Seeking arm's length:

An evaluation of formulary apportionment and predetermined margins as alternative or supplementary methods to establish proxy arm's length transfer prices for multinational intercompany transactions in South Africa

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ABSTRACT

Since the inception of democracy in South Africa and the subsequent lifting of sanctions and trade embargos placed upon South Africa, the country's economy has evolved from a much protected, inward looking economy into an internationally robust and competitive environment. Multinational enterprises (MNE's) which seek to invest in a geographical region often choose certain countries as a base from which they can expand their investments to the other countries in the region. With its sizable economy, political stability relative to the rest of Africa and overall strength in financial services, South Africa should be the ideal location from which foreign investors can extend their investments into the rest of Africa (Ogutta, 2011).

However, in South Africa foreign investment has reduced to an extent where local companies are now more invested in international markets than international investment in South Africa (Development, 2018). In monetary terms, at the end of 2017, South Africa had invested R3.3 trillion in foreign markets while foreign markets had only invested R 1.8 trillion in South Africa (Development, 2018).

With the current global economic challenges, developing countries like South Africa have become increasingly aware of the importance of tax revenue and the effects of base erosion and profit shifting on the financial well-being of the state (OECD:G20 Working group, 2014); (Economic Commissions for Africa, 2018).

Section 31 of the South African Income Tax Act, is the main section in the Act relating to transfer pricing in South Africa. Transfer pricing is one of the most important issues in international tax. It is estimated that more than 60% of international trade happens across borders but within the same corporate groups (Cobnam & Mcnair, n.d.). The transfer pricing rules of South Africa are closely aligned with the wording of the Organisation for Economic Cooperation and Development (OECD) and the United Nations (UN) Model Tax conventions and are in line with tax treaties and other international tax principals (SARS, 2010).

The cornerstone of the transfer pricing model is the use of the arm's length price. In terms of the arm's length principle, in order to test the reasonability of pricing within MNE's, tax authorities should use a similar but unrelated open market transaction as the benchmark

to determine if there were any profit shifting to avoid tax by the MNE's between their different establishments in the different tax jurisdictions.

The biggest challenge in South Africa and other countries, when applying the arm's length principle is the lack of local comparable data available to evaluate the transfer prices (intercompany transactions) within the MNE's (OECD Transfer Pricing Guidelines, 2018). There is a lack of publicly available company financial data that may be used to calculate comparative benchmarks, and the information which is available, is not necessarily sufficient or adequate for comparability purposes (Tax Justice Network, 2013). Information which is accessible may be incomplete and difficult to interpret. In other cases information may be difficult to obtain for reasons of its geographical location and, in some instances, it may simply not be possible to obtain information from independent enterprises due to enterprise competitiveness and confidentiality concerns (OECD Transfer Pricing Guidelines, 2018). Despite all of these limiting factors, the arm's length principle, as recommended by the OECD & UN Tax Model, remains the globally accepted guiding principle for calculating acceptable transfer prices. This is evident in the fact that almost all bilateral treaties in the world are based on these tax models (Steenkamp, 2017).

For the last decade in South Africa, corporate tax has been the third largest contributor toward total revenue collection by National Treasury (National Treasury, 2017). It is therefore important that domestic tax laws should be able to protect the country's tax base through legislation that discourages base erosion and profit shifting.

The objective of this dissertation is to consider whether South Africa should continue to exclusively apply the arm's length principle, which relies on comparable data, when determining transfer prices for goods in MNE's. In testing this position, the following two alternative methods namely, formulary apportionment and predetermined margins, will be considered to evaluate whether or not these additional or complementary methods should be applied in the determination of arm's length where comparable data is not available or requires significant adjustment as it relates to goods.

Table of Contents

CHAPTER 1:

