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Transfer pricing in South Africa: a comparative analysis between South Africa and more advanced jurisdictions, namely the United Kingdom and the United States of America

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Signed by candidate

.....

11 February 2010

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ABSTRACT

Transfer pricing is one of the most important yet controversial aspects of international tax in the last decade. South Africa is one of the few African countries which has set out regulations to deal with this issue yet undoubtedly the scope of application of these transfer pricing regulations is unsatisfactory especially in the age of globalization and the rise of multinational corporations which are driving this globalisation.

The legislation set out in section 31 of the Income Tax Act number 58 of 1962 lacks clarity and precision like the legislation set out in more advanced jurisdictions such as the United Kingdom and the United States of America. South Africa has not yet developed transfer pricing safeguards such as precise legislation on penalties, advanced pricing agreements, cost sharing agreements and transfer pricing regulations in the face of a recession.

In essence this study seeks to establish how far transfer pricing legislation in South Africa has keep abreast with international standards put forth by other jurisdictions.

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ABBREVIATIONS

CFC	Controlled Foreign Companies
CUP	Comparable Uncontrolled Price Method
CP	Cost plus Method
DTA	Double Tax Agreement
HMRC	Her Majesty Revenue and Customs
IT	Income Tax form
IRS	Internal Revenue Services
MNC	Multinational Corporation
MNE	Multinational Enterprise
OECD	Organisation for Economic Co-operation and Development
PS	Profit Split method
RP	Resale Price method
SARS	South Africa Revenue Service
STC	Secondary Tax on Companies
UK	United Kingdom
USA/US	United States of America
UN	United Nations
TNMM	Transaction Net Margin Method

1. INTRODUCTION TO THE STUDY

As Marx and Engels observed, nearly 160 years ago, capital is always in, "need of a constantly expanding market for its products, chases the bourgeoisie over the whole surface of the globe. It must nestle everywhere, settle everywhere, and establish connections everywhere." ¹

1.1 Definition of transfer pricing

To fully understand the nature of this study it is imperative to first define the meaning of transfer pricing. The definition of "transfer price" in business economics reads,

"The amount charged by one segment of an organization for a product or service that it supplies to another segment of the same organization." ²

Which means that the term 'transfer pricing' is used to describe arrangements involving the transfer of goods or services, at an artificial price, in order to transfer income or expenses from one enterprise to an associated enterprise in a different tax jurisdiction.³ Therefore it is a process by which related entities set prices at which they transfer goods or services among one another on an international scale.⁴ Transfer pricing allows global companies to set their transfer prices to position themselves optimally with regard to the tax regime in each country where they operate.⁵

Transfer pricing is a strategy to maximize profits, minimize taxes, maintain goal congruence, and/or evaluate managerial performance. These transfers are between domestic entities or involve cross-border transactions. The international transfer pricing activities are the ones which

¹ Marx and Engels, 'The Communist manifesto'. Available at <http://www.internationalviewpoint.org/spip.php?article1557> [accessed on 11 May 2009]. 1992, p. 6

² C. Horngren and G. Sundem, 'Introduction to Management Accounting', Prentice Hall International Inc. 9th edition p 336.

³ K. Huxham and P. Haupt, 'Notes on South African Income Tax' 24ed (2005) 346.

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

⁵ K. Thersby 'Transfer pricing attack: Motor industry under spotlight', *Moneyweb's Tax break*, December 2006 p2.

are potentially cross-border income shifting and tax reallocation to the multinational corporation's (MNC's) advantage.⁶

MNCs may choose to exploit differences in tax policies, transfer pricing regulations, import duties, withholding taxes, currency risks, and profit repatriation restrictions. This exploitation enables them to shift profits from subsidiaries between tax jurisdictions to maximize global profit and minimize taxes. The end result is that some countries are deprived of proper tax revenues.⁷ Tax jurisdictions accept methods for transfer pricing which are generally based on the arm's length principle.

1.2 Background

Awareness on transfer pricing really began when the United States and United Kingdom introduced specific transfer pricing provisions with an international focus during the First World War. These anti-tax avoidance provisions were intended to deter companies from shifting profits to associated companies overseas through under or over pricing of cross-border transactions.⁸ The companies which were mainly targeted by these provisions are now called Multi-national enterprise groups (MNE). These multi-national enterprise groups are defined as a group of associated companies with business establishments in two or more countries. A company which is part of this group is called a multinational enterprise (MNE).⁹

Since a multinational enterprise conducts business and has an economic presence in more than one legal jurisdiction therefore absent legal and tax considerations, territorial borders should not in themselves constitute barriers to the operations of the multinational group - despite the fact that, each of the associated enterprises of the multinational may be a legally distinct company in the jurisdictions in which it operates. The multinational maximises worldwide profits by freely disseminating the sources of competitive advantage to members of the multinational group. Any

⁶ S Borkowski, 'Transfer pricing concerns of developing and developed countries', *The International Journal of Accounting* Vol. 32, No. 3 p322 (1997).

⁷ S Borkowski [note 6] p322

⁸ Ad Hoc Group of Experts on International Cooperation in Tax Matters Tenth meeting Geneva, 'Transfer Pricing History C State of the Art C' Perspectives p5.

⁹ OECD Transfer pricing guidelines for Multinational Enterprises and Tax Administration at Glossary.

prohibitions to the effective exploitation of such competitive advantages would undermine the very rationale of the global operations of a multinational enterprise.¹⁰

The term MNE not only covers corporate giants such as IBM, Microsoft or Shell but also smaller companies with subsidiaries or permanent establishments (PE) in countries other than that where the parent company/head office is located.¹¹ Transfer pricing provides opportunities for MNEs to shift profits from a high taxing country to a country with a low corporate tax rate or with tax incentives for certain activities. Prior to 1979 administrative and legal guidance on the application of provisions relating to transfer pricing was scarcely available. The US Treasury in 1968 issued regulations for specific types of inter-company transactions which had a great influence on the discussions in the Organisation for Economic and Co-operation development (OECD) on transfer pricing.¹² This organisation has been at the forefront of issuing material on how to tackle the issue of transfer pricing.

In the seventies, the member states of the OECD decided to produce guidelines for transfer pricing to be administered in their various tax legislations. This was motivated by an increase in the number of MNEs and the increase of transactions within MNEs. Secondly these guidelines would help minimise double taxation of the MNE's within these jurisdictions.

It has become important to tax these multinational enterprises because of the technological advancements in communications which allow flexibility in these MNEs shifting activities 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.¹³

¹⁰ Michael Macdonald, *OTA papers Income shifting from transfer pricing: further evidence from tax return data* July 2008 p6 .Available at <http://www.ustreas.gov/offices/tax-policy/library/OTAttech02.pdf> [accessed on 9 September 2009].

¹¹ Ad Hoc Group of Experts on International Cooperation in Tax Matters Tenth meeting Geneva, '*Transfer Pricing History C State of the Art C' Perspectives* p5.

¹² Ad Hoc Group of Experts on International Cooperation in Tax Matters Tenth meeting Geneva, [note 11] p7.

¹³ 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>

1.3 Statement of the problem

The transfer pricing area of taxation has globally become a major source of income for tax authorities and the accompanying penalties and interest are onerous. The role of multi-national enterprises (MNEs) in world trade has increased dramatically over the last twenty years. It has led to increasingly complex tax issues for both tax administrations and MNEs themselves. There needs to be a greater focus on transfer pricing because the risk of revenue losses in these areas increased dramatically since the effects of the global financial crisis started hitting home.¹⁴

Transfer pricing is still a relatively new concept in South Africa it is clear that transfer pricing is not an exact science and that it is very specific to individual companies. There were problems with dealing with issues pertaining to transfer pricing within the South African Revenue Services (SARS). These problems range from lack of skills, a lack of experience, a lack of knowledge to simply not understanding certain issues of transfer pricing and not being able to come up with a definite solutions.¹⁵

The possibilities of 'transfer pricing' are increasingly being shaped by the emergence of microstates which are commonly known as offshore financial centres or tax havens considered to be "the cornerstone of the process of globalization". These microstates use their sovereign legislative powers to enact secrecy, light regulation, low or even no tax and persuade companies to set-up skeletal administrative structures to operate their transactions which results in them easily creating new assets and intellectual property. Nearly half of all world trade appears to pass through offshore financial centres, even though these jurisdictions account for only about 3 per cent of global gross domestic product (GDP).¹⁶ It is of no surprise that South African trade may pass through these tax havens stripping the country of the much needed revenue from tax. The problem which this study seeks to address is the limited nature of South Africa's transfer pricing legislation which may be exposing South Africa to lose of tax revenue to other tax jurisdictions.

¹⁴ TAXtalk January/February 2009

¹⁵ D Erasmus 'Transfer pricing: What is SARS take on it and what should you be doing?' TAXtalk p14

¹⁶ P Sikka and C Haslam 'transfer pricing and its role in tax avoidance AND flight of capital: Some theory and some evidence, University of Essex p 8.

1.4 Objectives of study

In light of the statement of the problem, the goal of this paper is to look in depth at South Africa's approach to transfer pricing laying out the current legislation on the issue. The extent South Africa has effectively applied its legislation which encompasses the OECD guidelines in transfer pricing will be examined. So ultimately the research paper will;

- (a) Examine South Africa's current approach to transfer pricing. South Africa is not a member state of the OECD
- (b) Examine the United Kingdom' approach to transfer pricing since they are a member state of the OECD.
- (c) Examine the United States approach to transfer pricing. They did not adopt the OECD approach and have their own regulations.
- (d) Lastly a comparison between South Africa and these two countries will be made to see what South Africa can adopt to improve its regulation on transfer pricing.

1.5 Reason for study

Developing and recent market economy countries (like South Africa) are new to international transfer pricing issues, are increasingly at risk of losing revenue because of these transactions.¹⁷ In an international study, focusing on international tax and transfer pricing issues, carried out in over 800 international businesses in 2003, sixty-eight percent of all survey respondents said that transfer pricing was the biggest tax issue they faced.¹⁸ Noting that this was the situation about seven years ago, it is probable that since world trade and globalisation have increased transfer pricing is even a bigger issue under more scrutiny by relevant tax authorities. Now transfer pricing has become a key site for social conflict as it plays a major role in relocating corporate profits, facilitating tax avoidance and flight of capital.¹⁹ The economic consequences of transfer pricing manipulations to relocate profits are significant and can be minimized through the

¹⁷ S Borkowski, 'Transfer pricing concerns of developing and developed countries', *The International Journal of Accounting* Vol. 32, No. 3 p321/322 (1997).

¹⁸ Maja Zaman 'Transfer pricing in multinational companies'. Available at <http://econpapers.repec.org/article/zagzirebs/> [accessed on 10 April 2009]

¹⁹ P Sikka and C Haslam 'transfer pricing and its role in tax avoidance and flight of capital: Some theory and some evidence University of Essex p7

establishment and enforcement of adequate transfer pricing policies and measures. Transfer pricing manoeuvres may result in distorted competitiveness among companies and to an undue reduction of the tax revenue in one country with a corresponding undue tax basis increase in another. Formerly, some developing countries avoided transfer pricing controls for fear of discouraging foreign investment. This may still be the case in some developing countries desperately that need foreign investments to drive their economies. This was combined with a lack of administrative experience in the implementation of transfer pricing. Transfer pricing regulations are critical for developing countries to compete in the current economic environment.²⁰

Transfer prices are important to MNC's because they affect calculations of divisional, segmental, product and global profits. The reported profits are significant to stock markets because they affect earnings, dividends, share prices and return on capital. Lastly, transfer prices are important to different countries because they affect the taxes that can be levied upon corporate profits to finance public goods.²¹

1.6 Significance of study

South Africa is not yet a member state of the OECD regime on transfer pricing, though it has adopted the guidelines to set own its own rules on transfer pricing. This paper seeks to explore how far South Africa has gone in establishing transfer pricing rules on comparison to the United Kingdom which is far more advanced in transfer pricing and the United States which has set out its own laws. This paper will compare and recommend transfer pricing differences from these two states which may aid South Africa to improve its current transfer pricing regime.

More effective legislation must be put in place by South Africa to include anti-income shifting clauses and arm's length concepts, safe harbour rules (in taxation these are, guidelines provided by the SARS for certain transactions, indicating specific parameters a taxpayer can observe to

²⁰ S Borkowski, 'Transfer pricing concerns of developing and developed countries', The International Journal of Accounting Vol. 32, No. 3 p321/322 (1997).

²¹ P Sikka and C Haslam 'transfer pricing and its role in tax avoidance and flight of capital: Some theory and some evidence University of Essex p8.

ensure favourable tax treatment or to avoid an unfavourable one. An example is a list of parameters that, if followed, will assure Sale and Leaseback treatment to certain transactions²²), and the provision for advance pricing agreements. This will safeguard the country from unfair transfer pricing arrangements.²³ Transactions must be subject to more disclosure to SARS. This will ensure transparency of transfer pricing agreements.

It is a fact ,that many developing countries, including South Africa are poorly equipped and tax authorities have relatively little capacity to scrutinize the complex tax structures and agreements.²⁴ This has made it significant for more research from other jurisdictions and literature to be written on transfer pricing to try and help explore and understand this confusing aspect of international tax law.

Due to the economic growth experience by South Africa over the last decade, some domestic companies have become multinationals and foreign companies have either set up businesses in South Africa or operate joint ventures with local companies. it is estimated that the combined sales of top 200 corporations(some of which have business interests in South Africa) are bigger than the combined economies of all countries less the biggest ten economies of the world.. Multinational corporations dominate virtually every sector of the economy and account for some twenty seven and a half percent (27.5%) of world economic activity.²⁵ It is needless to say that if South Africa does not adequately pay attention to transfer pricing policies it will lose a lot of revenue to lower tax jurisdictions.

1.7 Outline of study

This dissertation is made up of four chapters. Chapter one is the introduction and overall explanation of the topic. Chapter two analyses the South African legislative and practical approach to transfer pricing laying out its weaknesses and strengths. Chapter three deals with the United Kingdoms approach to transfer pricing. It will be in detail since they have a more

²² Business dictionary. Available at <http://www.answers.com/topic/safe-harbor-rule> [accessed on 11 February 2010].

²³ S Borkowski, 'Transfer pricing concerns of developing and developed countries', *The International Journal of Accounting* Vol. 32, No. 3 p321/322 (1997).

²⁴ P Sikka and C Haslam 'transfer pricing and its role in tax avoidance and flight of capital: Some theory and some evidence *University of Essex* p 9.

²⁵ P Sikka [note 24] p 9.

advanced transfer pricing structure and are governed by the OECD guidelines on transfer pricing which South Africa has incorporated into its tax system. Chapter four will look at the United States transfer pricing structure. This will be significant because they have developed their own guidelines some of which South Africa may adopt. Chapter five concludes the study and makes recommendations were necessary.

1.8 Methodology

This research is desktop based. The sources used are primary materials which include domestic and foreign legislation, International conventions and guidelines and practice notes. Secondary sources used are books, journals and relevant tax issues and newspaper reports. The internet was extensively used as it provided information on the foreign jurisdictions as this information was not available in the books found in the University of Cape Town Library.

2 CHAPTER TWO: TRANSFER PRICING IN SOUTH AFRICA

This chapter deals with the South African approach to transfer pricing. It will establish how the law has developed and South Africa's current position. There will be a brief history on the transfer pricing laws. The chapter will look at the South African Revenue Services approach, practice note no 7 which has adopted the OECD guidelines in transfer pricing. In essence, SARS approach to the arm's length principle will be discussed.

