which results in an adjustment on assessment, it is deemed that it is the commissioner who made the adjustment.¹⁹⁹

There is argument whether the section 64 C would apply to CFCs. As stated above, once the commissioner has made an adjustment as reflected in section 31 the adjusted amount will be deemed to have been distributed by a company to a recipient for purposes of section 64 C. Section 64 C deems certain amounts to be dividends for STC purposes. However, STC is only payable by residents and a CFC is, by definition, generally a non-resident and Section 9D (2A) provides that this is only for purposes of calculation of taxable income, which does not include STC. Consequently, STC will not be paid on adjusted any adjusted amounts for the net income of a CFC.²⁰⁰

As concerns timing of the determination of a transfer price, generally, the commissioner's discretion in terms of section 31 is exercised on assessment.²⁰¹ The date of assessment will as a result be dated when the deemed dividend accrues to the shareholder and consequently will be the date when the dividend cycle ends for STC calculation purposes.²⁰² It should however be noted that although normal provisions for assessment and recovery of income tax apply to STC, there are no specific STC penalty provisions.

Other than the above-mentioned penalties, section 89 bis and 89quat of the Act provide for interest on the underpayment of tax. It follows that these sections will

¹⁹⁸ Oliver L, op cit 11 at261

¹⁹⁹ Oliver L, op cit 11 at261

²⁰⁰ Oliver L, op cit 11 at 262

²⁰¹ Meyerowitz, 'Meyerowitz on Income Tax '(2001/2002) par. 13.33

²⁰² 'dividend cycle' defined in s 64 B (1) Income Tax Act 58 of 1962

also apply if the underpayment of tax results from non-compliance with section 31 of the Act.

3.15 Shortcomings of transfer pricing regulations in a South Africa

Although the adoption of the recommended OECD guidelines by South Africa has brought some clarity to the Transfer Pricing regulatory framework in South Africa, however there are shortcomings. This section will briefly highlight some of these areas.

SARS approach in the selection of a midpoint range especially in the absence of persuasive evidence when determining a transfer price is questionable.²⁰³ This approach deviates from the OECD guidelines and is contradictory to the arms' length principle. This is because to determine the range that relevant prices will fall on depends solely on the facts and circumstances of the particular case.²⁰⁴

SARS advice to convince the commissioner that prices are at arms length by applying more than one method seems is also questionable and it also seems to deviate from the OECD guidelines. The practice note's mere acknowledgement of the OECD guidelines that as a rule the taxpayer is not required to apply more than one method as it would be burdensome is inadequate. It is suggested that it should be clearly stated that the commissioner does not as a rule require the application of more than one method.²⁰⁵

Furthermore, clarity is needed in the area of transfer pricing regulation of intra-group services such as financial assistance. The main concern is on the characterization of intra-group debt. Reference to Section 31 shows that the definition of 'services' covers intra group loans in which the arm's length principle applies to the rate of interest. There are however two kinds of intra-group loans, inbound loans and outbound loans. SARS Practice Note 2 provides specific control of intra-group inbound loans especially in haven interest rates.²⁰⁶

²⁰³ SARS Practice Note No.7 pars 11.4.7-11.4.8

²⁰⁴ Oliver L, op cit 11 at 240

²⁰⁵ Oliver L, op cit 11 at 240

²⁰⁶ For detailed information see SARS Practice Note No. 2 On Thin Capitalisation par 2.2

Contrary to this, there are no specific provisions in the Act or SARS practice note no. 7 that determine interest and the rates for outbound-loans. The practice note in par 11.8 only provides guidelines for interest free loans to non residents in general. It provides that in the absence of specific guidelines, the OECD guidelines in chapter VII should apply. Furthermore, the tax treaties entered into by South Africa have not given specific guidelines for outbound loans.²⁰⁷ Consequently, as far as outbound-loans are concerned, the tax payer is left to rely on the general international principle that

'the market rate of interest must be determined as at the time the loan was advanced as if between unrelated parties in similar circumstance and this can be very high'.²⁰⁸

This will be disadvantageous to the taxpayer if competition with other enterprises more so independent enterprises is to be considered. This will mean that the affected taxpayer or MNE will be burdened by higher taxes.

Further, on an international and tax treaty context, it is acceptable that certain loans may be of an equity nature in certain specific circumstances, in which case there will be no requirement to charge interest and some countries recognise that in certain specific circumstances certain loans can be equity in nature hence not subject to payment of interest.²⁰⁹ In this regard, the OECD states that where the economic substance of a transaction differs from its form, then it is appropriate and legitimate for a tax administration to disregard the structure adopted by the tax payer.²¹⁰ SARS practice Note 7 does not give any insight on this point and it does not currently accept this argument as having application in South Africa hence does not accept the concept of equity loans.²¹¹ Therefore, for such equity loans interest is often at an excessive rate and is far above the market related rate for such loans the repercussion of a taxpayer paying higher tax rates.