INTRODUCTION……1

1.1 Introduction……1

1.2 Research objective……4

1.3 Limitation of scope……4

1.4 Structure of dissertation and research methodology……4

CHAPTER 2: TRANSFER PRICING IN SOUTH AFRICA……7

2.1 Influence of the OECD on South African Transfer pricing policy ……7

2.2 Challenges faced by developing countries……10

2.3 Base Erosion and Profit Shifting. (BEPS)……14

2.4 Final OECD BEPS Reports……17

2.5 South Africa after the Final OECD BEPS Reports……21

2.6 Post BEPS and the Arms' length principle……22

2.7 Chapter Summary……24

CHAPTER 3: FORMULARY APPORTIONMENT……26

3.1 What is formulary apportionment?……26

3.2 The European Union and formulary apportionment……27

3.3 Differences between formulary apportionment and arm's length pricing……30

3.4 Challenges of formulary apportionment……30

3.5 Countries currently using formulary apportionment……31

3.6 Voices for change from current international transfer pricing policy……32

3.7 Is formulary apportionment the better alternative or at least another approach to consider?.......34

3.8 Chapter Summary…… 38

CHAPTER 4: BRAZIL's TRANSFER PRICING POLICY……40

4.1 Transfer pricing policies in Brazil……40

4.2 Transfer pricing methods……43

4.3. Safe harbours……47

4.4 Strengths of the Brazilian transfer pricing method……48

4.5 Weaknesses of the Brazilian transfer pricing method…… 48

4.6 Documentation…… 50

4.7 Similarities between the Brazilian and South African economies……50

4.8 Chapter Summary……52

CHAPTER 5: CONCLUSION - A SOLUTION FOR SOUTH AFRICA……………………………………………………………..54

BIBLIOGRAPHY…….. 60

LIST OF ABBREVIATIONS and TERMS

BEPS : Base Erosion and Profit Shifting

OECD: The Organisation for Economic Co-operation and Development

MNE: Multinational enterprise (MNE)

UN: United Nations

Transfer pricing: a term 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. This result in the income derived at for each enterprise being disproportionate to their relative economic contributions, and thus impacting the relevant tax jurisdictions' fair share of tax.

Base Erosion and Profit Shifting (BEPS): Base erosion and profit shifting (BEPS) is a technical term referring to the negative effect of multinational companies' tax avoidance strategies on national tax bases. BEPS can be achieved through the use of transfer pricing, or, more correctly, "transfer mispricing".

Advance pricing Arrangement (APA): An arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An advance pricing arrangement may be unilateral (involving one tax administration and a taxpayer) or multilateral (involving the agreement of two or more tax administrations).

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

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

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

Multinational enterprise (MNE): is a company that has a worldwide approach to markets and production or one with operations in several countries.

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

Safe harbours: Where tax authorities give general guidelines on the interpretation of tax laws, these may state that transactions falling within a certain range will be accepted by the tax authorities without further questions.

Associated enterprises: Generally speaking, enterprises are associated where the same persons participate directly or independently in the management, control or capital of both enterprises, i.e. both enterprises are under common control.

Independent enterprises: Two enterprises are independent enterprises with respect to each other if they are not associated enterprises with respect to each other.

Comparability Analysis: Comparison of controlled transaction conditions with conditions prevailing in transactions between independent enterprises (uncontrolled transactions).

Controlled and uncontrolled transactions are comparable if none of the differences between the transactions could materially affect the factor being examined in the methodology (e.g. price or margin), or if reasonably accurate adjustments can be made to eliminate the material effects of any such differences.

Tax Haven/ Low tax jurisdiction: Tax haven in the "classical" sense refers to a country which imposes a low or no tax, and is used by corporations to avoid tax which otherwise would be payable in a high tax country.

CHAPTER 1 INTRODUCTION

1.1 Background

Since the inception of democracy in South Africa and the subsequent lifting of sanctions and trade embargos placed upon South Africa, the country's economy has evolved from a much protected, inward looking economy into an internationally robust and competitive environment. According to the secretary-general of the UN Conference on Trade and Development (UNCTAD), South Africa is home to more than 75% of the top global companies in Africa and has the oldest and most developed market economy in the whole of Africa (Musau, 2017). Multinational enterprises which seek to invest in a geographical region often choose certain countries as a base from which they can expand their investments to the other countries in the region. South Africa is the second largest economy in Africa with a GDP of $ 349.3 billion.[1] With its 'sizable economy, political stability relative to the rest of Africa and overall strength in financial services, South Africa should be the ideal location from which foreign investors can extend their investments into the rest of Africa (Ogutta, 2011).

However, in South Africa foreign investment has reduced to an extent where local companies are now more invested in international markets than international investment in South Africa (Development, 2018). In monetary terms, at the end of 2017, South Africa had invested R3.3 trillion in foreign markets while foreign markets had only invested R 1.8 trillion in South Africa (Development, 2018). The leadership of South Africa, beginning with the National Executive Committee needs to address the political and socio-economic challenges in the country in order to grow investor confidence and remain an economically feasible option for foreign investors. In addressing these challenges, the economic policies and tax legislative changes that could potentially be implemented should also be responsive to the stimulation and growth of the local economy. With the current global economic challenges, developing countries like South Africa are increasingly aware of the importance of tax revenue and the effects of base erosion and profit shifting on the financial well-being of the state (OECD:G20 Working group, 2014); (Economic Commissions for Africa, 2018). In South Africa, where

[1] International Monetary Fund : World Economic Outlook
http://www.imf.org/en/Publications/WEO/Issues/2018/07/02/world-economic-outlook-update-july-2018

corporate tax has been the third largest contributor toward total revenue collection by National Treasury for the last decade (National Treasury, 2017) it is important that domestic tax laws should be able to protect the country's tax base through legislation that discourages base erosion and profit shifting.