2.1 Transfer pricing legislation in South Africa

Initially, transfer pricing in South Africa was regulated by Article 9 of the OECD Model Tax convention Treaty. Though South Africa is not a member state of the OECD it placed reliance on the OECD transfer pricing rules. Exchange control protected the control and regulation of transfer prices. The source of income was a determining factor in the levying of taxes.²⁶ The provisions under the original s 31 of the Income Tax Act 58 of 1962 ('the Act') which has now been revised also played a role. However with effect from 19 July 1995, the revised section 31 was introduced in the income Tax Act 58 of 1962. Customs duties were also used to some extent in resolving transfer pricing problems in conjunction with the unrevised provisions of section 31 of the Income Tax Act. These regulatory channels were found to be inadequate. This section 31 specifically dealt with transfer pricing. After 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 revised provisions of section 31 were introduced.²⁷

The Commission of Inquiry in Certain Aspects of the Tax Structure of South Africa ("The Katz Commission") in its first interim report highlighted that there was a lack of protection against the abuse of transfer prices.²⁸ The Katz Commission noted that the South African tax system needed stricter legislation to protect itself against excessive price manipulation between related parties.²⁹

²⁶ SARS Practice Note No. 7 1999 paragraph 2.5.

²⁷ A. Onsando 'The OECD Transfer pricing guidelines: An analysis of their application in the South Africa legal regime'. Available at <http://lawspace2.lib.uct.ac.za/dspace/handle/2165/367?mode=full> [accessed on 2 May 2009]p 37].

²⁸ M Makola, 'Transfer Pricing in South Africa' (2003) at 3.

²⁹ Second Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa paragraph 14.6.24.

The Katz commission came up with a Second Interim Report. This report listed the four approaches which were developed by the different tax systems in the world which the South African Legislative had a choice to implement in order to counteract transfer pricing:

- a) The first approach is implemented in the United States. It constitutes a stringent legislative approach coupled with formal, detailed and binding regulations as to what constitute acceptable pricing.³⁰
- b) A second approach, which is similar to the German approach, also with legislative teeth, does not have formal regulations, but does have detailed guidelines as to acceptable pricing.³¹
- c) The third approach has anti-transfer pricing legislation, but relies on arm's length concepts to dictate acceptable pricing practices. This is adopted from the United Kingdom and other countries which rely strongly on OECD guidelines such as Japan and Australia.³²
- d) the fourth approach does not have any specific transfer pricing legislation and relies on normal, general anti-avoidance provisions and tax law to combat transfer pricing, such as in the Netherlands.³³

The Katz Commission recommended that the third approach, which adopted the arm's length principle as contained in the OECD guidelines, be implemented in South Africa. South Africa went on to adopt the OECD guidelines in transfer pricing in the practice note no.7 of 1999.

Before the transfer pricing provision, section 31 the legislation used other provisions in the act to deal with transfer pricing transactions. If profits and expenditure were grossly excessive they were reviewed and adjusted in terms of the general deduction formula or in terms of section 103(1) of the Act for general anti avoidance. In instances where property was disposed of for a consideration not constituting an arm's length amount, would be deemed to be a donation in terms of section 58 of the Act. As a result it the donation would be subject to donations tax.³⁴ Though these measures were put in place they were found to be inadequate.

2.1.1 Legislative Position before the revised section 31 of 1995

³⁰ T Lord '*transfer pricing in South African Income Tax law*'. Available at <http://lawspace2.lib.uct.ac.za/dspace/handle/2165/320> [accessed on 6 July 2009] p 11

³¹ T Lord[*note 30*] p 11

³² T Lord[*note 30*] p 11

³³ T Lord[*note 30*]p 11

³⁴ 8 Lynette Olivier and Michael Honiball, *International Tax: A South African Perspective* 3ed (2005) 400.

Section 31 of the Income Tax Act 58 of 1962, before it was revised, in 1995, dealt with the transfer pricing provisions. In its application, this section dealt with 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 Double Tax Agreement (DTA).³⁵

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 relevant DTA.³⁶ This allowed South Africa the right to use the arm's length principle to determine the price of the commodity sold between enterprises governed by the DTA with South Africa as a contracting party.

Section 31 made it possible for the general deduction formula or the terms of the general anti avoidance Section 103 (1) of the Income Tax Act to apply where expenditure incurred for the commodity was grossly excessive.³⁷ Section 31 was applicable subject to section 103(1) of the Act.

2.1.2 Legislative Position after the revised section 31 of 1995

The revised section 31 (1) was enacted to amend the loopholes of the original section 31. The essence of this section is to put in place anti-avoidance measures to safeguard South African taxable profit which has been lost to other jurisdictions. The artificial removal of taxable profits 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.³⁸

The new section 31(1) makes reference to terminology that is relevant to its application. The relevant words include: goods, services, international agreement, permanent establishment, connected person, controlled transaction and uncontrolled transaction. Section 31 (2) specifically

³⁵Original s 31 (a) Income Tax Act 58 of 1962.

³⁶ Danziger E, 'International Income Tax, the South African Perspective' (1991) paragraph 19.101.

³⁷ Original s 31 (a) Income Tax Act 58 of 1962.

³⁸ DJM Clegg 'Deemed Source and Transfer Pricing' Sept 1997 *The Tax Payer* at 163-4

contains transfer pricing rules and regulations that apply to associated enterprises which engage in cross-border transactions. This section is used to regulate the pricing of goods and services in circumstances where an international agreement between connected persons takes place.³⁹

Though the provisions of section 31 are wide in application, the fundamental aspect of section 31 is that it empowers the Commissioner to adjust the non arm's length consideration of international agreements between connected persons. The commissioner can adjust the prices of goods and services according to what is deemed a fair price.

The adjustment is made where the selected price by the connected persons is either greater or less 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.⁴⁰

2.1.3 Transfer pricing definitions and terminology in the Income Tax Act 58 of 1962

It is imperative that that certain phrases and words in the Act⁴¹ are defined to have a clear understanding of the concept of transfer pricing. Section 1 and section 31(1) of the Act contain the following definitions:

(a) Goods

These goods are defined to include any corporeal moveable thing, fixed property and any real right in such thing or fixed property.

(b) Services

The term 'services' has a broad definition, it includes anything done or to be done, including the following:

³⁹ A. Onsando 'The OECD Transfer pricing guidelines: An analysis of their application in the South Africa legal regime'. Available at <http://lawspace2.lib.uct.ac.za/dspace/handle/2165/367?mode=full> [accessed on 2 May 2009] p 40.

⁴⁰ SARS Practice Note No 7 paragraph 4.4.

⁴¹ Income Tax Act no. 58 of 1952.

- the granting, assignment, cession or surrender of any right, benefit or privilege;
- the making available of any facility or advantage;
- the performance of any works;
- an agreement of insurance; and
- the conferring of rights to incorporeal property

This definition of services includes in terms of subsection (c), the granting of financial including a loan, advance or debt, and the provision of any security or guarantee. This provision has made it possible for may be taxed on a passive investment income arising from a controlled foreign entity (CFE) in terms of section 9D of the Act.⁴² Deemed interest stemming from t application of provisions relating to interest free loans are also subject to tax under this definition of services.⁴³

(c) Permanent establishment

Section 1 of the Act sets out that permanent establishment should be defined with reference to the definition contained in article 5 of the OECD Model Tax Convention Treaty. In the convention permanent establishment is described as ‘a fixed place of business through which the business of an enterprise is wholly or partly carried on’. The business profits are taxable where the fixed place of business is based.

(d) Connected person

Section 1 widely defines the term ‘connected person’ in relation to; natural persons;

- trusts
- partnerships
- companies
- close corporations

Section 31(2) is only applicable if the acquirer and the supplier of goods or services are connected persons in relation to one another.⁴⁴

⁴² Income Tax Act no.58 of 1952.

⁴³ E Roper, ‘South African transfer pricing explored’. Available at <http://butterworths.uct.ac.za/nxt/gateway.dll/7b/9d/49/iaa/tknk>[accessed on 8/April 2009].

⁴⁴ Lynette Olivier and Michael Honiball *International Tax: A South African Perspective* 3ed (2005) 404.

2.1.4 Transfer pricing definitions and terminology in the SARS Practice Note no. 7 of 1999

(a) OECD Guidelines

The Organisation for Economic Co-operation and Development (OECD) guidelines are defined in the Practice Note no.7 of 1999 ('the practice note') as the ones set out in 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.⁴⁵

(b) Transfer prices

The practice note defines the term transfer pricing as the process by which entities set the prices at which they transfer goods or services between each other.⁴⁶

(c) Controlled transaction

Controlled transaction is distinguished as a transaction in terms of which the ownership or control relationship is able to influence the transfer price set. With regard to section 31, a controlled transaction will be any transaction between connected persons, as defined in section 1 of the Income Tax Act.⁴⁷

(d) Uncontrolled transaction

Uncontrolled transaction in contrast is defined as a transaction which is concluded at arm's length between enterprises that are not connected persons in relation to each other. Uncontrolled transactions form the standard against which a multinational's transfer pricing is appraised in deciding whether its prices are arm's length or not.⁴⁸

(e) Managed or controlled

The concept of 'managed or controlled' in the practice note is used in a wide sense. It is also used numerous times in other sections of the Income Tax Act. The practice note establishes that, in order

⁴⁵ SARS Practice Note No. 7 Paragraph 1.2.4.

⁴⁶ SARS Practice Note No. 7 Paragraph 1.2.5.

⁴⁷ SARS Practice Note No. 7 Paragraph 1.2.1.

⁴⁸ SARS Practice Note No. 7 Paragraph 1.2.2.

to determine the place where an entity is managed or controlled, consideration will be given to the business activities of the entity and business activities of connected persons, as well as the degree of independence under which the entity operates. SARS perception is that the control of an entity is to be found at the meeting place of the people who take precedence over and control direction of the entity's trade.⁴⁹

(f) Multinational

The term 'multinational' is refers to any group of connected persons with members or business activities in more than one country. In addition the term 'member' refers to component parts (including natural persons) of that multinational, each having a separate legal existence.⁵⁰

2.2 The arm's length principle

In 1995, when the South African economy was opened up to trade , and the partial relaxation of exchange controls was introduced, section 31 of the Income tax Act was amended to allow for amendments in pricing where the prices are not on an arm's length basis. This amendment applied to goods and services and financial assistance. This was the introduction of the arm's length principle in South African transfer pricing legislation. The OECD international guidelines set a basis in paragraph 1 of Article 9 of the OECD Model Tax Convention Treaty for the arm's length principle which South Africa has adopted. This Convention is the framework for bilateral treaties between OECD countries and many non OECD governments like South Africa.⁵¹

⁴⁹ SARS Practice Note No. 7 Paragraph 1.1.3.

⁵⁰ SARS Practice Note No. 7 Paragraph 1.2.3.

⁵¹ John Neighbour 'Transfer pricing: Keeping it at arm's length.' Available at http://oecdobserver.org/news/fullstory.php/aid/670/Transfer_pricing:_Keeping_it_at_arms_length.html [Accessed 9 December 2009].

The Australian government's guide on applying the arms length principle has defined the concept as,

"...the [arm's length principle] principle that uses the behaviour of independent parties as a guide or benchmark to determine how income and expenses are allocated in international dealings between related parties. It involves comparing what a business has done and what a truly independent party would have done in the same or similar circumstances."⁵²

This definition in essence means prices set for transactions between group entities should for tax purposes be derived from prices which would have been applied by unconnected parties in comparable transactions under similar conditions in the open market.⁵³ It is therefore based on a sound economic principle, namely that the competitive market is the best way to allocate resources and rewards of risks.⁵⁴

Distinct transfer pricing provisions with an international focus on the application of the arm's length principle were first introduced during World War I in the United Kingdom and the United States. These anti-tax avoidance provisions were aimed at deterring companies from shifting profits to associated companies overseas through under or over pricing of cross-border transactions.⁵⁵

The arm's length principle is based on the concept of equal treatment or the neutrality principle. This means shareholders with a controlling interest in a company are placed in a similar position as other shareholders and controlled taxpayers are placed on par with uncontrolled taxpayers through application of the arm's length principle which neutralises the advantage of the former.⁵⁶ This means that the arm's length principle is an international tax practice that has become the international norm for assigning transfer prices, since it purports to place business entities on the same economic footing, with no competitive advantage to commonly controlled firms, and no

⁵² International Transfer pricing: *Applying the arm's length principle*, Australian Taxation Office [2005] page 3.

⁵³ Ad Hoc Group of Experts on International Cooperation in Tax Matters Tenth meeting Geneva, '*Transfer Pricing History C State of the Art C' Perspectives* p4.

⁵⁴ Maxi Steyn, '*Foreign branch operations in a global environment: a south African income tax perspective (part 2)* South African business review 2003 vol. 7 (2) p 62.

⁵⁵ Ad Hoc Group of Experts on International Cooperation in Tax Matters Tenth meeting Geneva [note 53] p4

⁵⁶ Ad Hoc Group of Experts on International Cooperation in Tax Matters Tenth meeting Geneva [note 53] p4

incentive to alter the ownership structure according to tax liability⁵⁷ this avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of enterprises, regardless of entity type. As a result in removing these tax considerations from economic decisions, the arm's length principle promotes the growth of international trade and investment.⁵⁸

Countries do not want their tax bases to suffer because of transfer pricing this is why they rely on the OECD guidelines on the arm's length principle. The guidelines assist corporations to avoid double taxation, they help tax administrations to receive a fair share of the tax base from multinational enterprises. However abuse of transfer pricing may be a significant problem for developing countries such as South Africa, as MNE's might take advantage of it to get round exchange controls and to repatriate profits in a tax free form. The OECD guidelines provide technical assistance to these countries to help them implement and administer transfer pricing rules in a generally standard way, while taking into consideration each country's particular situation.⁵⁹

Section 31(2) of the income tax act sets out the requirements on how the arm's length principle is to be adopted in South African law. It should be charged on cross border transactions between connected persons, one of whom must be a South African resident or be a permanent establishment of a non-resident in South Africa. The relevant factor is that there should be a controlled transaction between these types of parties.⁶⁰

Section 31(2) establishes that where there is sale of products through an international agreement and the supplier and acquirer are connected persons if SARS suspects the price is not at arm's length (market value) then they may adjust the price to an arm's length price in calculating the taxable income of either party.

⁵⁷Maxi Steyn 'Foreign branch operations in a global environment : a south African income tax perspective (part 2) South African business review 2003 vol. 7 (2) p 59

⁵⁸ Maxi Steyn [note 57] p59

⁵⁹ John Neighbour 'Transfer pricing: Keeping it at arm's length.' Available at http://oecdobserver.org/news/fullstory.php/aid/670/Transfer_pricing:_Keeping_it_at_arms_length.html [Accessed 9 December 2009]

⁶⁰ E Roper, 'South African transfer pricing explored'. Available at <http://butterworths.uct.ac.za/nxU/gateway.dll/7b/9d/49/iaa/tknk> [accessed on 8/April 2009]

In Practice Note 7,⁶¹ the arm's length principle is described as being the overriding principle that transactions between connected parties are to be conducted at a value having the substantive financial characteristics of a transaction between independent parties, where each party will strive to get the utmost benefit from the transaction.⁶² The arm's length principle therefore entails finding a comparable transaction between independent parties (an uncontrolled transaction), which should be used as a benchmark against which to appraise the multinational's prices (the controlled transaction).⁶³

The main issue to be resolved when dealing with cross border transactions involving transfer pricing is how a multinational should determine what price would have been charged for the transaction if it was subject to market forces between unconnected parties. The solution which is provided by the arm's length principle is that a comparative transaction between unconnected parties should be used as a yardstick against which to assess the multinational's prices. This has been clearly stated in the SARS practice note no.7 of 1999 it states,

*'... the problem to be resolved is how a multinational should determine what price would have arisen if transactions between its members were subject to market forces. The solution advanced by the arm's length principle is that a comparable transaction between independent parties (an uncontrolled transaction) should be used as a benchmark against which to appraise the multinational's prices (the controlled transaction). Any difference between the two transactions can then be identified and adjusted. An arm's length price that will reflect the economic contributions made by the parties to the transaction can be determined for the controlled transaction.'*⁶⁴

So despite the fact that neither Section 31 nor the tax treaties entered into by South Africa prescribe any particular methodology for determining an arm's length consideration, Practice Note 7 states that the most appropriate method in any given case would be the method that produces the highest degree of comparability⁶⁵.

⁶¹ SARS Practice note no.7 of 1999.

⁶² Maxi Steyn 'Foreign branch operations in a global environment : a south African income tax perspective (part 2) South African business review 2003 vol.7 (2) p63.