An example of the above situation comes from argument that in certain circumstances charging interest on a shareholder loan would not be at arm's length. One school of thought suggest that the terms of a shareholders loan and non share

²⁰⁷ SARS Practice Note No. 7 par 11.8

²⁰⁸ Oliver L, op cit 11 at 243

²⁰⁹ Betten (Ed) *IBFD The New Netherlands Transfer Pricing Regime* (2002) at 64

²¹⁰ OECD Guidelines Chapter 1 par 1.3

²¹¹ Horak 'Tax Reform and practice under the new South Africa political dispensation- A critical review' 2002 *Acta Juridica* 54

holder loans should be compared to determine if it is at arms' length. This paper agrees with one scholar who warns that, one should not compare the terms of a shareholders loan with those of a loan from non-shareholders. In connection to this the scholar argued stated that,

*...it is a non-sense to inquire what the terms might have been of a loan between independent persons dealing at arms length, for the simple reason that inherent to 'the transaction' [as envisaged in s31] is the fact that is a transaction between persons who are, ex hypothesis, neither independent nor dealing at arm's length...because it is then a different transaction not "the transaction" contemplated by s 31 (2) (b).*²¹²

The conclusion is that, an assumption has to be made that the financial instrument is in law a loan and not equity hence subject to a normal comparative analysis. This would conform to the arm's length principle.

It also seems illogical that transactions entered into between two South African resident companies are not subject to provisions of section 31 but a similar transaction entered into between two CFC companies whether incorporated or resident in the same country is subject to the provisions of the section even if incorporated or resident in the same country. For example, management fees charged between South African resident companies are not subject to section 31 but a similar management fee charged between two CFCs incorporated or registered in the same country will be subject to section 31.²¹³

Under s 31(2) the commissioner has discretion whether to adjust the price in the hands of both parties to the agreement or whether to adjust the price in the hands of only one of the parties. If the commissioner decides to adjust the price upwards in the hands of the only one of the parties (CFCs) without a corresponding downwards adjustment in the hands of the other CFC, it will obviously have a significant impact on the income to be attributed to the South African resident. As the transfer pricing provisions will allow the commissioner to make an adjustment because the management fees are not at arm's length the business establishment exemption under s 9D (9) (b) (i) will also apply.

Finally, although not a short coming per say, SARS needs to address the issue of advance pricing agreements. Par 16.2 provides that APAs are not available

²¹² Emslie T 'Shareholders' loans to off Shore Subsidiaries: A critique' 2003 *The Tax Payer* 229

²¹³ Oliver I, op cit 11 at 246

In South Africa. It states that, 'the APA process will not in the foreseeable future be made available to South African Taxpayers.' Unfortunately no reasons are given. SARS should aim at establishing this process as it avoids long drawn-out audits, queries and controversies.

Having examined both the OECD and South African approaches to transfer pricing, the conclusion and appropriate recommendations follow.

CHAPTER IV

4. CONCLUSION AND RECOMMENDATIONS

4.1 Conclusion

This study sought to examine transfer pricing legislation in South Africa. The OECD guidelines form the basis of South African legislation on this subject. The overall goal of this study was to examine OECD guidelines on transfer pricing, with a view of determining the manner and extent to which, South Africa has adopted such guidelines. Critical to this analysis was the extent to which such legislation is relevant and credible in the South African context. The adopted OECD guidelines have inherent weaknesses such as:

- (i) the arm's length standard does not reflect the economical reality of the MNEs
- (ii) the arm's length standard cannot be efficiently applied in some circumstances. For example where MNEs take part in transactions that independent parties would not undertake, and
- (iii) where trade is conducted electronically, that is, e-commerce.