Section 31 of the South African Income Tax Act 58 of 1962 ('the ITA') relates to transfer pricing.

Transfer pricing is one of the most important issues in international tax (Cobnam & Mcnair, n.d.). It is estimated that more than 60% of international trade happens across borders but within the same corporate groups.[2] Intragroup cross border transactions recorded at transfer prices not reflective of an arm's length price have been identified as a tool with which Multinational Enterprises (MNE's) are able to shift profits between different jurisdictions (OECD Transfer Pricing Guidelines, 2018). The OECD Glossary of terms defines transfer pricing as follows:

> *"A transfer price is a price, adopted for book- keeping purposes, which is used to value transactions between affiliated enterprises integrated under the same management at artificially high or low levels in order to effect an unspecified income payment or capital transfer between those enterprises"* (OECD, 2003)

Section 31 of the ITA was amended in 2012. In terms of the amendment, the discretion and duty to adjust transfer prices to reflect an arm's length price is not the onus of the Commissioner. This responsibility has been transferred to the taxpayer. It is expected that the taxpayer should determine and document transfer prices reflective of an arm's length transaction (Ratombo & Blumenthal, 2017). In terms of the amended s 31, the onus lies with the taxpayer to make a transfer pricing adjustment in determining the taxable income, when a cross border transaction is entered into between a South African taxpayers and another tax payer who are connected persons in relation to each other. The adjustment is only required if one of these transacting parties receives a tax benefit as a result of any terms or conditions in the transaction which is different to that which would have existed had those persons not been connected persons and dealing at arm's length. (SAIT, 2016). The application of the arm's length principle grants local tax authorities the ability to compare an intercompany cross- border transaction to a similar transaction by an independent enterprise in the open market. This comparison

[2] Tax Justice Network: Transfer pricing https://www.taxjustice.net/topics/corporate-tax/transfer-pricing/

will reflect if the price charged by the MNE in the intercompany transaction is indeed a reasonable price that would have been charged had it been entered into by independent enterprises (OECD Transfer Pricing Guidelines, 2018).

The biggest challenge in South Africa and elsewhere, when applying the arm's length principle is the lack of local comparable data available to evaluate the transfer prices (intercompany transactions) within the MNE's (OECD Transfer Pricing Guidelines, 2018). Comparable data, which is the core requirement in determining an arm's length price, is very limited for developing economies. This lack of publicly available company financial data that may be used to calculate comparative benchmarks, and the information which is available, is not necessarily sufficient or adequate for comparability purposes (Tax Justice Network, 2013). Information which is accessible may be incomplete and difficult to interpret. In other cases information may be difficult to obtain for reasons of its geographical location and, in some instances, it may simply not be possible to obtain information from independent enterprises due to enterprise competitiveness and confidentiality concerns. In some cases, the information could simply not exist, or there may be no comparable independent enterprises from which to source the information (OECD Transfer Pricing Guidelines, 2018).

European and American databases are used by some developing countries as a source for comparable data in order to determine the appropriate transfer prices for certain transactions. A challenge when developing countries use developed countries' databases as a source for comparable is that problems may arise due to significant differences such as geographical locations and market conditions (Mcnair, et al., 2017). These differences could render the available data unsuitable for the specific transaction pricing as the market and environmental conditions would not necessarily be comparable to the environment in which the MNE operates in the developing country.

Despite all of these limiting factors, the arm's length principle remains the generally accepted guiding principle in establishing an acceptable transfer price. This is evidenced through the wording of Article 9 of both the UN and OECD Tax Model treaties which underpins the incorporation of the arm's length principle (OECD Centre for Tax Policy and Administration, 2011).

1.2 Objectives and rationale of the research

The objective of this dissertation is to consider whether South Africa should continue to exclusively apply the arm's length principle, which relies on comparable data, when determining transfer prices for MNE's. In testing this position, the following two alternative methods namely, formulary apportionment and predetermined margins, will be considered to evaluate whether or not these additional or complementary methods should be applied in the determination of arm's length where comparable data is not available or requires significant adjustment.