⁶³ SARS Practice note no.7 of 1999.

⁶⁴ SARS Practice Note no.7 of 1999 paragraph 7.3.

⁶⁵ SARS Practice Note no.7 1999: paragraph 8.1.4 .

Though the arm's length principle is the international standard used for transactions involving transfer pricing it's not without criticism. It seems the trend towards greater globalisation, integration and specialisation increasingly results in situations where the arm's length standard proves to be challenging since the opinion is taken that the arm's length standard does not reflect the economical reality of the globally integrated multinational.⁶⁶ A complication associated with the application of the principle is that it is based on the separate entity approach, whereas multinationals are often integrated enterprises. It is through this integration that economies of scale are achieved in logistics, brand development, risk management and technology, and these 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.⁶⁷ Therefore applying the arm's length principle by dividing a multinational into separate parts generally produces a range of ambiguity, depending on the magnitude of the economies of integration and the relative profitability of the parties⁶⁸

Another difficulty that may affect the effective application of the arm's length principle arises from situations in which multinationals deal in transactions that independent parties would not pursue, for instance maintaining a new associated company at a loss to create market share, or transferring valuable technology to an associated enterprise for no consideration. These transactional relationships among associated enterprises may differ in important and fundamental ways from potentially comparable transactions between unrelated parties. This idea renders the search for comparable transactions among unrelated parties rather unsuccessful, since appropriate adjustments may not be possible in specific contexts, thereby calling into question the strict observance of the arm's length principle.⁶⁹

Despite these shortcomings of the arm's length principle it has been established that if taxpayers do not apply it they may expose themselves to unnecessary risks of double taxation, as well as

⁶⁶ Borkowski, S.C 'Electronic commerce, transnational taxation and transfer pricing: issues and practices', International Tax Journal, 1: 36 2002.

⁶⁷ Maxi Steyn 'Foreign branch operations in a global environment : a south African income tax perspective (part 2) South African business review 2003 vol. 7 (2) p63

⁶⁸ Miesel, V.H., Higinbotham, H.H. & Yi, 'International transfer pricing: practical solutions for inter-company pricing', International Tax Journal 1: 22. C.W. 2002 p 63.

⁶⁹ Miesel, V.H [note 68] p 63.

potential conflict with tax authorities, when a transfer pricing approach that is inconsistent with this standard is followed.⁷⁰

The OECD Transfer pricing guidelines give guidance on the application of the arm's length principle. The factors to be considered are:

- Comparability analysis
- Recognition of actual transaction
- Separate and combined transactions
- The Arm's length range
- Multiple year data
- Losses
- Government policies
- Intentional set-offs
- customs valuations

2.3 Methods of transfer pricing according to Practice note no. 7 of 1999

We have to turn to the methods set out in the practice note because the Act does not give any enlightenment on the issue.

The practice note enumerates five standard transfer pricing methods:

- The Comparable Uncontrolled Price (CUP) method
- The Resale Price (RP) method
- The Cost Price (CP) Method
- The Transactional Net Margin (TNM) method
- The Profit Split (PS) method.

In terms of section 31, the methods do not have a particular hierarchy in terms of importance or use. SARS does not have a preference in application of these methods but will use the one

⁷⁰ Maxi Steyn 'Foreign branch operations in a global environment: a South African income tax perspective (part 2)' South African business review 2003 vol. 7 (2) p64.

which yields the most reliable results with the least adjustments required.⁷¹ The application of a particular method will depend on different factors, for instance,

- Quality of available data.
- The taxpayer's particular circumstances.
- Number of adjustments required and the reliability thereof.
- Commercial and economic reality underlying a particular transaction.⁷²

2.3.1 Explanation of methods

(a) The Comparable Uncontrolled Price

'A transfer pricing method that compares the price for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances'.⁷³

In practice, however, the comparability of goods or services is made difficult due to small changes in trading circumstances that can significantly impact the price.⁷⁴ Practice Note no. 7 states that the CUP method should be used over other transfer pricing methods if comparable uncontrolled transactions can be obtained.⁷⁵

(b) The Resale price method

'A transfer pricing method based on the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. The resale price is reduced by the resale price margin. What is left after subtracting the resale price margin can be regarded, after adjustment for other costs associated with the purchase of the product, as an arm's length price of the original of the transfer property between the associated enterprises.'⁷⁶

'For the RP method the comparability of the functions performed by the connected and the independent entities is more important than that of the product comparability. The reason for this

⁷¹ E Roper, 'South African transfer pricing explored'. Available at <http://butterworths.uct.ac.za/nxt/gateway.dll/7b/9d/49/iaa/tnk?> [accessed on 8/April 2009].

⁷² E Roper [note 71].

⁷³ OECD Transfer pricing guidelines for multinational Enterprises and tax administration (1995-2000) at glossary

⁷⁴ T Lord 'Transfer pricing in South African Income Tax law' available at <http://lawspace2.lib.uct.ac.za/dspace/handle/2165/320> [accessed on 6 July 2009] p 19.

⁷⁵ T Lord [note 74] p 20.

⁷⁶ OECD Transfer pricing guidelines for multinational Enterprises and tax administration (1995-2000) at glossary

is that differences in products are more likely to have an affect on prices than on profit margins. The RP method is therefore preferred to the CUP method in situations where controlled and uncontrolled transactions are comparable in all aspects other than the product itself.⁷⁷

(c) The Cost Price Method

'A transfer pricing method using the costs incurred by the supplier of property (or services) in a controlled transaction. An appropriate cost plus mark-up is added t this cost, to make an appropriate profit in light of the function performed(taking into account assets used and risks assumed) and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction.'⁷⁸

The application of this method may cause certain difficulties in practice .Firstly, it is difficult to determine the costs to use as the effectiveness of companies varies, resulting in some incurring lower costs than others.⁷⁹ Secondly, to stay in line with accounting principles the same type of costs need to be compared, which may result in the need to make appropriate adjustments.⁸⁰ Thirdly, segregated product data is often required in respect of the uncontrolled enterprises that are being used as comparison, this data is not always available.⁸¹

(d) The Transactional Net Margin method

' A transactional profit method that examines the net profit margin relative to an appropriate base(e.g. costs, sales and assets) that a taxpayer realizes from a controlled transaction.'⁸²

This method is seen as the combination of the resale price method and the cost price method because it also makes use of comparable companies to determine an appropriate margin to apply.⁸³ A further resemblance with the RP and CP methods is that the TNMM concentrates on the functions performed by an enterprise, but however comparing net profit as opposed to gross profit.⁸⁴ However traditional transaction methods are seen as more reliable than the TNMM

⁷⁷ T Lord '*Transfer pricing in South African Income Tax law*' accessed at <http://lawspace2.lib.uct.ac.za/dspace/handle/2165/320> on 6 July 2009] p 20.

⁷⁸ OECD Transfer pricing guidelines for multinational Enterprises and tax administration (1995-2000) at glossary

⁷⁹ T Lord [note 77] p 22

⁸⁰ T Lord [note 77] p 20

⁸¹ SARS' *Practice Note No 7* op cit note 16 paragraph 9.6.3

⁸² OECD Transfer pricing guidelines for multinational Enterprises and tax administration (1995-2000) at glossary

⁸³ T Lord [note 77] p 25

⁸⁴ SARS' *Practice Note No 7* op cit note 16 paragraph 9.7.2.

because the TNMM is susceptible to the differences in cost structures of comparable enterprises because of the inclusion of operating expenses, also the TNMM requires structural similarity between the associated enterprise and the independent enterprise being compared, when in fact firms are structurally unique in practice.⁸⁵

(e) The Profit Split method

'A transactional profit method that identifies the combined profit to be split for the associated enterprises from a controlled transaction and then splits those profits between the associated enterprises based upon an economically valid basis that approximate the division of profits that would have been anticipated and reflected in an agreement made arm's length.'⁸⁶

Two methods are used in determining the arm's length principle under the RP method. These methods are

- **Residual Profit Split Analysis**

This method involves two stages. First of all, each enterprise is allocated a basic return that is determined with reference to comparable transactions, in terms of functions and risks, of independent enterprises. The second stage involves the allocation of the remaining residual profit amongst the enterprises in an approach that would have been adopted by independent enterprises. Contributions by the enterprises to the residual profit are often subjectively measured due to the lack of an external standard when the transactions entered into between the enterprises are unique.⁸⁷This approach makes us question the reliability of this method to determine an arm's length price.

- **Contribution Analysis**

This approach is valuable when the transaction is between large integrated multinationals that function under economies of scale. This is because independent enterprises are not always able to save costs in the same way large integrated multinationals can and therefore it may be hard for

⁸⁵ T Lord '*Transfer pricing in South African Income Tax law*' accessed at <http://lawspace2.lib.uct.ac.za/dspace/handle/2165/320> on 6 July 2009] p 25.

⁸⁶ OECD Transfer pricing guidelines for multinational Enterprises and tax administration (1995-2000) at glossary

⁸⁷ SARS' *Practice Note No 7* op cit note 16 paragraph 9.8.2

such multinationals to find an uncontrolled comparable transaction in order to determine a reliable arm's length transfer price.⁸⁸

The combined operating profit of the two enterprises is divided amongst the enterprises with reference to the value of the functions each one has performed, taking into account assets used and risks assumed.⁸⁹

The OECD guidelines point out that none of the proposed methods is suitable in every possible situation therefore circumstances of each case will determine the applicability of any other method.⁹⁰ It seems the guidelines imply that MNEs have the freedom to apply methods not described in the OECD guidelines when establishing transfer prices. Regardless of this, the OECD guidelines caution that prices derived by methods not described by the OECD must satisfy the arm's length principle with the taxpayer having to provide documentation establishing how its transfer prices were established.⁹¹

It is inadequate that Section 31(2) which deals with the arm's length principle does not provide any guidelines in terms of how to objectively determine an arm's length price. Though The SARS' Practice Note No 7 sets out a range of international methods for determining an arm's length price, they are of little value since SARS' Practice Notes and Interpretation Notes do not normally constitute law, this leaves the Commissioner with no option but to look at the facts of each case to be able determine whether an arm's length transfer price has been achieved. The commissioner has to consider the fact that an arm's length price does not necessarily constitute a single price, but a range of prices.

2.4 Documentation

Practice note no. 7 of 1999 is the South African legislation which spelt out the documentation requirements for enterprises dealing with transfer pricing. However, prior to 2004, companies

⁸⁸ SARS' *Practice Note No 7* op cit note 16 paragraph 9.8.2.

⁸⁹ OECD *Transfer Pricing Guidelines* (1997) 20 III-6.

⁹⁰ OECD *Transfer pricing Guidelines* (1997) chap I par 1.68.

⁹¹ OECD *Transfer Pricing Guidelines* (1997) chap II par 1.68.

were not accountable through documentation to prove that they adhered to transfer pricing rules. The legislature was not clear on this issue of documentation. In 2004, SARS introduced a new transfer pricing policy disclosure requirements to deal with the uncertainty.⁹²

The guidelines on documentation preparation set out in the practice note⁹³ are adopted from chapter five of the OECD guidelines on transfer pricing.⁹⁴ The guidelines in paragraph 10.3 of the practice note are a comprehensive guide which set out the factors that should be considered by tax payers in determining the appropriate level of documentation for their specific circumstances. It should be borne in mind that transfer pricing documentation and reporting can be expensive and time consuming for the tax payer mainly because the documentation firstly indicates *prima facie* compliance to tax authorities, and also discharge the taxpayer's burden of proof in litigation circumstances.⁹⁵

Section 31 of the Income Tax Act⁹⁶ does mention anything transfer pricing documentation, However sections 74, 74A, 74B, 74C, 74D and 75 of the Act are the only legislation giving SARS access to a company's transfer pricing information and documentation. And section 69 of the Act may also be used to assist the Commissioner.⁹⁷ The Practice note specifies that it is not mandatory for companies to prepare and maintain transfer pricing documentation.⁹⁸ . None the less a taxpayer should be aware that a request for documentation in terms of section 65 of the income Tax Act is a mandatory statutory requirement.

There is an addendum to Practice note no. 7⁹⁹ which SARS issued in 2005. The addendum stipulates that it is not a statutory requirement for taxpayers to prepare transfer pricing policy documentation, but that it is advisable for them to do so in order to minimise the risks associated

⁹² M Honiball, 'Transfer pricing: A criminal offence' 2004 *Finance Week* 41 at 41.

⁹³ Practice note 7 of 1999.

⁹⁴ SARS' *Practice Note No 7* op cit note 16 paragraph 10.3.1; Ernest Mazansky 'Transfer pricing documentation requirements clarified' (2005) 238 *Tax Breaks Newsletter* 7 at 7.

⁹⁵ A Onsando, 'The OECD Transfer pricing guidelines: An analysis of their application in the South Africa legal regime'. Available at <http://lawspace2.lib.uct.ac.za/dspace/handle/2165/367?mode=full> [accessed on 2 May 2009] p40

⁹⁶ Income Tax Act of 1956

⁹⁷ SARS' *Practice Note No 7* op cit note 16 paragraph 10.1.1.

⁹⁸ SARS' *Practice Note No 7* op cit note 16 paragraph 10.2.1;

⁹⁹ Practice note no. 7 of 1999

with a lack of documentation.¹⁰⁰ If the taxpayer does not submit documentation and SARS requests information, the taxpayer should submit a response within 30 days. So in essence the taxpayers are not required by law to prepare policy documentation, however they are under obligation to furnish SARS with policy documentation it, with their annual tax return, should they indicate in the tax return that such documentation exists.¹⁰¹

2.4.1 SARS' Documentation requirements

When a taxpayer presents transfer pricing documents, SARS requires information regarding the identification of comparable international transactions, copies of the relevant agreements, descriptions of their nature, and the terms of the transactions and prices of the transactions.¹⁰² The transfer pricing method used to arrive at the nature and terms of the transaction should be presented, together with proof that alternatives were considered. Incorporated should be the reasons why a specific method was used and explanations why the method provides an arm's length result. SARS will have good reason to assess the taxpayers transfer pricing in detail if the taxpayer fails to deliver the required documents.¹⁰³

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.¹⁰⁴ The taxpayer must include an analysis of turnover and gross profits; details of management fees, license fees and royalty agreements. It is imperative to include financial information of controlled foreign entities and details of foreign dividends.

2.4.2 Documentation in relation to subsidiaries in tax havens

¹⁰⁰ Billy Joubert 'Do you need a Transfer Pricing Policy Document?' Available at http://www.deloitte.com/dt/press_release/0,1014,sid%253D23596%2526cid%253D135642,0 [accessed on 6 July 2009]

¹⁰¹ B. Joubert [note 100].

¹⁰² A. Onsando 'The OECD Transfer pricing guidelines: An analysis of their application in the South Africa legal regime' available at <http://lawspace2.lib.uct.ac.za/dspace/handle/2165/367?mode=full> [accessed on 2 May 2009] p70

¹⁰³ SARS Practice Note No. 7 par 10.2.2

¹⁰⁴ A. Onsando 'The OECD Transfer pricing guidelines: An analysis of their application in the South Africa legal regime'. Available at <http://lawspace2.lib.uct.ac.za/dspace/handle/2165/367?mode=full> [accessed on 2 May 2009] p70

SARS pays particular attention to transactions involving subsidiaries based in tax havens.¹⁰⁵

In particular they seek to establish whether subsidiaries have permanent establishments in the countries where they are incorporated, permanent establishments in countries where they are managed and controlled and in countries where the day to day decisions are made. SARS will investigate how many employees they have, and whether the subsidiaries act as agents as opposed to operating for their own profit.¹⁰⁶ Attention will be paid to gross margins of the sales including details of contracts, connections with multinational enterprises, financial statements for the last 5 years and management autonomy. This is to establish whether the subsidiaries are truly independent operating entities or merely MNC's shells for manipulating funds.¹⁰⁷

Other details investigated by SARS to establish the true nature of the subsidiary is the physical addresses, descriptions of premises and copies of rental agreements. For SARS to prove that the employees genuinely live in the tax havens they work 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, SARS will investigate the issues such as floor plans, staffing and floor space and whether the employment is full time or not and the degree of autonomy the employee.¹⁰⁸

2.4.3 Documentation in relation to foreign branches in tax havens

SARS is more particular on foreign branches in tax havens compared to subsidiaries.¹⁰⁹ SARS will look into details of their location and how head office expenses are allocated to them. This

¹⁰⁵ SARS Practice Note No. 7 paragraph 12.6

¹⁰⁶ A. Onsando 'The OECD Transfer pricing guidelines: An analysis of their application in the South Africa legal regime'. Available at <http://lawspace2.lib.uct.ac.za/dspace/handle/2165/367?mode=full> [accessed on 2 May 2009] p72

¹⁰⁷ '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 12 January 2010]

¹⁰⁸ 'Transfer pricing: the next SARS target' [note 107].