In adopting these guidelines, necessary adjustments were to be made to alleviate or minimise the impact of the weaknesses inherent in the OECD guidelines, in South Africa's transfer pricing regime. It seems that the same reason given by the OECD that there is no justifiable substitute applies on a South African context. However when compared with its predecessor; the revised section 31 the Income Tax Act when read together with SARS Practice Note No. 7 adequately attempts to provide a more comprehensive regime on transfer pricing. In this regard, the study made the following findings:

Firstly the OECD guidelines are comprehensive and hence designed to ensure appropriate protection of the tax base in each jurisdiction by avoiding double taxation. This is achieved through the application of the arms length principle in the methods used to determine a transfer price. The methods preferred are:

- (i) Traditional transactional methods such as; Comparable Uncontrolled Price Method (CUP), Resale Price method (RP) and the Cost Plus Method (CP)

- (ii) Transactions profit methods, including Profit Split Method and Transaction Net Margin Method (TNMM)

The applicability of these methods depends on circumstances of each case and documentation of the process of determining a transfer price is crucial. Furthermore, the principle advocates the separate entity approach focusing on the nature of the dealings between members of the group. The principle also grants tax authorities the right to adjust the profits of associated companies to reflect an arm's length profit. Although there are practical problems in the application of the principle in certain circumstances; there is a general admission that there has not been any justifiable substitute. The principle is hence accepted to create and ensure the most convenient and stable economic environment for enterprises to operate within.

Secondly, South Africa has enacted legislation (section 31 of the Income Tax Act 58 of 1962) that has wide application. As a result SARS attempts to interpret the section through its Practice Note No. 7. This practice note heavily relies on the OECD guidelines hence show that although a non member South Africa has adopted the OECD and compares favourably the guidelines. This was done bearing in mind the South African economic, geographical and market related situation. Due to the practice note's international nature there was uncertainty as to its legal status. However our courts as in *ITC 1682 (62 SATC 380)* have established that its provisions are not law but they left room for taxpayers if they fulfil the given requirements to hold SARS to its practice notes.

On the status of the OECD Model Tax Convention and Double tax treaties (DTAs) it was established that they embody the arm's length principle hence are not inconsistent with the Income Tax Act. In addition they do not restrict or limit the application of Section 31 of the Act regardless of the methods a tax payer may choose to select to determine an arm's length consideration. The result being that they should be interpreted in as much a way as possible as to be consistent with each other as long as they are embodied in our municipal law by legislative process as was held in *Pan American World Airways Inc v SA Fire and Accident Insurance Co Limited 1965 (3) SA 150*. On non-compliance the study showed that taxpayers need to be ware of section 65 statutory requirements to provide documentation as well as the penalties in

sections 75 and 76. The taxpayer also needs to be ware of the application of section 9D which applies to controlled foreign companies.

Overall, South Africa adopted the OECD regulations on transfer pricing as a basis of and with a view of improving its tax regime. These developments show that South Africa has significantly managed to keep abreast with the international developments in transfer pricing. However, the approach taken by SARS has in some instances given rise to complex situations amongst others in intra-group finance. As a result further improvement is required.

4.2 Recommendations

From the foregoing and having drawn the above conclusion, the following recommendations are relevant and useful in two important ways: Improving the quality and character of the resultant legislations as well as SARS practice note number seven.

- (i) SARS needs to consider its approach in the selection of a midpoint range where there is absence of persuasive evidence when determining a transfer price. This approach is contradictory to the arm's length principle.
- (ii) SASR should do away with advice that a taxpayer by using more than one method convinces the commissioner of compliance to transfer pricing regulations. The application of more than one method is costly and burdensome to the taxpayer. SARS should clearly state that the commissioner does not as a rule require the application of more than one method. This is a deviation form the OECD guidelines approach.
- (iii) Specific provision should be included in SARS practice note no.7 or the Income Tax Act that determine interest and the rates for outbound-loans. The taxpayer who affected by this notion is currently burdened by excessive interest rates if internationally accepted rates are
- (iv) SARS practice note no. 7 should consider its position on re-characterisation of intra-group debt. It is suggested in given

circumstances an assumption has to be made that the financial instrument is in law a loan and not equity. This would require a normal comparative analysis as if the parties were at arm's length hence conform to the OECD approach.

- (v) SARS should consider devising a means in which it encourages compliance to transfer pricing issues rather than relying on the current penalty policy. This will save time and resources that are wasted in adjustments as well as ensuing processes such as the alternate dispute resolution process.
- (vi) As SARS boost its administrative capacity it should give more consideration the issue of APAs for purpose of building in roads to eventually utilise them in the future. This is because APAs are binding for a fixed number of years and sometimes retrospective. APAs can be beneficial in that they avoid long drawn-out audits, queries and controversies.
- (vii) Finally MNEs should strive at using transfer pricing as a strategic business tool. This will facilitate tax efficiency within MNEs with an intention of realising global tax minimisation within the group. The minimised tax rates can significantly reshape the value chain in favour of the MNEs.
- (viii) SARS should specify the contents the transfer pricing policy document should have. As it stands it some taxpayers argue that in some circumstances they may not have to provide all information because not all companies are in a position to obtain all the required information from affiliates.

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