To achieve this objective, this dissertation will address the following:

- the influence of the OECD transfer pricing regulations on the South African transfer pricing policies,
- the transfer pricing legislation in South Africa, namely s31.
- the formulary apportionment method.
- the use predetermined margins, as used in Brazil, as a basis of establishing transfer prices for goods.

1.3 Limitation of scope

This dissertation is not intended to propose tax legislative changes. It only intends to identify existing challenges with the current legislation and provide alternative approaches in the form of supplementary transfer pricing methods that could potentially form part of a guidance document for transfer pricing of goods only. This guidance document, with the support of a binding general rule could become generally prevailing practice for the Tax Administration Act. Whilst economic and political factors will be considered in discussion on the overall investment/ trade climate in South Africa, these factors will not be analysed in detail as they are included as background and go beyond the scope of this study.

1.4 Structure of dissertation and research method

This paper will consist of the following chapters:

- **CHAPTER 2: Status quo of transfer pricing in South Africa**

This chapter will serve as an introduction to the South African landscape as it relates to MNE's and the treatment of cross border transactions within a group. It will look at the OECD model, its influence on the international tax practices established in South Africa as well as the changes brought about by the BEPS action plans and the recommendations made by the Davis Committee in South Africa. This chapter will look at the advantages as well as the disadvantages of the arm's length principle, and the problems faced by, and actions taken by other developing countries that might be facing the same global challenges.

- **CHAPTER 3: Formulary apportionment**

This chapter will introduce formulary apportionment and the noted advantages and disadvantages that exist when implementing the method. This chapter will refer to academic papers and recognised tax journals to assess whether formulary apportionment could be a reasonable and reliable replacement of the arm's length principle, at least in selected circumstances. It will also look at the differences between formulary apportionment and the arm's length principle.

- **CHAPTER 4: Brazil – can predetermined margins be a solution to the South African problem?**

This chapter will look at the transfer pricing methods implemented in Brazil. Brazil's tax administration and the legislation have been considered by some as radical in its approach to transfer pricing. Transfer pricing rules were introduced in Brazil in 1996 through the enactment of Law 9,430 (Valadao, 2013). These rules were modelled on the OECD practices, but it differed in the most fundamental way. The Brazilian method or also known as the Sixth Method[3] does not base the transfer price of goods on the arm's length principle and it is applied specifically to commodities In terms of the Brazilian method the transfer price is based on predetermined margins (The United Nations, 2017, p. 528). This chapter will address the differences as well as the similarities between predetermined margins as implemented in Brazil, the arm's length principle and also any synergies with formulary apportionment.

- **CHAPTER 5: Conclusion: A solution for South Africa**

After reviewing the current transfer pricing legislation in South Africa and the alternative methods available as discussed in earlier chapters, this chapter will seek to determine if

[3] Sixth Method: The OECD CUP method (Cost plus method), applied specifically for commodities.

any of these methods would be better than, alternative; or, complementary to the current arm's length principle. An alternative method may be justified if it would provide a price more reflective of the economic substance of the transaction than the arm's length principle.

CHAPTER 2: STATUS QUO OF TRANSFER PRICING IN SOUTH AFRICA

2.1 Influence of the OECD on South African Transfer pricing policy

2.1.1 The Organisation for Economic Co-operation and Development (OECD)

The Organisation for Economic Cooperation and Development (OECD) is an intergovernmental organisation with 36 member countries where the governments of these countries work together to promote economic growth, prosperity and sustainable development on a global scale (OECD, 2018a).

The OECD provides a platform where its member country governments can compare policy experiences, seek answers to common problems, identify good practice and coordinate domestic and international policies in order to support sustainable economic growth. The organisation also seeks to boost employment, raise the standard of living, maintain financial stability, assist other countries' economic development and contribute to growth in world trade. In collaboration with its official partners, the OECD is involved in the establishment and setting of international standards on matters ranging from the safety of chemicals to tax and even agriculture. The organisation has a number of official partners, such as The World Bank, African Development Bank, The World Health Organisation, and a number of United Nations Organisations (OECD, 2018b).

South Africa is not a member of the OECD but it has observer status and as such is a participant and regularly provides input at various working party meetings within the organisation. In May 2007 the co-operation between the OECD and South Africa, along with other emerging economies was strengthened via the "Enhanced Engagement programme."[4] South Africa is regarded as a key partner[5] even though full membership status to the organisation has not been granted. It is expected of the key partners to contribute to the OECD's work in a comprehensive and sustained manner (OECD, 2014).

The OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, which was last updated in 2018, provides member countries and non-member countries with a guide on how to address the allocation of profits between

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[4] **Enhanced Engagement** is the result of a decision by the Council at Ministerial level in May 2007 "to invite the Secretary-General to strengthen OECD co-operation with 5 of its key partners namely, Brazil, China, India, Indonesia and South Africa through **Enhanced Engagement programmes** with a view to possible membership.

[5] Key partners contribute to the OECD's work in a sustained and comprehensive manner.

multinational enterprises when it comes to cross border activities and the setting of transfer prices.

The cornerstone of the OECD transfer pricing model is the use of the arm's length price. Paragraph 1 of Article 9 of the OECD Model Tax Convention[6] (OECD MTC) gives authority to the use of the arm's length price. *"The primary purpose of Article 9(1) is to ensure that the domestic rules comply with the arm's length principle in respect of transactions regarding business income between associated enterprises with the objective of mitigating economic double taxation. Article 9(1) permits the contracting states to adjust profits in line with the arm's length principle, which can be undertaken by imputing income or reducing expenses according to the provisions of national tax law.*" (Solilová & Steindl, 2013).

Article 9 forms the basis of bilateral tax treaties of OECD member countries and non-member countries (OECD Transfer Pricing Guidelines, 2018). The arm's length principle is based on the ability to compare a controlled transaction entered into by an MNE with that of an uncontrolled independent enterprise and determining if the conditions that have arisen in the controlled transaction would have existed if the same transaction was entered into by independent uncontrolled enterprises (OECD Transfer Pricing Guidelines, 2018). OECD member and non-OECD member countries, like South Africa, frequently express concerns about the lack of availability and quality of financial data on transactions between unrelated parties that can be used to make the relevant comparison (OECD Transfer Pricing Guidelines, 2018). This shortcoming creates an environment that enables MNE's to set transfer prices that cannot be compared and evaluated adequately, which could eventually result in fiscal loss to the tax authorities of the country in which the MNE's operate.

2.1.2 Current legislation on transfer pricing in South Africa

In the 2010 South African Budget Speech, then Finance Minister of South Africa, Mr Pravin Gordhan announced that corrective action would be taken against taxpayers making use of complicated tax avoidance arrangements and the use of transfer pricing and cross-border mismatches (Budget, 2010). This was indicative of the fact that the South African National Treasury had become increasingly aware of the misuse of the transfer pricing legislation by multinational enterprises to move profits to lower tax

[6] "An accord reached between member states of the Organization for Economic Cooperation and Development (OECD) that serves as a guideline for establishing tax agreements. The convention consists of articles, commentaries, position statements and special reports on evolving tax issues. Its primary application is in guiding the negotiation of bilateral treaties between two or more countries. (WebFinance, Inc, 2018)"

jurisdictions and in so doing eroding the collections by National Treasury. The finance minister's statement in the 2010 budget speech regarding this matter was followed by the introduction of the redrafting of s31 through the Taxation Laws Amendments Bill and the Taxation Law Amendments Act of 2011. [7] Section 31 of the South African Income Tax Act, is the main section in the Act relating to transfer pricing in South Africa. The aim of the redrafting of s31 and the accompanying practice notes was to align the South African transfer pricing rules with the international best practices as determined by the OECD and UN model tax conventions and bring the South African approach closer to the guides as issued by the OECD (SARS, 2010).

The Explanatory Memorandum to the Taxation Laws Amendment Bill, 2010 provided the following reasons for the modernisation of the South Africa Transfer Pricing rules (SARS, 2010).

- *"The wording of the old section 31 focused on separate transactions, as opposed to overall arrangements driven by an overarching profit objective.*
- *This narrow focus gave rise to artificial arguments by certain taxpayers seeking an excessive emphasis on the literal terms of the transactions, as opposed to a focus on the overall economic substance and commercial objective of the arrangement.*
- *The language of the old section unduly emphasised the comparable uncontrolled price (CUP) method over other transfer pricing methodologies, which may in fact be more reliable under particular circumstances; and*
- *The emphasis on price as opposed to profits did not neatly align with wording contained in tax treaties, potentially creating difficulties in the mutual agreement procedures available under tax treaties"* (SARS, 2010).

The new transfer pricing rules for South Africa commenced in April 2012, with the new laws applying to years of assessment commencing on or after that date. In the National Treasury's Explanatory memorandum it was stated that,

> "*the new transfer pricing rules are closely aligned with the wording of the OECD and UN Model Tax conventions and are in line with tax treaties and other international tax principals. South Africa will continue to follow the OECD Transfer Pricing Guidelines closely both with respect to transfer pricing in general and the power to re-characterise transactions in the application of the transfer pricing rules"* (SARS, 2010).