¹⁰⁹ '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 12 January 2010]

information enables SARS to identify the use of common commercial transactions and the internal administrative arrangements engaged in transfer pricing.¹¹⁰

2.4.4 Tax returns documentation and disclosure and the relation to transfer

Pricing

The Commissioner is allowed by section 65 of the Income tax Act to request the taxpayer to 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 the taxpayer to disclose of the following information in respect of any cross-border transactions with connected parties:

- names of the contracting parties and relationship with the company
- details of the basis for determining the prices used
- details of the prices which would have been used had the transaction been between independent parties dealing a arm's length
- copies of the agreement between the contracting parties
- a copy of the transfer pricing policy document when SARS specifically requested it to do so.¹¹¹

Companies are now required to attach a transfer pricing policy document to a company's tax return form. In part 15 of the 2004 IT 14 form the company is required 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.¹¹²

It is not specified in the IT 14B what is meant by a transfer pricing policy document or what the transfer pricing policy document should contain¹¹³. This flaw in the law is problematic for the

¹¹⁰ A Onsando 'The OECD Transfer pricing guidelines: An analysis of their application in the South Africa legal regime'. Available at <http://lawspace2.lib.uct.ac.za/dspace/handle/2165/367?mode=full> [accessed on 2 May 2009] p72

¹¹¹ A Onsando [note 110] p73

¹¹² A Onsando [note 110] p73

¹¹³ For detail see SARS Practice Note No. 7 paragraph 10

taxpayer since they are not aware of what is required from them as a result some taxpayers may argue that in such circumstances they may not have to provide this information.

A clear example of this problem is set out in *Meditor Capital Management Ltd v Feighan (HMIT) [2004] STC (SCD) 273*.¹¹⁴ 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. However, the evidence given was not factual. The relevant revenue authority asked for the nature of activities in Bermuda, role and number of employees and interest in the funds under management. MCM did not meet 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 in the alternative that the information on the activities in the Bermuda Holding company was irrelevant, and that the information request was unreasonable. Furthermore, 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. 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.'¹¹⁵

¹¹⁴ Roxanna Nyiri, 'Examining Inter-company Cross border Transactions' Available at https://www.saica.co.za/documents/SAICA_Transfer_Pricing_Presentation.pdf [accessed 12 January 2010]

¹¹⁵ A. Onsando 'The OECD Transfer pricing guidelines: An analysis of their application in the South Africa legal regime'. Available at <http://lawspace2.lib.uct.ac.za/dspace/handle/2165/367?mode=full> [accessed on 2 May 2009] p73

Relying on this case, it shows that in essence the taxpayers should take note of the adequacy of the evidence that the OECD and revenue authority consider relevant if the taxpayer wants to avoid penalties.

2.5 Penalties

In South Africa general income tax penalties apply to transfer pricing cases. A taxpayer under Section 65 of the Income tax Act is required to prepare and maintain transfer pricing documentation. This documentation includes a transfer pricing policy document which is supposed to be submitted together with the corporate income tax return form (2004 IT 14 form). Section 75 and 76 of the Income tax Act set out the penalties for failure to adhere to these requirements.

Section 75 (1) (b) (i) spells out a penalty of a fine or 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. Consequently the same will apply 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.¹¹⁶

According to section 75 (1) d, the taxpayer may be penalised where they fail to disclose to the commissioner when preparing or making such return, any facts which, if so disclosed would affect the commissioner's decision. Section, 76 says 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's taxable income. This amount will be double the tax chargeable for that year of assessment if the taxpayer fails to submit a tax return.¹¹⁷ The double amount would apply if the taxpayer made an incorrect statement in any return.¹¹⁸ 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

¹¹⁶ A. Onsando 'The OECD Transfer pricing guidelines: An analysis of their application in the South Africa legal regime'. Available at <http://lawspace2.lib.uct.ac.za/dspace/handle/2165/367?mode=full> [accessed on 2 May 2009] p76

¹¹⁷ Income Tax Act 58 of 1962 s 76 1 (a)

¹¹⁸ Income Tax Act 58 of 1962 s 76 1 (b)

included.¹¹⁹In essence section 76 (1) (a) and (c) apply to any transfer pricing related to incorrect statement while section 76 (1) (a) seems to apply if a transfer pricing policy document is not attached to a tax return when submitting to SARS. The tax return can be viewed as not having been fully submitted.¹²⁰

The taxpayer may also be faced with being penalised under indirect penalties. These can be described as the tax cost arising from the re-characterisation of income.¹²¹ In South Africa the Secondary Tax on Companies (STC) payable when the adjusted amount becomes a deemed dividend is such an indirect penalty.¹²² Section 64C of the Income Tax Act stipulates 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 31.¹²³ The definition includes any shareholder of a company or any connected person in relation to a share holder. 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.¹²⁴

It is important to establish whether this deeming provision applies when the taxpayer voluntarily makes an adjustment in terms of section 31 (2). Section 64C (2) (e) stipulates that a deemed distribution of an amount which has been adjusted or disallowed in accordance with the

¹¹⁹ Income Tax Act 58 of 1962 s 76 1 (c)

¹²⁰ A Onsando 'The OECD Transfer pricing guidelines: An analysis of their application in the South Africa legal regime'. Available at <http://lawspace2.lib.uct.ac.za/dspace/handle/2165/367?mode=full> [accessed on 2 May 2009]

p77

¹²¹ A Onsando [note 120]p76

¹²² A Onsando [note 120] p77

¹²³ A Onsando [note 120] p77

¹²⁴ A Onsando [note 120] p77

provisions of section 31 which also provides for the adjustment or disallowance to be made by the commissioner.¹²⁵ SARS Practice Note No. 7 provides that the determination of the thin capitalization adjustment is made by the commissioner either on assessment or by notice prior to assessment.¹²⁶ It follows that the taxpayer may voluntarily make adjustments. What should be noted is that there is no similar provision relating to transfer pricing in SARS Practice Note No. Ultimately it seems that where the taxpayer has completed his return, having made the adjustment himself, section 31 cannot apply.¹²⁷ The section specifically provides that the adjustment or disallowance has to be made by the commissioner.

However, where the taxpayer voluntarily gives SARS information which results in an adjustment on assessment, it is deemed that it is the commissioner who made the adjustment.¹²⁸ If the commissioner makes 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 which 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.¹²⁹

In relation to the timing of the determination of a transfer price, generally, the commissioner's discretion in terms of section 31 is exercised on assessment.¹³⁰ 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.¹³¹ It is worth noting that although normal provisions for assessment and recovery of income tax apply to STC, there are no specific STC penalty provisions.¹³² Lastly section 89bis and 89quat of the Act provide for

¹²⁵ A. Onsando 'The OECD Transfer pricing guidelines: An analysis of their application in the South Africa legal regime'. Available at <http://lawspace2.lib.uct.ac.za/dspace/handle/2165/367?mode=full> accessed on 2 May 2009] p77

¹²⁶ A Onsando [note 125] p77

¹²⁷ A Onsando [note 125] p78

¹²⁸ A Onsando [note 125] p78

¹²⁹ A Onsando [note 125] p78

¹³⁰ Meyerowitz, 'Meyerowitz on Income Tax' (2001/2002) paragraph. 13.33

¹³¹ A Onsando [note 125] p78

¹³² A Onsando [note 125] p78

interest on the underpayment of tax. It follows that these sections will also apply if the underpayment of tax results from non-compliance with section 31 of the Act.¹³³

2.6 Advanced Pricing agreements

The OECD defines an APA as follows:

An advance pricing agreement ('APA') is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, and critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An APA is formally initiated by a taxpayer and requires negotiations between the taxpayer, one or more associated enterprises, and one or more tax administrations.¹³⁴

Unfortunately, South African taxpayers do not have the option of agreeing in advance to an acceptable range of pricing with the SARS.¹³⁵ This is made clear in paragraph 16.2 of the SARS' Practice Note No 7, which states that 'the APA process will not in the foreseeable future be made available to South African taxpayers'. It is unfortunate that SARS does not give reasons to why advanced pricing agreements are not extended to South African taxpayers. These APA are offered both in the United Kingdom and the United States. In the later chapters dealing with the UK and USA a clear explanation to the advantages and disadvantages of APAs will be made.

¹³³ A Onsando, *The OECD Transfer pricing guidelines: An analysis of their application in the South Africa legal regime*. Available at <http://lawspace2.lib.uct.ac.za/dspace/handle/2165/367?mode=full> accessed on 2 May 2009] p77

¹³⁴ OECD '*Transfer Pricing Guidelines*' paragraph 4.124

¹³⁵ T Lord 'transfer pricing in South African Income Tax law' available at <http://lawspace2.lib.uct.ac.za/dspace/handle/2165/320> [accessed on 6 July 2009] p 46.

3. CHAPTER THREE: TRANSFER PRICING IN THE UNITED KINGDOM

3.1 Introduction

It is imperative to look at the United Kingdom's transfer pricing regime as a yardstick to see how South Africa can improve its own. This is because South Africa is fast becoming integrated into the global market through more MNCs investing in the country. Globalisation offers MNCs the opportunity to achieve economies of scale and explore new markets. It also increases the number of cross border flows, no less between affiliates within the same multinational enterprise as between unrelated enterprises.¹³⁶ As a result, governments like the ones in the United Kingdom have financial commitments and spending objectives which turn into pressure on the tax authorities. This pressure is passed onto taxpayers through increased complexity in tax regulatory and enforcement regimes, including in the field of transfer pricing.¹³⁷ For the United Kingdom retain as much revenue from these MNCs and curb transfer pricing they have set up a complex transfer pricing system. This chapter will explore the history of the UK transfer pricing, the current law, documentation requirements and their approach to advanced pricing agreements.

3.1.1 History of transfer pricing in the United Kingdom

Previously in the United Kingdom without specific UK transfer pricing legislation, a UK entity could divert profits to connected entity in another country by manipulating the price paid for intra group sales or services. In 1951 the United Kingdom enacted transfer pricing rules.¹³⁸ Throughout the years the rules evolved and a major change was made in 1998 when a new Finance Act was introduced. This Act required UK entities including foreign controlled companies bases in the United Kingdom to comply with new transfer pricing regulations introduced by this new legislation. The UK legislation (Section 770A and Schedule 28AA ICTA 1988) applied from the commencement of UK Corporation Tax Self Assessment (CTSA) for companies that is for all accounting periods which ended on or after 1 July 1999 and years of

¹³⁶ M. Fieldman and A. Riordan, 'Transfer pricing today (dis)harmony rules?' Available on www.crai.com.bbgintl.com [accessed on 15 January 2010] p1

¹³⁷ M. Fieldman and A. Riordan, 'Transfer pricing today (dis)harmony rules?' Available on www.crai.com.bbgintl.com [accessed on 15 January 2010] p1

¹³⁸ HM Revenue and customs, '*HRMC approach to transfer prices for large businesses*' Consultation Document June 2007 p6

assessment 1999/2000. therefore the effective date of these transfer pricing rules was 1 July 1999. The new legislation spelt out in the Finance Act of 1998 was structured in a way that explicitly identified it with Article 9 of the OECD Model Treaty and the OECD Transfer Pricing Guidelines.¹³⁹

Subsequent to 1 April 2004, transactions between connected UK entities were not subject to the arm's length transfer pricing regulations, unless one of the entities carried on their business using an overseas branch.¹⁴⁰ Therefore transfer pricing had only been an issue for international trade.¹⁴¹ However from 1 April 2004 transfer pricing rules were extended to cover transaction between connected UK companies. The transfer pricing legislation adopted the arm's length principle which is the internationally accepted standard for setting transfer prices. This application of transfer pricing legislation to commonly controlled UK entities was largely attributable to EU regulations ensuring the UK transfer pricing legislation does not discriminate against other EU based entities.¹⁴² The UK's tax legislation therefore imposes arm's length transfer pricing on transactions with connected overseas entities so as to protect their tax base.¹⁴³ With effect from 1 April 2004, interest deductions on connected party borrowing and loan guarantees were incorporated within the UK transfer pricing legislation, this is to reduce the excessive use of debt finance between connected persons.¹⁴⁴ Also the relevant authority which deals with taxes in the UK which is Her Majesty Revenue and Customs (HMRC) required connected companies to consider the sale price of goods and services traded between them and to rest them for tax purposes to the price which would have been used on the open market.¹⁴⁵

Since 1 April 2004, the UK transfer pricing system was as follows:

¹³⁹ Greenback Alan LLP 'Transfer pricing: transactions and connected Entities-An overview', March 2008, the Daily NNA UK

¹⁴⁰ Greenback Alan LLP [note 139]

¹⁴¹ B. Lewis, '*Potentially sticky transfer*', Charity Finance July 2005 p 24 available on <http://www.bateswells.co.uk/Files/Articles/Potentially%20Sticky%20Transfers.pdf> [accessed on 12 August 2009]

¹⁴² Greenback [note 139]

¹⁴³ Greenback [note 139]

¹⁴⁴ B. Lewis [note 141]

¹⁴⁵ B. Lewis [note 141]

- only large UK entities are subject to full transfer pricing on all connected party transactions, including those where the other party is a UK entity, and¹⁴⁶
- most small and medium sized entities no longer have to apply UK transfer pricing principles in dealings with connected overseas entities located in tax treaty countries.¹⁴⁷ Small means organisations with less than fifty (50) employees and whose turnover and assets come to no more than ten (10) million pounds. Medium sized organisations are the ones with no more than 250 employees and whose turnover assets come to no more than fifty (50) million pounds.¹⁴⁸
- The HRMC now allows a two year transitional relaxation of penalties associated with not producing evidence to demonstrate that the results are at arm's length.¹⁴⁹
- Transfer pricing rules applied to parties where one party owns between 40-50 percent in the other party or voting power or share capital are under common control.¹⁵⁰
- With respect to financing transactions, where the lender has acted together with shareholders to provide funding, the shareholders' stake can be attributed to the lender, meaning a financing transaction may be caught by the legislation where there is no or a very small direct relationship between the lender and the borrower.¹⁵¹

Despite this relief given to small and medium enterprises the HMRC has the right to withdraw the exemption from these enterprises, even retrospectively, where a significant amount of tax is at stake.¹⁵²

The large UK entities which exceeded the small and medium sized criteria were required however to demonstrate that reasonable steps have been taken to apply the arm's length principle

¹⁴⁶ Greenback Alan LLP 'Transfer pricing: transactions and connected Entities-An overview', March 2008, the Daily NNA UK.

¹⁴⁷ Greenback Alan LLP [note 146]

¹⁴⁸ B. Lewis, 'Potentially sticky transfer', Charity Finance July 2005 p 24. Available on <http://www.bateswells.co.uk/Files/Articles/Potentially%20Sticky%20Transfers.pdf> [accessed on 12 August 2009]

¹⁴⁹ HM Revenue and Customs, 'Compliance cost review: reform rules on transfer pricing and thin capitalisation (2004)'. Available on www.hmrc.gsi.gov.uk [accessed on 12 August 2009].

¹⁵⁰ J Neighbour KPMG, 'Global transfer pricing review' (2009) p140

¹⁵¹ J Neighbour KPMG [note 150] p140

¹⁵² B. Lewis [note 148]

as a matter of compliance with UK tax law, and must have satisfactory documentation justifying their transfer pricing policy.¹⁵³

3.1.2 Recent developments and trends in the United Kingdom Transfer pricing

In the last two years the United Kingdom has had some significant development in there transfer pricing regime. The HM Revenue and Customs (HMRC) have made a resolve to litigate were necessary, transfer pricing cases and to bring to bear specialist transfer pricing economics input.¹⁵⁴ At the begging of the year 2009, the United Kingdom HRMC established a business International Directorate to address international tax issues. This Directorate has assumed governance of the Transfer price group which was solely established to deal with this complex area of tax in the United Kingdom.¹⁵⁵ A separate specialist transfer pricing team exists to address issues involving thin capitalisation and financial services transfer pricing.

HMRC is now implementing a new risk-based approach to transfer pricing enquiries, targeting high risk transactions and structures and aiming to complete transfer pricing enquiries within 18-36 months depending with the complexities of the issue.¹⁵⁶

3.2 Transfer pricing definitions and terminology in the United Kingdom legislation (Taxes Act 1988)

To have a better understanding of the transfer pricing regime in the United Kingdom it is essential to understand the legislative provisions surrounding UK transfer pricing. Transfer pricing regulations are set forth in sections 770-773 of the Income and Corporation taxes Act of 1988.¹⁵⁷ We will deal specifically with sections 92A-C which defines special terms such as associated enterprise and the computation of the arm's length principle in the UK transfer pricing regime.

¹⁵³ Greenback Alan LLP 'Transfer pricing: transactions and connected Entities-An overview', March 2008, the Daily NNA UK

¹⁵⁴ M Clayson & D Beeton, 'Recent developments and trends in UK transfer Pricing'. Available at <http://www.freshfields.com/publications/pdfs/2009/aug09/ClaysonBeeton.pdf>] p 1

¹⁵⁵ M Clayson & D Beeton [note 154] p 1

¹⁵⁶ J Neighbour KPMG, 'Global transfer pricing review' (2009) p140

¹⁵⁷ S. Borkowski, 'Transfer pricing of intangible property; Harmony and discord across five countries' International Journal of Accounting36 (2001) p357

3.2.1 Section 92 Computation of Income from an international transaction having regard to an arm's length price (ALP)

Any income arising from an international transaction shall be computed having regard to the arms length price. This means that the allowance for any expense or interest arising from an international transaction shall also be determined having regard to the ALP.¹⁵⁸

Section 92 (2) of the Taxes Act¹⁵⁹ which is a special provision relating to the avoidance of tax, stipulates that where in an international transaction, two or more associated enterprises enter into a mutual agreement or arrangement for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises, the cost or expense allocated or apportioned to, or, as the case may be, contributed by, any such enterprise shall be determined having regard to the arm's length price (ALP) of such benefit, service or facility, as the case may be.¹⁶⁰ Section 92(3) of the taxes Act¹⁶¹ says the provisions of that section shall not apply in a case where the computation of income under sub-section (1) or the determination of the allowance for any expense or interest under that sub-section, or the determination of any cost or expense allocated or apportioned, or, as the case may be, contributed under sub-section (2), has the effect of reducing the income chargeable to tax or increasing the loss, as the case may be, computed on the basis of entries made in the books of account in respect of the PY in which the international transaction was entered into.¹⁶²

3.2.2 Section 92A :Associated Enterprise

In the United Kingdom Income tax Act of 2007 an associated enterprise means an enterprise;

(a) Which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise;¹⁶³ or

(b) In respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons

¹⁵⁸ Transfer pricing sections and rules: provisions under the Income Tax Act available at http://www.transferpricing.com/worldtransferpricing_files/world_files/britian/britian.htm [accessed on 9 November 2009].

¹⁵⁹ Income and Corporation taxes act of 1988

¹⁶⁰ Transfer pricing sections and rules [note 158].

¹⁶¹ Income and Corporation taxes act of 1988

¹⁶² Transfer pricing sections and rules [note 158].

¹⁶³ Transfer pricing sections and rules [note 158].

who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.¹⁶⁴

There is an apt description of the circumstances when two enterprises will be considered associated. Firstly, two enterprises shall be deemed to be associated enterprises if, one enterprise holds, directly or indirectly, shares carrying not less than 26% of the voting power in the other enterprise; or any person or enterprise holds, directly or indirectly, shares carrying not less than 26% of the voting power in each of such enterprises. Secondly if a loan advanced by one enterprise to the other enterprise constitutes not less than 51% of the book value of the total assets of the other enterprise; or one enterprise guarantees not less than 10% of the total borrowings of the other enterprise. If more than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise the two enterprises will be considered associated or if more than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises are appointed by the same person or persons.¹⁶⁵

If the manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent on the use of know-how, patents, copyrights, trade-marks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights or 90% or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other

¹⁶⁴ Transfer pricing sections and rules: provisions under the Income Tax Act available at http://www.transferpricing.com/worldtransferpricing_files/world_files/britian/britian.htm [accessed on 9 November 2009].

¹⁶⁵ Transfer pricing sections and rules [note 164]

conditions relating to the supply are influenced by such other enterprise, the two enterprises shall be deemed to be associated.¹⁶⁶

If the goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise then the two enterprises shall be deemed to be associated.¹⁶⁷

Enterprises are deemed to be associated where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual. Or where one enterprise is controlled by a HUF (Hindu undivided family) the other enterprise is controlled by a member of such HUF or by a relative of a member of such HUF or jointly by such member and his relative then the enterprises are deemed to be associated. For tax purposes a HUF can be defined as a family that consists of a common ancestor and all his lineal male descendants. This indicates that a person may be assessed in two different capacities; as an individual and his HUF. Finally where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds not less than 10% interest in such firm, association of persons or body of individuals or if there exists between the two enterprises, any relationship of mutual interest, as may be prescribed.¹⁶⁸

3.2.3 Section 92C: Computation of Arm's length price.

The arm's length price (ALP) in relation to an international transaction shall be determined by the transfer pricing methods set out in the OECD guidelines for transfer pricing. The most appropriate method should be used with regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons.¹⁶⁹ These methods are

- Comparable uncontrolled price method (CUPM)
- Resale price method (RPM)

¹⁶⁶ Transfer pricing sections and rules: provisions under the Income Tax Act, available at http://www.transferpricing.com/worldtransferpricing_files/world_files/britain/britain.htm [accessed on 9 November 2009].

¹⁶⁷ Transfer pricing sections and rules [note 166].

¹⁶⁸ Transfer pricing sections and rules [note 166].

¹⁶⁹ Transfer pricing sections and rules [note 166].

- Cost Plus Method (CPM)
- Profit Split Method (PSM)
- Transactional Net Margin Method (TNMM)

These transfer pricing methods are the same as the ones adopted by South Africa based on the OECD's transfer pricing guidelines.

So far the United Kingdom has not had traditional transfer pricing litigation, however there has been a significant transfer pricing decision decided in 2009 on the pricing methodologies and the first case concerned with the detailed transfer pricing code introduced as schedule 28AA of the Income and Corporate taxes Act 1988.¹⁷⁰ This decision was made in the landmark case of DSG retail limited v Revenue and customs Commission (2009TC00001) (the DSG case).

3.2.4 New provisions set out in the Finance Act of 2001 which substituted section 92

The Finance Act, 2001, has substituted the existing section 92 of the Income-tax Act by new sections 92 and 92A to 92F. These new provisions lay down that income arising from an international transaction between associated enterprises shall be computed having regard to the arm's length principle.¹⁷¹ The term associated enterprise retains its definition in section 92A. Section 92B defines an international transaction between two or more associated enterprises. The provisions contained in section 92C provide for methods to determine the arm's length principle in relation to an international transaction, and the most appropriate method to be followed out of the specified methods. It should be noted that South Africa does not have legislation setting out the most appropriate transfer pricing method to use in certain transactions which would a better arm's length result. While the primary responsibility of determining and applying an ALP is on the assessed enterprise, section 92C (3) empowers the accounting officer (AO) to determine the ALP and compute the total income of the enterprise accordingly. Section 92D provides for certain information and documents required to be maintained by persons entering into

¹⁷⁰ M Clayson & D Beeton, 'Recent developments and trends in UK transfer Pricing'. Available at <http://www.freshfields.com/publications/pdfs/2009/aug09/ClaysonBeeton.pdf>] p 1

¹⁷¹ Transfer pricing sections and rules: provisions under the Income Tax Act available at http://www.transferpricing.com/worldtransferpricing_files/world_files/britian/britian.htm [accessed on 9 November 2009].

international transactions, and section 92E provides for a report of an accountant to be furnished along with the return of income.¹⁷²

3.3 The UK application of the arm's length principle.

The UK's transfer pricing rules as already mentioned, are based on the internationally recognised "arm's length" principles promulgated by the OECD transfer pricing guidelines. The application of these transfer pricing rules in the United Kingdom can involve the exercise of judgement rather than the application of precise rules.¹⁷³

The important features about the United Kingdom Transfer pricing rules are that;

- 'They ensure fairness between taxpayers and help to achieve a fair division between countries of the tax base relating to corporate profits enabling international double taxation to be addressed'.¹⁷⁴
- 'They help to protect the UK tax base by preventing the artificial diversion of profits;
- they have the potential to impose a significant compliance burden on companies to demonstrate, by assembling evidence, that arm's length results have been used in the calculation of taxable profit'.¹⁷⁵
- 'They can involve complex analysis and specialist knowledge which can make disputes difficult and lengthy to resolve'.¹⁷⁶
- 'Where the nature of the issues merits it, Advance Pricing Agreements can be reached to deliver earlier and greater certainty'.¹⁷⁷

¹⁷² Transfer pricing sections and rules: provisions under the Income Tax Act. Available at http://www.transferpricing.com/worldtransferpricing_files/world_files/britain/britain.htm [accessed on 9 November 2009].

¹⁷³ HM Revenue and customs, '*HRMC approach to transfer prices for large businesses*' Consultation Document June 2007 p6

¹⁷⁴ HM Revenue and customs [note 173] p6

¹⁷⁵ HM Revenue and customs [note 173] p6

¹⁷⁶ HM Revenue and customs [note 173] p6

¹⁷⁷ HM Revenue and customs [note 173] p6

The UK law requires a company to ensure in its tax return that the results of relevant transactions are adjusted to arm's length results. An enterprise must have appropriate evidence to authenticate the figures it contains when making a tax return. The law does not require a company to provide the evidence to HMRC at the time the return is made. In the event that there is no enquiry made by the HMRC, then proof that the arm's length principle has been adhered to might never be established.¹⁷⁸ Evidence has to exist by the time the return is made in order to provide confidence that the return is correct. Having insufficient evidence may indicate negligence and attract a tax-geared penalty.¹⁷⁹

In 2008 there has been a decision passed the British courts which directly deals with the application of the arm's length principle. This case involved the transfer pricing arrangements between a major UK retailer (Dixons) and the group captive insurer in the Isle of Man (DISL).¹⁸⁰ The facts of the case are as follows; DISL bore most or rather all of the risk on extended warranties or service contracts purchased by customers. Despite the fact that all the details are not available, this was apparently a very profitable business. The insurance contracts regarding the insurance company, were sold to customers when they purchased electrical goods in the stores of the main UK trading company, DSG Retail limited (DSG). The issues in dispute were whether the arrangements between these companies were at arm's length and in the event that they were not could DSG, the UK retail company be charged tax on imputed income.¹⁸¹ The courts decided that the transfer pricing rules did not apply to the transactions between DSG, the retail company and DISL, the insurance company. The considered all the particular circumstances including absence of relevant comparables and the need to understand the overall contribution by both parties to the arrangement and not just review the transfer pricing from the aspect of one of the parties and the decided that a profit split approach was the most suitable one.

3.4 Documentation in the United Kingdom

Corporate entities which are subject to UK corporation tax on their profits, including a UK trading presence of a non-UK resident company, may be obliged to prepare and maintain

¹⁷⁸ HM Revenue and customs *HMRC approach to transfer prices for large businesses* Consultation Document June 2007 p6

¹⁷⁹ HM Revenue and customs [note 178] p7

¹⁸⁰ High street partners Incorporated, *'Changing tax laws overseas; what you need to know'*. Available at www.hsp.com [accessed on 13 January 2010].

¹⁸¹ High street partners Incorporated [note 180].

documentation which sets out its transfer pricing policy and demonstrates its consistency with the arm's length principle.¹⁸² The HM Revenue and customs (HRCM) have issued transfer pricing guidelines which set out the requirements which must be followed by large entities when maintain documentation supporting their inter-company pricing policies.

The guidelines guidance particularly state that the documentation should identify the following:-

- Relevant commercial or financial relations falling within the scope of the legislation.¹⁸³
- The nature and terms (including prices) of relevant transactions. Transactions which are clearly one family e.g. regular purchases made by a distributor throughout a return period of the same or similar products for resale may be aggregated.¹⁸⁴
- The method or methods by which the nature and terms of relevant transactions were carried out, including a study of comparables and any functional analysis undertaken.¹⁸⁵
- How that method has resulted in arm's length terms, or where it has not, what computational adjustments are required and how they have been calculated. This will include an analysis of market data or other information on third party comparables.¹⁸⁶
- The terms of relevant commercial arrangements with both third party and affiliated customers. These will include commercial agreements (e.g. service on distribution contracts, loan agreements) and any budgets, forecasts or other papers containing information relied on in arriving at arm's length terms, or in calculating any adjustment made in order to satisfy the requirements of the transfer pricing legislation.¹⁸⁷

The UK legislation does not require a specific form in which transfer pricing evidence needs to be recorded. The enterprise can keep documentation containing evidence in any form it chooses. (This analysis draws a distinction between evidence and documentation; evidence refers to proof of a fact or to the strength and logic of an argument while documentation refers to the format and

¹⁸² UHY Global transfer pricing guide 2009. Available <http://www.uhy.com/media/PDFs/UHY%20Global%20Transfer%20Pricing%20Guide%202009.pdf> [accessed on 11 December 2009] p 103.

¹⁸³ HM Revenue and customs, '*HRCM approach to transfer prices for large businesses*' Consultation Document June 2007 p7.

¹⁸⁴ HM Revenue and customs [note 183]p7

¹⁸⁵ HM Revenue and customs[note 183] p7

¹⁸⁶ HM Revenue and customs[note 183] p7

¹⁸⁷ HM Revenue and customs[note 183] p7

medium in which the evidence is contained.)¹⁸⁸ The main principle relevant to the cost to be incurred in assembling evidence and recording it in documentation is that it should be commensurate with the risk involved in arriving at the arm's length result.¹⁸⁹ Complex and high value transactions would generally require greater attention by the enterprise than simple and high volume ones.

A UK enterprise should ensure proper care and setting in documenting transfer pricing. This will help avoiding penalties. Under the UK's CTSA legislation, UK entities must ensure that their Corporation Tax Return, Form CT600, reflects arm's length transfer pricing on transactions with non-resident connected entities. Where such transactions are not priced on an arm's length basis, an appropriate adjustment is required in arriving at the declared taxable profit.

3.4.1 Deadline to prepare and submit documentation in the United Kingdom

Documentation forms part of the company's records and should be ready before the filing of the company's tax return. Without the relevant documentation setting out the company's transfer pricing policy, the company will not be in a position to make a correct self assessment of its chargeable profits.¹⁹⁰ The HMRC may request documentation during enquiries into a filed tax return. However there is no statutory requirement to prepare and retain documentation to support the entries on a taxpayer's tax return, including transfer pricing documentation.¹⁹¹ In the event that the HMRC requests documentation the company has a deadline of 30- 60 days to submit the relevant documents. This deadline may be extended where a company is a small or medium enterprise.¹⁹² This is because, as already mentioned the legislation in 2004 exempted them from compliance with the transfer pricing regulations. If they have large profits which may be proof of transfer pricing, the HRMC may require them to adhere to the transfer pricing laws.

¹⁸⁸ HM Revenue and customs '*HRMC approach to transfer prices for large businesses*' Consultation Document June 2007 p7.