[7] Any intended amendments to primary legislation are announced by the Minister of Finance in his annual Budget Review. They are tabled by the Minister of Finance in the National Assembly as Amendment Bills and, after approval by the Standing Committee on Finance (National Assembly) and the Select Committee on Finance (National Council of Provinces), they are sent to the President for assent before they are promulgated as Acts of Parliament.

The success of the OECD and UN model tax conventions is demonstrated in the fact that almost all bilateral treaties in the world are based on them with the third most prominent Model being the US Tax Model (Steenkamp, 2017). "*Their (OECD & UN Tax Models) wide acceptance and the standardisation of many international tax rules have been important factors in reducing international double taxation*" (Arnold, 2015). The South African National Treasury understands that as a developing country with an emerging economy, South Africa's tax treaties with other countries are an important tool to encourage foreign investment and trade.

South Africa is a party to a number of tax treaties with developed countries within the OECD, neighbouring countries across the African continent and other developing countries. For this reason the general need to preserve South Africa's international competitiveness by creating a tax environment conducive to economic growth should always be a factor to consider when implementing fiscal policies and tax laws (NCOP Finance, 2015). As per the SARS website, as at 12 February 2018, South Africa has entered into 85 bilateral treaties (SARS, 2018).

2.2 Challenges faced by developing countries.

The majority of bilateral treaties in the world are based on the OECD and UN tax model convention. This majority also includes developing countries as the governments of these countries considers compliance with these international principles an integral part of remaining marketable and relevant in the global economy (Mcnair, et al., 2017).

The arm's length approach to pricing cross border intercompany transactions is simply regarded as a principle of international tax law by the OECD, even though it is regarded and implemented as anti-avoidance and anti- tax evasion measures in the domestic tax law of various countries (United Nations, 2012). Therefore even as a non-member country of the OECD, South Africa like many other emerging and developed countries have adopted the international tax guidance per the OECD model tax convention into its domestic tax laws. The listed OECD member countries include the world's most advanced and influential economies. Of the 36 member countries, 27 of these countries are listed as developed countries as per the International Monetary Fund (IMF, 2017). These member countries are also the countries in which many of the large multinational corporations currently benefiting from the economic imbalance that can be created through the existing architecture of the arm's length principle are resident (Cobnam, 2018). So it would not be unreasonable to conclude that the laws and treaties

developed by the OECD would be done with the best interest of its members and not necessarily considering the impact the policies would have on developing and other non-member countries.

The United Nations Committee of Experts on International Cooperation[8] in Tax Matters represents one of very few multilateral forums where the members of the committee can engage in international tax cooperation, and carry out their duties as mandated. The member, as selected by the Secretary General in consultation with member states of the OECD is meant to represent an equitable geographical distribution and be representative of different tax systems. Given the duties that the committee is mandated with, the members should be selected from the fields of tax policy and tax administration. The committee consists of 25 members nominated by governments but acting in their own personal capacity. The current members' term is due to expire in 2021 (UN Economic and Social council, 2018).

The lack of skills, and resources in developing countries were identified as the reasons why tax administrators fail to identify transfer pricing mechanisms in MNE's operating in their tax jurisdictions. This enables MNE's to shift profits to low tax jurisdictions without much challenge from the tax authorities (Mcnair, et al., 2017).

Developing countries are usually characterised by general poverty, low income per capita, poor health services, underdeveloped infrastructure and poor standard of education for the majority of the population (Thapa, 2010). These countries are often rich in natural resources, which are underexplored, and a human capital base that could generally be employed at a lower per capita cost (Thapa, 2010). This makes these countries good destinations for MNE's to establish their operations, keeping production costs low.

The establishment of MNE's are welcomed by the governments of these developing nations as their presence should create the opportunity to stimulate and grow the local economy of the country. However, the existing international tax laws and policies, as it relates to cross border transactions and transfer pricing, appears to create a challenge

[8] The Committee of Experts on International Cooperation in Tax Matters as a subsidiary body of the Economic and Social Council is responsible for keeping under review and update, as necessary, the *United Nations Model Double Taxation Convention between Developed and Developing Countries* and the *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries.* It also provides a framework for dialogue with a view to enhancing and promoting international tax cooperation among national tax authorities and assesses how new and emerging issues could affect this cooperation

for the tax administrators in these countries. Instead of reaping the benefit of collecting tax revenue from these MNE's for the use of its resources, these poorly resourced tax administrators have to accept profit shifting by MNE's operating in the country to lower tax jurisdictions (Ogutta, 2016). With inadequate resources and a lack of available, relevant, reliable information for comparative purposes, complex cross border transactions go unchallenged by these tax administrators. In some instances, due to the complexity or uniqueness of some of these transactions, there is simply no comparable information available to be used for a comparability analysis (Ogutta, 2016).