¹⁸⁹ HM Revenue and customs [note 188] p7

¹⁹⁰ UHY Global transfer pricing guide 2009. Available at <http://www.uhy.com/media/PDFs/UHY%20Global%20Transfer%20Pricing%20Guide%202009.pdf> [accessed on 11 December 2009] p 103

¹⁹¹ J Neighbour KPMG, 'Global transfer pricing review' (2009). Available at http://kpmgsk.lcc.ch/dbfetch/52616e646f6d49563eb14c16deda6e55f9bf1175e7acefeebe5e6408c23d8263/invitation_insurance_final_030209.pdf [accessed on 2 January 2010] p140.

¹⁹² UHY Global transfer pricing guide 2009 [note 190]

If a company has not complied with its documentation requirements, HRMC can impose a penalty of 3000 pounds for each year of non-compliance. In addition, in the case of negligence, a tax geared penalty of up to 1005 of any tax adjustment can be imposed.¹⁹³

3.5 Advanced Pricing Agreements in the United Kingdom

Advanced pricing agreements (APAs) are written agreements between a business and the Board of Inland Revenue which determine a method for resolving transfer pricing issues in advance of a tax return being made. When the terms of the agreement are adhered to, they provide assurance that the treatment in accordance with the agreement of those transfer pricing issues will be accepted by both the Revenue and the business for the period covered by the agreement.¹⁹⁴

An APA may remain limited to a binding agreement between a UK business and the Inland Revenue in accordance with Section 85 of the Finance Act of 1999: this is referred to as a "unilateral APA".¹⁹⁵ However, a unilateral APA can only provide a partial resolution of cross-border transfer pricing issues because, although it confirms the tax treatment in the UK, it does not determine how the issues are to be resolved in the other country involved. Consequently, it does not remove the risk of double taxation in relation to the transfer pricing issues it addresses. In order to remove the risk of double taxation in the case of cross-border transfer pricing issues where a Double Taxation Agreement exists between the UK and the other country containing a Mutual Agreement Procedure article, the Inland Revenue would have to reach agreement also with the tax administration of the other country: this is referred to as a "bilateral APA".¹⁹⁶

An Advance Pricing Agreement (APA) offers a means of securing tax authority approval of your transfer pricing policies and methodologies in advance. An APA is a financial advantage to a company because it can save money, boost cash flow and mitigate risks by meeting information challenges up front, eliminating onerous and time-consuming documentation requirements later

¹⁹³ Tenontax, 'Transfer pricing documentation requirements'. Available at <http://www.tenongroup.com/~media/Files/tax/Transfer%20Pricing.ashx> [accessed on 5 January 2010].

¹⁹⁴ HM Revenue and Customs. Available at <http://www.hmrc.gov.uk/international/technical3a.htm> [accessed on 17 January 2010].

¹⁹⁵ HM Revenue and Customs [note 194]

¹⁹⁶ HM Revenue and Customs [note 194]

on and obtaining agreement about the company's proceedings without concern about penalties or double taxation.¹⁹⁷

The requirement in the United Kingdom for 'contemporaneous documentation' of a taxpayer's transfer pricing methodologies in order to avoid exposure to substantial penalties has led more taxpayers to consider entering into an Advance Pricing Agreement (APA) instead of using the documentation methods to clarify their transfer pricing issues. To these taxpayers, APAs represent an opportunity to remove the prospect of penalties and other areas of uncertainty related to transfer pricing enforcement usually through documentation requirements.¹⁹⁸ In a nutshell APAs enable taxpayers to manage transfer pricing uncertainties and audit risks proactively.¹⁹⁹ For a better understanding of APAs a breakdown of the basic procedure of APAs is as follows:

- A taxpayer proposes to one or more tax authorities its proposals for addressing the pricing of selected intra-group cross border transactions.²⁰⁰
- The tax authority undertakes a review of the taxpayer's proposal.²⁰¹
- The taxpayer and the tax authority negotiate an agreement in the case of unilateral APAs or the taxpayers authorities involved negotiate with each other (bilateral/multilateral APAs).²⁰²
- Once the agreements are finalised the parties execute the APA.²⁰³

¹⁹⁷ Deloitte . Available at http://www.deloitte.com/view/en_US/us/Services/tax/Transfer-Pricing-Tax/Advance-Pricing-Agreement-Transfer-Tax/index.htm [accessed on 17 January 2010].

¹⁹⁸ M. Markham, 'The advantages and disadvantages of using an advance pricing agreement: Lessons for the UK from the US and Australian experience', *Intertax: International tax review* 33.5 (2005): 214-229 available at http://works.bepress.com/michelle_markham/3/ [accessed on 17 January 2010].

¹⁹⁹ KPMG Global transfer pricing services. Meeting of the minds-Resolving transfer pricing controversies, J Bajger, 'The Sequential APA strategy: A roadmap for dealing with developing transfer pricing jurisdictions' available at http://www.kpmg.com.br/publicacoes/tax/Meeting_Minds_Transfer_Pricing_5_Aug.pdf [accessed on 7 August 2009].

²⁰⁰ KPMG Global transfer pricing services [note 199]

²⁰¹ KPMG Global transfer pricing services [note 199]

²⁰² KPMG Global transfer pricing services [note 199]

²⁰³ KPMG Global transfer pricing services [note 199]

APA procedures are similar in all jurisdictions but however a variation comes with the differences in levels of experience. The European Union (EU), which the United Kingdom is a part of, in 2007 issued new advanced pricing agreements guidelines are designed to avoid transfer pricing disputes and increase legal predictability. These guidelines explain how the EU states should conduct APA processes, provide APA information for taxpayers and describe how the specific problems should be resolved. These guidelines help avoid conflicts between the EU countries.

3.5.1 Advantages of Advanced Pricing Agreements

The Advanced Pricing Agreement between a company and tax authorities helps the company by reducing the uncertainty a company may face regarding its transfer pricing because the tax authority and the company would have agreed on what is expected from the company in setting out its transfer. The company which is the taxpayer is obtaining more certainty but is incurring substantial amounts of lost time for personnel and document creation, as well as the cost required to secure the APA. In some cases, the APA Office is stricter than what the regulations require.²⁰⁴ However, APA taxpayers are generally less concerned with the transfer pricing methodology (TPM) used in the APA and its effects than avoiding uncertainty and the threat of double taxation.²⁰⁵ The key benefit of all this is the increased certainty that the agreed price will be respected by the taxing authority. In the case of a multilateral APA, both taxing authorities will agree to respect the price.²⁰⁶

Using APAs ensures an upfront acceptance of the MNC's version of the arm's length transaction.²⁰⁷ APAs substantially reduce the possibility of future double taxation. MNCs can project future tax liabilities because APAs clarify the investment decisions regarding overseas transactions. With APAs the MNC can negotiate with the relevant tax authority before hand. With regard to multilateral and bilateral tax agreements, the MNC can be certain of tax treatment

²⁰⁴ Robert Cole, "Fourteen Facts Offered to the Senate Finance Committee to Assist in Its Review of the Advance Pricing Agreement Program," Tax Management International Journal March, 2004

²⁰⁵ Robert Cole [note 204]

²⁰⁶ By Harden, J William and Timothy B, 'Advance Pricing Agreements: A Chance for Certainty Amidst Chaos. Part 2' Strategic Finance Friday, October 1 2004. Available at <http://www.allbusiness.com/finance/3591902-1.html> [accessed on 17 January 2010].

²⁰⁷ Bulbul Sen, 'advance pricing mechanisms in transfer pricing; world experience and lessons from India', September 9 2005. Microsoft power point presentation

by the relevant tax authorities.²⁰⁸ When it comes to judicial or administrative proceedings an MNC can expect more cooperative venture with regards to the system rather than an adversarial approach. The relevant revenue authority will benefit from APAs because they have insight into the structure, assets, functions and risks within a MNC and practical problems with the MNC establishing an arm's length approach.²⁰⁹

3.6 Transfer pricing penalties in the United Kingdom

In the UK law there is no separate penalty for transfer pricing; the general rules about making an incorrect return apply. The general tax penalties and conditions apply for transfer pricing penalties. Under the general penalty regime for incorrect returns, a transfer pricing adjustment may lead to a penalty based on a percentage of potential tax lost, even if the result for the period is a loss.²¹⁰ Penalties are up to 30 percent for a failure to take reasonable care, up to 70 percent for a deliberate understatement or over claim and up to a 100 percent for a deliberate understatement aggravated by concealment. HMRC may apply lower percentage penalties where there is disclosure, the extent of mitigation depending whether disclosure is prompted or unprompted.²¹¹ It should be noted that penalties can be for a number of reasons, one being cooperation with the HMRC.²¹²

3.7 United Kingdom's approach to transfer pricing during the current global economic recession

The current global recession has made transfer pricing even more significant for the multinational companies as they try and minimise their tax obligations by shifting profits to lower tax jurisdictions. Due to the recession which left the world in shock it is of essence to discuss how the United Kingdom has handled transfer pricing issues during this time to

²⁰⁸ Bulbul Sen '*advance pricing mechanisms in transfer pricing; world experience and lessons from India*', September 9 2005. Microsoft power point presentation

²⁰⁹ Bulbul Sen [note 208]

²¹⁰ J Neighbour KPMG, 'Global transfer pricing review' http://kpmgsk.lcc.ch/db/fetch/52616e646f6d49563eb14c16deda6e55f9bf1175e7acefebe5e6408c23d8263/invitation_insurance_final_030209.pdf accessed on 2 January 2010 p140.

²¹¹ J Neighbour KPMG [note 210]

²¹² J Neighbour KPMG [note 210]

safeguard their tax base.²¹³ This analysis will help bring some light to the South African approach to transfer pricing.

The change in the economic climate may have influenced changes in some of the MNC's business models. This may have forced the revisiting of advanced pricing agreements which were agreed in less tough times.²¹⁴ As more jurisdictions, such as South Africa introduce transfer pricing compliance requirements and penalties, and those with existing requirements are enforcing them more aggressively, the potential for friction between the tax authorities and companies is high. The current recession has increased the potential dramatically and its effects will be felt for several years to come as taxpayers are asked to defend losses in tax returns that have still to be examined by tax authorities.²¹⁵ Losses by companies are the key areas of risk the HMRC will analyse when carry out transfer pricing enquiry with regards to companies. The HMRC sees transfer pricing as the biggest tax risk area generally and is becoming more aggressive in its efforts to collect additional tax where it believes incorrect transfer pricing have been used.²¹⁶ Particular risk areas identified in the tax bulletin 60 by the HMRC are,²¹⁷

- Profit margins in the UK are lower than in the group generally and there are reasons to believe that it should not be the case.²¹⁸
- The UK company possesses the resources to generate high margin profit yet produces only a routine low margin profit. The Revenue will look for the presence of factors such as heavy investment, a highly skilled and remunerated technical or Research and development workforce and intangibles for example trading names, know-how and patents.²¹⁹
- Royalty or management fee payments that do not appear to make commercial sense and which substantially impact on the UK bottom line for example for a brand name unknown

²¹³ Tax Planning International Report, *'Transfer pricing in a Recession'*, BNA international INC , March 2009 p3

²¹⁴ Tax Planning International Report [note 213].

²¹⁵ Member Firms of Grant Thornton International, *'International Comparisons- how taxpayers and tax authorities are responding, implications for risk management'*, [Transfer pricing in a Recession] BNA international Inc., March 2009 p 17

²¹⁶ Member Firms of Grant Thornton International [note 215] p 24.

²¹⁷ Member Firms of Grant Thornton International [note 215] p 23.

²¹⁸ Member Firms of Grant Thornton International [note 215] p 23.

²¹⁹ Member Firms of Grant Thornton International [note 215] p 23.

to the United Kingdom, for technology to which significant value has been added by complex processes carried out in the UK, or for nebulous bundles of intangibles.²²⁰

- Poor performance over a number of years when there is no obvious prospect of super profits in later years to justify the risk of continuing losses.²²¹
- Any period in which changes in intra-group contractual arrangements purport to adjust the risk profile, and hence the reward, of the UK group, for example a distributor becomes a commission agent, a full manufacturer becomes a contract manufacturer, research and development activities that once generated royalties move to a contract basis, or cost sharing arrangements are introduced.²²²

The HMRC now allows a MNC experiencing persistent losses caused by the recession to approach it and negotiate advanced risk assessment discussions prior to its filing of tax returns. The HMRC has been using the new transfer pricing risk assessment since July 2008, conducting pre-return discussions and risk assessments. The HMRC only opens transfer pricing enquiries where there is a likelihood of restating a reasonable amount of tax. The advanced risk assessment negotiations can only be done by companies using the compliance risk assessment framework set out by the HMRC. The companies will be required to show that their losses are not due to transfer pricing policies. The HMRC have a list of documents which they refer when examining risk areas. These documents are;

- A review of any previous transfer pricing papers.
- A detailed examination of six year' consolidated group accounts and of accounts of individual UK an appropriate UK entities.
- Consideration of the group structure and identification of haven/shelter countries.
- A review of industry trends, details of the company's place in the sector, and recent developments within the group.

²²⁰ Member Firms of Grant Thornton International, '*International Comparisons- how taxpayers and tax authorities are responding, implications for risk management*', [Transfer pricing in a Recession] BNA international Inc., March 2009 p 23

²²¹ Member Firms of Grant Thornton International [note 220] p 23

²²² Member Firms of Grant Thornton International [note 220] p 23

- A review of databases for multiple year data and potential comparables.
- A review of the company's returns in other jurisdictions.
- Liaison with the Pay As You Earn (PAYE) office for details of highly paid staff.
- Possibly liaison of corporation Inspectors with the customs and exercise officers.²²³

The HMRC also want proof that the company though is experiencing persistent losses they expect profits in the future, the company should ensure that they have the profit forecast when they engage n the dialogues with the HMRC.

²²³ Member Firms of Grant Thornton International, '*International Comparisons- how taxpayers and tax authorities are responding, implications for risk management*', [Transfer pricing in a Recession] BNA international Inc., March 2009 p 23

4 CHAPTER FOUR: TRANSFER PRICING IN THE UNITED STATES OF AMERICA

4.1 Introduction

Transfer pricing is one of the highest priority issues for the tax authorities in the United States. The Internal Revenue Services (IRS) auditors are turning to transfer pricing enforcement as the foundation of their investigations of multinational enterprises (MNEs). In the United States there is a focus on the outbound transfer of intangibles with particular emphasis on cost sharing arrangements (these will be explained later on in the chapter). Intercompany services are also coming under scrutiny as a result of the new regulations published in 2006.²²⁴

The legislation dealing with transfer pricing in the USA is the Internal Revenue Code 482 (latest amendment effective for tax years beginning after 31 December 1986).²²⁵

4.2 Legislature dealing with transfer pricing in the United States of America

In 1968 the IRS issued its first set of Transfer pricing regulations. The regulations specified five types of intra-firm transactions; these were loans, rentals, or sales of intangible property and performance of various business services.²²⁶ Over the period of 1986-1994, the US Treasury revised its corporate income tax legislation and regulations in the area of transfer pricing. This was in response to the pressures of globalisation, heavy inward foreign direct (FDI) investment by MNC's in the USA. This resulted in the growing of international trade in services and intangibles.²²⁷ It has been argued by scholars that when compared with other industrialized countries, the U.S. "subjects the foreign operations of its MNCs to the severest tax constraints and the heaviest tax burden," as well as with difficult administrative complexities. Section 482 of the Internal Revenue Code is a major component of this overall tax policy. A single paragraph long, it requires almost two hundred pages of interpretation.²²⁸ The US seems to use this legislative approach to ensure strict compliance by MNCs to its transfer pricing policies.

²²⁴ S. Foley, 'Transfer Pricing in the Americas', KPMG Global Transfer Pricing review, 2009 p6

²²⁵ Deloitte '2009 Strategy Matrix for global transfer pricing'.

²²⁶ L. Eden, 'Taxes, transfer pricing, and the multinational enterprise', available at <http://www.voxprof.com/eden/Publications/EDEN-OHIB-CHAPTER-12102552.pdf> accessed on 5 Jan 2010 at p604

²²⁷ L. Eden [note 226] p592

²²⁸ S Borkowski, *Factors Affecting Transfer Pricing and Income Shifting (?) Between Canadian and U.S. Transnational Corporations*, (1997) International journal of Accounting p394

The relevant section in the US legislation dealing with transfer pricing is Section 482 of the IRS Tax Code. USA published the section 482 in 1994.²²⁹ Section 482 permits the IRS to adjust the income, deductions, credits, or allowances of commonly controlled taxpayers to prevent evasion of taxes or to clearly reflect their income. The regulations under section 482 generally provide that prices charged by one affiliate to another, in an intercompany transaction involving the transfer of goods, services, or intangibles, yield results that are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances. In essence the section advocates for an arms' length approach to intercompany transactions. This section applies to both domestic and international transactions.²³⁰

Section 482 provides two approaches to transfer pricing:

- Dividing the total income from the transaction between related parties
- Comparing controlled transactions with uncontrolled transactions

Of the two methods set forth, these regulations prefer that transfer pricing be based on the comparison of transactions method rather than the division of income approach.²³¹

Section 482, justifies the IRS, and the accompanying Regulation's necessity in preventing related taxpayers in different taxing jurisdictions from easily and artificially shifting items of income and expense between these different tax jurisdictions (with differing rates of tax). The intent of section 482 is to ensure that, from a United States tax perspective, an arm's-length price is charged in all related-party multi-jurisdictional transactions.²³² Before the section 428 regulations came into effect, the IRS could challenge a taxpayer's transfer price as not arm's length, and the IRS could then assert a specific transfer price that it believed was arm's length.²³³ Now the IRS is allowed by section 482 extend to any case in which the taxable income of a controlled taxpayer is other than it would have been had the taxpayer, in the conduct of his affairs, been dealing at arm's length with an uncontrolled taxpayer.²³⁴

²²⁹ L. Eden, '*Taxes, transfer pricing, and the multinational enterprise*', available at <http://www.voxprof.com/eden/Publications/EDEN-OHIB-CHAPTER-12102552.pdf> accessed on 5 Jan 2010 p604

²³⁰ http://www.usa-international-offshore-company-tax.com/transfer_pricing.asp

²³¹ R. Feinschreiner, '*Practical aspects of transfer pricing*', June 2004 p3

²³² http://www.usa-international-offshore-company-tax.com/transfer_pricing.asp

²³³ R. Feinschreiner [note 231].

²³⁴ http://www.usa-international-offshore-company-tax.com/transfer_pricing.asp

Transactions between controlled taxpayers which may fall under section 482 include the following:

- 'One entity makes a loan or advances to another entity and charges no interest or does not charge an arm's-length interest rate.'²³⁵
- 'One entity performs services for another entity without charge or at a charge which does not reflect an arm's-length payment.'²³⁶
- 'One entity leases property to another entity at a rental charge that is not an arm's-length rental charge.'²³⁷
- 'One entity sells property to another entity at a sales price that is not an arm's-length price.'²³⁸
- 'One entity leases intangible property to another entity for no royalty fee or a fee that is not an arms-length fee.'²³⁹
- 'One entity enters into a cost sharing arrangement with another entity to share costs to develop intangibles but all related costs are not shared.'²⁴⁰

A number of different methods are offered by the regulations. These methods are the same methods set out in the OECD guidelines, the same used by both South Africa and the United Kingdom. These methods are:

- Comparable Uncontrolled Price Method (also called the Comparable Uncontrolled Transaction Method for intangible transfers);
- Comparable Profits Method;
- Profit Split Method;
- Resale Price Method;
- Cost plus Method.

²³⁵ http://www.usa-international-offshore-company-tax.com/transfer_pricing.asp

²³⁶ http://www.usa-international-offshore-company-tax.com/transfer_pricing.asp

²³⁷ http://www.usa-international-offshore-company-tax.com/transfer_pricing.asp

²³⁸ http://www.usa-international-offshore-company-tax.com/transfer_pricing.asp

²³⁹ http://www.usa-international-offshore-company-tax.com/transfer_pricing.asp

²⁴⁰ http://www.usa-international-offshore-company-tax.com/transfer_pricing.asp

The IRS introduced a new transfer pricing method in 2006. This is the Cost of Services plus method, it is defined in section 1.482-9T of the IRS transfer pricing regulations. It is useful when one entity provides essentially the same services to unrelated parties as it does to related ones. In such cases, the price charged to unrelated parties for those services can be used to value the same services when they are provided to related parties.²⁴¹ Another new method was introduced in 2006; this is the gross services margin method. The official definition of gross services margin as it applies under United States transfer pricing rules can be found in proposed Section 482-9T (d) of the transfer pricing regulations.

(d) Gross services margin method--(1) In general. The gross services margin method evaluates whether the amount charged in a controlled services transaction is arm's length by reference to the gross profit margin realized in comparable uncontrolled transactions. This method ordinarily is used in cases where a controlled taxpayer performs services or functions in connection with an uncontrolled transaction between a member of the controlled group and an uncontrolled taxpayer. This method may be used where a controlled taxpayer renders services (agent services) to another member of the controlled group in connection with a transaction between that other member and an uncontrolled taxpayer. This method also may be used in cases where a controlled taxpayer contracts to provide services to an uncontrolled taxpayer (intermediary function) and another member of the controlled group actually performs a portion of the services provided.

This new method for pricing services is similar to the resale price method for tangible property. This method takes the same approach to valuing services as the resale price method takes to valuing tangible property. This method values services provided among related parties by reference to profit margins of comparable services being provided among unrelated parties. The method is ordinarily used in transactions involving three or more parties where two parties that are not related conduct a main transaction, but a third party that is related to one of them provides some of the services associated with the transaction, either on a contract or supplemental basis to the main transaction.²⁴²

Finally, in 2006 the IRS issued final and temporary transfer pricing services regulations. These new regulations made significant changes to the proposed regulations issued in 2003, including the elimination of the heavily criticised Simplified-Cost Based Method, which was replaced in the new regulations by the Services Cost Method. According to the Treasury Department, the

²⁴¹ http://www.ustransferpricing.com/comparable_profits_method.html

²⁴² http://www.ustransferpricing.com/comparable_profits_method.html

Services Cost Method is intended to reduce complexity for valuing low-margin services. The Services Cost Method includes a safe-harbour rule for reducing services transaction valuations by amounts paid for support services that was not available in the Simplified-Cost Based Method, which was roundly criticised and being too complicated by tax practitioners.²⁴³

Section 482 requires that the "best method" be employed to determine arm's length pricing for each inter-company transaction. Among the factors to be taken into account in determining the best method is "the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparable and the quality of the data and assumptions used in the analysis."²⁴⁴

4.2.1 Recent developments on the legislature dealing with transfer pricing; Services And Intangible Property

The USA has realised the importance of regulating transfer pricing of intangibles because of the growing world trade surrounding these types of goods. The Internal Revenue Services (IRS) has supplemented the original section 482 regulations on services and intangible property on several occasions. Treasury guidance on services and intangible property was amended and supplemented in 2004. The amended regulations provided updated guidance under section 482 that replaced existing guidance under section 1.482-2(b) relating to controlled services transactions and existing guidance under section 1.482-4(f)(3) relating to the allocation of income attributable to intangible property.²⁴⁵

The Treasury U.S. Department and Internal Revenue Service in 2006, issued proposed and temporary regulations on the tax treatment of services transactions, including services transactions related to intangible property, under the related party transfer pricing rules.²⁴⁶ The regulations were issued in temporary form with a delayed effective date for taxable years beginning after December 31, 2006. Controlled taxpayers may also elect to apply these temporary regulations to any taxable year beginning after September 10, 2003, the date of

²⁴³ http://www.ustransferpricing.com/comparable_profits_method.html

²⁴⁴ http://www.usa-international-offshore-company-tax.com/transfer_pricing.asp

²⁴⁵ http://www.usa-international-offshore-company-tax.com/transfer_pricing.asp

²⁴⁶ W F Heinz 'IRS Issues new transfer pricing regulations for IP and services available at http://www.ustransferpricing.com/IP_NewRegs_Heinze_TKHR.html [accessed on 20 January 2010].

publication of the 2003 proposed regulations.²⁴⁷ The updated regulations of 2004 provided that the arm's length amount charged in a controlled services transaction must be determined by one of the transfer pricing methods such as the Profit Split Method or the Cost plus Method. These methods involve a comparison of the relative economic contributions made by each taxpayer to the venture, and a division of the returns from the venture according to the relative value of each party's contribution calculated on an arm's length basis.²⁴⁸

The guidance regarding transfer pricing methods provided for in the proposed regulations generally is consistent with the current regulatory guidance regarding the transfer pricing methods applicable to transfers of tangible or intangible property and is consistent with international standards set out by the OECD guidelines in this area.²⁴⁹

The new regulations provided a new cost based method of transfer pricing. It may be used to price low-margin controlled services transactions that meet certain quantitative and qualitative conditions and requirements. This simplified cost-based method generally requires a less vigorous analysis of services transactions within its scope than would be required under the other pricing methods.²⁵⁰ The cost-based method is intended to preserve aspects of the current rules that provide appropriately reduced administrative and compliance burdens for low-margin services. It helps with bringing the current rules more into line with the arm's length principle and removes aspects of the current rules that have proved challenging.

The new rules put forth guidance for transfers involving intangible property. The Treasury Department and the IRS believe that the transfer pricing rules should reach similar results in the case of economically similar transactions, regardless of the characterisation or structuring of such transactions. Thus, several provisions of the proposed regulations are intended to minimise or to eliminate the differences between the transfer pricing analysis of services transactions

²⁴⁷ W F Heinz 'IRS Issues new transfer pricing regulations for IP and services. Available at http://www.ustransferpricing.com/IP_NewRegs_Heinze_TKHR.html [accessed on 20 January 2010].

²⁴⁸ Michelle Markham, 'Transfer pricing of intangible assets in the US, the OECD and Australia: Are profit split methodologies the way forward? Law Review 8 2004 University Of Western Sydney [Available at <http://eprints.qut.edu.au> accessed on 11 January 2010] p8

²⁴⁹ http://www.usa-international-offshore-company-tax.com/transfer_pricing.asp
²⁵⁰ http://www.usa-international-offshore-company-tax.com/transfer_pricing.asp

related to intangibles and the analysis of transfers of intangible property. The new regulations stipulate that an arms length approach should be used with regard to intangible property.²⁵¹

This essentially means the US favours a profit-based methods or cost based methods to be adopted by the taxpayer when dealing with intangible property. In practice, where inter-affiliate transactions involve intangibles, MNEs experience great difficulty in finding reliable data to analyse comparability, especially where non-routine intangibles are involved. Consequently, the US tax authorities and the OECD have all come to accept the need for profit methods, with varying degrees of enthusiasm, the OECD being less enthusiastic.²⁵² However a taxpayer is free to use any other transfer pricing method as long as it achieves the most appropriate arm's length price, relying on the best method principle applied in the USA.

For purposes of section 482, the term "intangible" refers to any item included in one of six broad categories specified in the regulations, provided the item has substantial value independent of the services of any individual.²⁵³ These categories of intangible property include:

Patents, inventions, formulas, processes, designs, patterns or know how; Copyrights and literary, musical, or artistic compositions; Trademarks, trade names, or brand names; Franchises, licenses, or contracts; Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and Any other similar item that derives its value from its intellectual content rather than its physical attributes.²⁵⁴

4.3 The American Jobs Creation Act of 2004

The American Jobs Creation Act of 2004 (the Act) included a new tax deduction, contained in Section 199 of the Tax Code, based on a percentage of the taxpayer's qualified production activities (QPAI), intended to replace the international export tax incentive schemes banned by

²⁵¹http://www.usa-international-offshore-company-tax.com/transfer_pricing.asp

²⁵² Michelle Markham, 'Transfer pricing of intangible assets in the US, the OECD and Australia: Are profit split methodologies the way forward? Law Review 8 2004 University Of Western Sydney. Available at <http://eprints.qut.edu.au> [accessed on 11 January 2010] p8.

²⁵³ Department of Treasury, 'Report to the congress on Earnings stripping, transfer pricing and US income tax treaties' available at <http://www.ustreas.gov/offices/tax-policy/reports.shtml> [accessed 5 Jan 2010] p33.

²⁵⁴ Department of Treasury, 'Report to the congress on Earnings stripping, transfer pricing and US income tax treaties' available at <http://www.ustreas.gov/offices/tax-policy/reports.shtml> [accessed 5 Jan 2010]p33.

the World Trade Organisation (WTO). The new deduction brings to light some transfer pricing issues. The deduction probably applies to both US and foreign-owned businesses operating in the USA. For transfer pricing purposes, the allocation of gross receipts between qualifying domestic production gross receipts (DPGR) and non-qualifying gross receipts is critical.²⁵⁵

4.4 Arms length principle in relation to US transfer pricing

To determine an arm's length price for commodities can sometimes be as simple as, determining a comparable pricing from non-related party transactions, however when dealing with proprietary goods and services or intangibles, arriving at an arm's length price can be much more complicated. US transfer pricing law requires that the best method rule to be used in determining which transfer pricing methodology is most appropriate for determining the arm's-length price of a given transaction.²⁵⁶ The "best method rule" of transfer pricing requires that the method used to determine the transfer price be the one that offers the greatest precision in matching the price of an arm's-length transaction between unrelated parties. IRS regulations specify the best method for a given type of transaction.²⁵⁷

4.5 The United States approach to Advanced pricing agreements

The IRS offers an alternative for taxpayers. Instead of waiting for their transfer pricing methodology to be accepted they can enter into an advanced pricing agreement with the Revenue Services. The IRS defines APAs as follows:

*The Advance Pricing Agreement (APA) Program is designed to resolve actual or potential transfer pricing disputes in a principled, cooperative manner, as an alternative to the traditional adversarial process. An APA is a binding contract between the IRS and a taxpayer by which the IRS agrees not to seek a transfer pricing adjustment under IRC § 482 for a covered transaction if the taxpayer files its tax return for a covered year consistent with the agreed transfer pricing method.*²⁵⁸

²⁵⁵ http://www.usa-international-offshore-company-tax.com/transfer_pricing.asp

²⁵⁶ Arm's length principle, available at http://www.ustransferpricing.com/arms_length_principle.html [accessed on 25 January 2010].

²⁵⁷ Best Method Rule, available at http://www.ustransferpricing.com/best_method_rule.html [accessed on 25 January 2010].

²⁵⁸ Advance Pricing Agreements, available at <http://www.ustransferpricing.com/APA.html> [accessed on 25 Jan 2010].

These APAs are not available for all transactions and do have up-front costs. The IRS uses an extensive process of fact-finding and negotiation that goes into the development of an APA.²⁵⁹

4.6 Cost-Sharing Arrangements in the United States of America

The cost sharing arrangements are a method by which related parties may cooperate to develop intangible property and attribute cost proportionately to anticipated benefits to be derived from that property.²⁶⁰ The cost sharing arrangement is an approach used in the USA to minimise the risks associated with transfer pricing. Under a cost sharing arrangement, related parties agree to share the costs and risks of intangible development in proportion to their reasonable expectations of the extent to which they will relatively benefit from their separate exploitation of the developed intangibles.²⁶¹ Cost-sharing arrangements have been particularly popular among U.S. software developers with affiliated entities abroad. In some countries, as well as in the OECD guidelines, cost-sharing arrangements are referred to as cost-contribution arrangements. The IRS issued new proposed cost-sharing regulations in 2005.

The primary tax advantage associated with cost-sharing agreements is that (estimated) market prices get replaced by incurred costs.²⁶² A clear example of this would be if a company consists of two divisions, a parent and its subsidiary, and that these two divisions construct a cost-sharing agreement. The parent then develops an intangible asset for instance a patent on some product that can be sold by both divisions. Given the cost-sharing agreement, the subsidiary must pay the parent a fraction of the cost of developing the patent, with the fraction determined by the patent's relative benefits to the parent and subsidiary.²⁶³ On the contrary, if no cost-sharing agreement had been entered into, the subsidiary would have to make a royalty payment to the parent for each unit of the patented product the subsidiary sells, with the royalty equaling the estimated market value of the license to sell the patented product. Both the subsidiary's royalty payments

²⁵⁹ Advanced Pricing Agreements, available at <http://www.ustransferpricing.com/APA.html> [accessed on 25 January 2010].