The challenges encountered with transfer pricing and cross border transactions is not limited to developing countries. Developed countries experience the same frustrations. The economic impact from these tax avoidance schemes and profit shifting by MNE's tends to be greater for developing countries as they are more heavily reliant on the contribution of corporate taxes to their respective national treasuries (OECD, 2012). The United Nations Practical Transfer Pricing Manual for Developing Countries (2012) was written as a response to the need, often expressed by developing countries, for clearer guidance on the policy and administrative aspects in applying transfer pricing analysis (United Nations, 2012). In paragraph 1.10.6, this manual describes specific challenges for developing countries as follows:

> *"It is often in practice extremely difficult, especially in some developing countries, to obtain adequate information to apply the arm's length principle for the following reasons:*
>
> *(a) In developing countries there tend to be fewer organised players in any given sector than in developed countries and finding proper comparable data can be very difficult;*
> *(b) In developing countries the comparable information may be incomplete and in a form which is difficult to analyse because the resources and processes are not available. In the worst case, information about an independent enterprise may simply not exist. Databases relied on in transfer pricing analysis tend to focus on developed country data that may not be relevant to developing country markets (at least without resource and information-intensive adjustments), and in any event are usually very costly to access; and*
> (c) *In many developing countries whose economies have just opened up or are in the process of opening up there are many "first movers" who have come into*

existence in many of the sectors and areas are therefore still unexploited or unexplored; in such cases there would be an inevitable lack of comparables".

Unfortunately, short of highlighting the challenges faced in the developing countries, the guide did not go very far in guiding or equipping these developing countries on how to effectively overcome any of the very real challenges faced in applying the practice of the arm's length principle. In 2014, the OECD released the "Transfer Pricing Comparability Data and Developing Countries Report [2014]". This document was developed by the OECD as a response to concerns about the lack of availability and the poor quality of comparable financial data to which developing countries have access when it comes to transfer pricing.

The document focused on four alternative approaches to addressing the concerns regarding availability, reliability and relevance of information that could be used by developing countries in determining transfer prices.

The four approaches discussed were namely:

- Expanding access to data sources for comparable data;
- More effective use of comparable data sources for and guidance on making adjustments;
- Approaches to reducing reliance on directly comparable data,
- Advance pricing agreements and mutual agreement proceedings.

At the end of the report the four approaches listed above were summarised and possible actions to try and achieve each approach was summarised in the report.

A number of responses by monitoring groups were critical of this OECD report and the proposed guidelines contained in it. The Tax Justice Network[9] submitted their response to the OECD on the report as follows*:*

> ***"****In our view, the Report is disappointing. It is inadequate and unhelpful for developing countries. The Report:*
>
> - *assumes that developing countries should use transfer pricing methodologies which have been found deficient even by OECD countries, and are currently being revised, especially through the project on Base Erosion and Profit Shifting (BEPS);*
> - *prioritizes the use of comparables, although these methods have been shown to be deficient in both theory and practice, especially for developing countries;*

[9] The Tax Justice Network (TJN) is an independent international network launched in 2003. It conducts high-level research, analysis and advocacy on international tax; on the international aspects of financial regulation; on the role of tax in society; and on the impacts of tax evasion, tax avoidance, tax 'competition' and tax havens. It seeks to create understanding and debate, and to promote reform, especially in poorer countries. The TJN is not aligned to any political party.

- *obscures the real problem, which is not the absence of data but lack of appropriate comparables, due to the integrated nature of multinational firms;*
- *fails to provide any information about what databases are available, or an evaluation of whether or how the data that they provide is supposed to be helpful for the purposes of auditing transfer pricing;*
- *encourages developing countries to use methods which are likely to require case-by-case negotiation to ameliorate the fundamental deficiency of data without acknowledging the asymmetries of knowledge and power between developing country tax administrations and both tax advisers and developed country tax administrations; and*
- *Provide only a superficial consideration of alternatives to the use of comparables.*
- *In our view methods based on either comparable prices or comparable profits are unsuitable for developing countries, and likely to lead to either over- or under-taxation, because:*
    - *the lack of appropriate comparable means that appropriate assessments require detailed examinations, specialist knowledge, and subjective judgment;*
    - *such assessments are time-consuming, and require skilled specialists, who developing countries find it hard to recruit and retain;*
    - *the subjective judgments involved leave officials open to undue pressures and temptations to corruption.*