²⁶⁰ Cost-Sharing Arrangements, <http://www.ustransferpricing.com/CSA.html> [accessed on 25 January 2010].

²⁶¹ http://www.usa-international-offshore-company-tax.com/transfer_pricing.asp

²⁶² N. Mori, V. Starkov and Y. Saito, '*Cost Sharing Agreements May Allow Multinational Companies To Reap the Benefits of Intangible Asset Investment*' available at http://www.nera.com/image/PUB_Cost_Sharing_Apr2009.pdf [accessed on 6 February 2010].

²⁶³ N. Mori, V. Starkov and Y. Saito, '*Cost Sharing Agreements May Allow Multinational Companies To Reap the Benefits of Intangible Asset Investment*' available at http://www.nera.com/image/PUB_Cost_Sharing_Apr2009.pdf [accessed on 6 February 2010].

to the parent (under the transfer pricing agreement) and the subsidiary's cost-sharing payment to the parent (under the cost-sharing agreement) constitute taxable income to the parent, and are tax deductible for the subsidiary.²⁶⁴ So, if the parent operates in a higher tax jurisdiction than does the subsidiary, and the cost of developing the patent is less than the market-based royalty payments, the firm could reduce its worldwide tax liability by implementing a cost-sharing agreement instead of adopting royalty-based transfer prices.²⁶⁵

However cost sharing agreements do have their disadvantages. If the returns to developing the intangibles are uncertain and the market value of the intangibles turns out to be below their development costs then entering into a cost-sharing agreement is undesirable.²⁶⁶ Cost-sharing agreements also could be disadvantageous if most of a company's intangibles are developed by a subsidiary operating in a low tax jurisdiction. In that case, the US parent company would be required to make a payment to the subsidiary for the parent companies share of the cost of intangibles developed by the subsidiary.²⁶⁷ This is less satisfactory than using (typically higher) market-based transfer prices because in this case market-based transfer prices would have the advantage of shifting more of the taxpayer's worldwide income to the subsidiary's lower tax jurisdiction than would a cost-sharing agreement.²⁶⁸

4.7 Penalties

In the Us penalties for incorrect application of transfer-pricing regulations are severe, and the IRS has considerably stepped up its audit activity on transfer pricing, so that companies of all sizes need to take precautions, either by commissioning transfer-pricing reviews from external professionals, or by negotiating Advanced Pricing Agreements with the IRS.²⁶⁹

Two types of penalties can be imposed on transfer pricing adjustments

- Substantial valuation misstatement

²⁶⁴ N. Mori, V. Starkov and Y. Saito, 'Cost Sharing Agreements May Allow Multinational Companies To Reap the Benefits of Intangible Asset Investment' available at http://www.nera.com/image/PUB_Cost_Sharing_Apr2009.pdf [accessed on 6 February 2010].

²⁶⁵ N. Mori [note 264]

²⁶⁶ N. Mori [note 264]

²⁶⁷ N. Mori [note 264]

²⁶⁸ N. Mori [note 264]

²⁶⁹ www.ustransferpricing.com

- Gross valuation misstatement²⁷⁰

The two penalties are of the same type but differ in magnitude. The substantial valuation misstatement penalty is 20 percent of the tax and the gross valuation misstatement penalty is 40 percent of the tax.

There are four types of transfer pricing penalties:

- Transactional penalty: substantial valuation misstatement
- Transactional penalty: gross valuation misstatement
- Net 482 adjustment: substantial valuation misstatement
- Net 482 adjustment: gross valuation misstatement²⁷¹

Transactional Penalty

A *substantial valuation misstatement* penalty applies to a taxpayer who uses unnecessarily high or low valuations. A *gross valuation misstatement* penalty applies to a taxpayer who uses more extreme low valuations or more extreme high valuations.²⁷² This means if the valuation of any transfer price is two hundred percent (200%) greater or fifty percent (50%) or less of an arm's-length transfer price, then the penalty for exceeding the particular threshold are twenty percent (20%). If the valuation of any transfer price is four hundred percent (400%) greater or twenty five percent (25%) or less of an arm's-length transfer price then the penalty for exceeding the particular threshold is forty percent (40%).²⁷³

Net Adjustment Penalty

The *net adjustment penalty* is based on "net Section 482 adjustments," which are the sum of all increases in taxable income less any decreases in taxable income. Increases are counted to determine the net adjustment if they result "from allocations under Section 482." Decreases are counted to determine the net adjustment if the decreases are attributable collateral adjustments.

²⁷⁰ R. Feinschreiner, 'Practical aspects of transfer pricing', June 2004 p5 [available at http://eu.wiley.com/WileyCDA/WileyTitle/productCd-0471573604_descCd-tableOfContents.html accessed on 1 February 2010

²⁷¹ R. Feinschreiner, 'Practical aspects of transfer pricing', June 2004p5

²⁷² R. Feinschreiner, 'Practical aspects of transfer pricing', June 2004 p6

²⁷³ www.ustransferpricing.com

Thus it is contemplated that positive adjustments will exceed negative adjustments by a wide margin.²⁷⁴ This means if the valuation of any transfer price in relation to the net §482 adjustment for the particular taxable year exceeds the lesser of \$5 million (at the time of writing) or 10% of the taxpayer's gross receipts, then the penalty for exceeding the particular threshold is 20%. If the net section 482 adjustment for the particular taxable year exceeds the lesser of \$20 million (at the time of writing) or 20% of the taxpayer's gross receipts, then the penalty for exceeding the particular threshold is 40%.²⁷⁵

More penalties are based on non submission or incorrect documentation. Transfer pricing reviews provide the documentation necessary to withstand IRS audits. In any case, most companies in the US with related-party transactions are required to compile "reasonable and full" documentation of arm's-length pricing prior to filing annual returns. Failure to produce this documentation within 30 days of notice of audit places the company at risk for additional tax, interest and penalties on the adjustments identified.²⁷⁶

Moreover in cases where no transfer price was charged or where no transfer pricing report was prepared, then the 40% penalty will generally always apply.²⁷⁷

Although an advanced pricing agreement is the most secure way to avoid the burden of transfer pricing penalties, the process of agreeing an APA is complex and in itself expensive, so that smaller businesses cannot realistically imply APAs. The IRS has developed APA procedures tuned to the needs of small businesses, but costs can still be prohibitive in many cases. So in essence a transfer pricing review may in many cases be the more cost-effective option.²⁷⁸

²⁷⁴ R. Feinschreiner, 'Practical aspects of transfer pricing', June 2004 p7

²⁷⁵ www.ustransferpricing.com

²⁷⁶ www.ustransferpricing.com

²⁷⁷ www.ustransferpricing.com

²⁷⁸ www.ustransferpricing.com

5 CHAPTER FIVE: CONCLUSION AND RECOMMENDATIONS

This chapter first sets out the flaws of South African transfer pricing regulations and tries to draw a comparison with transfer pricing in the UK and USA. Secondly, recommendations on possible improvements on transfer pricing issues will be set out

5.1 Shortcomings of Transfer Pricing in South Africa

Transfer pricing is a new phenomenon in South Africa despite the fact that there has been some literature written on it. South Africa compared to countries like the United States of America and the United Kingdom, substantially lacks expertise on transfer pricing issues particularly in its application of some of the OECD guidelines as set out in practice note no.7 of 1999.

5.1.1 Arm's length Principle versus actual legislation

South African is in need of stricter legislation to protect itself against excessive price manipulations between related parties. For a long standing solution to the problem South Africa needs to adopt favourable practices from all over the world. In this paper, analysis was made of only two other countries in the world namely the United States and the United Kingdom. This does not mean that South Africa should narrow its search for a better transfer pricing approach to these two countries. South Africa should try and strike a balance between the strict approach of the USA and more interactive approach of the United Kingdom and various approaches of other countries that are developed in issues of transfer pricing. For instance the Katz commission recommended that South Africa adopt an approach which has anti-transfer pricing legislation, but relies on the arm's length concepts set out in the OECD guidelines as countries such as Australia, United Kingdom and Netherlands. The approach recommended by the Katz Commission may be criticised on the ground that the arm's length approach though recommended and widely used it does have its shortcomings. For instance it is based on a on the separate entity approach, whereas multinationals are often integrated enterprises. Therefore applying the arm's length approach by separating the multinational into different entities may produce ambiguity on the actual operations of the multinational enterprise, this will depend on

the magnitude of the economies of integration and profitability. The United Kingdom has even moved away from an approach which is anti-transfer pricing legislation and has set out proper legislation to be followed by UK entities. This is a result of the lack of adequate safeguards to protect their tax base especially in the recent times of the recession.

Therefore it is recommended that South Africa sets up draft clear legislation which adds onto section 31 of the Income Tax Act in addition to their adoption of the arm's length approach. Also it would be better if they move away from setting out requirements of transfer pricing in the Practice note no.7 of 1999 because law under these practice notes is not binding. South Africa should now incorporate transfer pricing rules into the Income Tax Act because the Practice notes are not enforceable. For a proper implementation of transfer pricing regulations there should be adequate enforceable laws.

5.1.2 Documentation

In South Africa law according to the Practice note no. 7, it is not mandatory for companies to prepare and maintain documentation however the taxpayer under section 65 of the Income tax Act if the Commissioner requests for documentation it is mandatory for the taxpayer to produce it. Such an approach leads to confusion on what is expected from the taxpayer in terms of documentation. It is appreciated that preparing the documentation is time consuming for the taxpayer. Though the law seems to aid the taxpayer by not making it mandatory for companies to maintain documentation, it is ultimately not doing them any favours because in the event that the Commissioner requests the documentations and the taxpayer cannot comply, they are faced with the possibility of being penalized or even being tangled in court battles. South Africa can adopt the approach used in the United Kingdom where the Her Majesty Revenue and Customs (HMRC) have issued transfer pricing guidelines which set out documentation requirements which must be followed by large entities. The large entities need to support their inter-company pricing policies using the relevant documentation. They have not made this mandatory for smaller enterprises. This approach ensures that all large entities are accountable for their inter-company transactions and it does not burden smaller companies which are not a major threat. These small companies do not need to be burdened by the expense of maintaining

documentation. South Africa can adopt this approach and require large entities to mandatorily maintain and produce documentation to SARS; this will help to safeguard the countries tax base.

5.1.3 Advanced Pricing Agreements

In South Africa there is no provision for advanced pricing agreements. In the practice note no. 7 it even says this approach will not be adopted in the foreseeable future. This practice note came into effect in 1999, approximately ten years ago. The world has evolved since then and South Africa has seen immense economic growth since then. More multinational companies have invested in the country. To protect these investments, South Africa needs to find ways to protect the investors. Introducing advanced pricing agreements would be a start to this in relation to transfer pricing. This is because APAs give the taxpayer an advantage by allowing them resolve transfer pricing issues in advance of handing in their tax returns. Both the HRMC of the United Kingdom and the Internal Revenue Services of the USA offer this service to their taxpayers. The advantage of APAs is that the taxpayer can have earlier and greater certainty in regards to their inter-company transactions and their proposed transfer pricing methods. The tax authority in this instance SARS will benefit from this because they will have an insight into the structure, assets, functions and risks within a MNC and practical problems with the MNC establishing an arm's length approach.

5.1.4 Cost sharing Agreements

South Africa has not adopted this approach because it does not have clear legislation in on transfer pricing affecting intangible goods. The United States has advanced in its approach to intangible property because the impact which intangible property has had on this trade. The US has acknowledged that some of the most difficult transfer pricing issues have always been in the area of intangible property The tax treatment of intangible assets therefore warrants particular attention in the transfer pricing context.²⁷⁹

²⁷⁹ Michelle Markham, 'Transfer pricing of intangible assets in the US, the OECD and Australia: Are profit split methodologies the way forward? Law Review 8 2004 University Of Western Sydney [Available at <http://eprints.qut.edu.au> accessed on 11 January 2010].

They have even come up with new transfer pricing methods, a cost based method which incorporates transfer pricing of intangibles. The USA has developed this approach because the inter-company pricing of intangibles is as important as tangible property. Multinational companies such as Microsoft deal in intangible property in the form of software and royalties. If there is inadequate legislation to deal with their kind of trade countries may lose significant tax profits. South Africa should closely look at these transfer pricing laws which deal with intangible goods and see how best to incorporate them into out transfer pricing laws.

5.1.5 Application of transfer pricing methods

According to the Practice note no. 7 a taxpayer can apply more than one transfer pricing method to convince the commissioner that prices are at arm's length. This approach is not idle because it is burdensome and may lead to confusion. The practice note acknowledges that under the OECD guidelines the taxpayer is not required to apply more than one transfer pricing method because it may be burdensome and inadequate. There should be clarity in the practice note that the commissioner should not require the application of more than one of the methods as a rule.

To achieve a good result using the arm's length principle the taxpayer needs appropriately use the transfer pricing methods. South Africa uses the traditional methods yet lacks the application of the comparable uncontrolled transactions method. This leads in difficulty in its applicability and encourages the use of foreign comparables, which leads to further complications such as the ability to make adjustments to enhance comparability.¹⁸³ Comparable uncontrolled transactions are also difficult to find when trade is conducted electronically and therefore in certain situations transaction profit methods will be more suitable.²⁸⁰

²⁸⁰ A. Onsando 'The OECD Transfer pricing guidelines: An analysis of their application in the South Africa legal regime' [available at <http://lawspace2.lib.uct.ac.za/dspace/handle/2165/367?mode=full>] accessed on 2 May 2009] p90.

5.1.6 Penalties

In South Africa there are no specific provisions in the Income tax Act dealing with penalties in relation to transfer pricing, the general penalties in regard to gross misconduct of the taxpayer are the ones applied to transfer pricing. South Africa can adopt a strict approach to transfer pricing penalties like the USA in a bid to advance their transfer pricing policy and as a deterrent measure to companies which manipulate their transfer prices and cost the country tax revenue. Of course it is advisable that the penalties will be implemented in moderation to also protect investments by MNCs. South Africa can strive to have specific provisions which deal with transfer pricing to keep abreast with the developments of the rest of the world. These will be useful in a time of a recession like recently experience by the globe. These provisions will aid in protecting the tax revenue which is greatly needed by the country.

5.1.7 Is there need for a special committee dealing with transfer pricing issues?

South Africa can adopt the approach used in the United Kingdom where the HMRC has recently established an international directorate which deals with international tax issues (including transfer pricing issues). This Directorate has assumed governance of the Transfer pricing group which was established to deal with this complex area of tax. South Africa needs to appreciate the need to have specialist expertise in the area of transfer pricing. If a special task force is set in place to deal with transfer pricing issues, then this area of international tax will be demystified in South African law. It will be a first step by SARS into closely assessing the transfer pricing of MNCs. This committee will investigate on the adequacy of South African law on transfer pricing and will set out the necessary recommendations which are abreast with international standards. They can also deal with transfer pricing cases and enquiries by MNCs. They can work hand in hand with the parliament and the judiciary in establishing appropriate transfer pricing laws which benefit both the taxpayer and the revenue authority.

5.2 CONCLUSION

Transfer pricing is probably the most important tax issue in international tax according to the United Nations.²⁸¹ It is of no doubt that transfer pricing is certainly one of the most interesting tax issue of the 21st century. South Africa should keep abreast with the rest of the world in these issues because South Africa is affected by the global economic growth which is driven by multinational corporations. Updating South African transfer pricing regulation will help SARS protect revenue income being lost to low tax jurisdictions at the same time if multinationals are fully aware of these regulations they will be encouraged to invest in the country.

²⁸¹ M Markham, *Transfer pricing of intangible assets in the US, the OECD and Australia: Are profit split methodologies the way forward?* Accessed from <http://eprints.qut.edu.au> on 2 February 2010, University Of Western Sydney, School of Law 2004

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