"Our recommendations are that developing countries should:

- *learn from the mistakes of the OECD countries, and build on their own experience, for example the `sixth method', or the Brazilian approach;*
- *anticipate rather than await reforms likely to result from initiatives to combat BEPS, such as country-by-country reporting;*
- *establish methods which are clear, transparent and easy to administer without the need for significant ad hoc investigation or subjective judgment"*

2.3 Base Erosion and Profit Shifting (BEPS)

"The BEPS project came about as an attempt by the world's major and emerging economies to update the tax rules on corporate taxation, and address the perception that global MNE's are not paying their fair share of taxes in today's global economy (Mansori & Sanshagrin, 2016)*."*

Base erosion and profit shifting (BEPS) refers to tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations (OECD, 2014). Transfer pricing, as a tool used for pricing cross border transactions, is

not a negative element in international tax. It is the underlying arms' length pricing model that has become a tool of pricing manipulation and profit shifting in a growing number of incidents (Beebeejaun, 2018). South Africa, like many other countries, be they developed or developing are facing a number of practical challenges when it comes to transfer pricing and the determining of an arm's length price for comparability purposes as required in terms of the OECD guidelines.

On 19 March 2014 in an article written by Amanda Visser for BD Live she stated that studies undertaken have showed that MNE's were shifting profits of approximately $365bn a year from developing countries to developed countries through the use of transfer pricing mechanisms. In her article she said that South Africa had billions of rand leaving the country in the form of royalties, intellectual property payments as well as management & service fees. The global economic crises had highlighted, especially to developing countries the importance of tax revenue and the negative impact it has on the sovereignty of a state when tax revenue is lost through base erosion and profit shifting to low tax jurisdictions. The article also referred to a consultative conference of the African Tax Administration forum that was held to the end of 2012 to discuss the importance and participation of Africa in the development of new rules and methods to prevent base erosion and profit shifting. In the same article the impact and the negative effect of base erosion was also highlighted by Sunita Manik, head of SARS's Large Business Centre (Visser, 2014). *"Ms Manik told delegates from 29 African countries and representatives of the Organisation for Economic Cooperation and Development (OECD) that some multinational companies in* certain sectors had an effective tax rate of 3%-5%, while the average for the rest of the sector was 11%. *The OECD head of global relations Richard Parry said international tax rules were more than 100 years old. The global economic crisis had made governments step back and revisit their sustainability. Lee Corrick, special adviser to the OECD on transfer pricing, said the challenge facing Africa was a lack of appropriate legislation for tax administrators to deal with base erosion and profit shifting* (Visser, 2014)*".*

It is understandable that South Africa needs to maintain transfer pricing laws that will continue to attract multinationals to operate within its borders, but this should not be done at the loss of the country's tax revenue in these cross border transactions. South Africa's tax administration is not alone in their challenge of addressing BEPS (Parliamentary Monitoring Group, 2014). Tax administrators in many countries have experienced that BEPS is difficult to regulate by way of unilateral actions and that a multinational approach was required. In response to international pressure and public

concern, in June 2012 the G20 world leaders called for action to be taken by the OECD to reform the international tax system (BEPS Sub- Commitee, 2014).

In February 2013, the OECD released a Report entitled "Addressing Base Erosion and Profit Shifting" (BEPS) in which it is noted that BEPS constitute a serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike. This report was followed by the release of a 15 item Action Plan of the OECD in July 2013 (BEPS Sub- Commitee, 2014).The 15 separate Actions Plans each identified weaknesses and challenges within a particular area of the international tax law. Action plans of interest, as it relates to transfer pricing is Action plans 8 – 10 focusing on the alignment of transfer pricing with value creation and Action plan 13 focusing on transfer pricing documentation.

The BEPS Action Plan was established by the OECD to try and address issues and flaws in international tax rules on a multinational basis. The BEPS project was endorsed by the G20 leaders and their finance ministers at their G20 summit held in St Petersburg in September of 2013. The Tax Annexure to the St Petersburg Declaration stated the following mandate for the BEPS project:

- *"First, changes to international tax rules must be designed to address the gaps between different countries' tax systems, while still respecting the sovereignty of each country to design its own rules.*
- *Second, the existing international tax rules on tax treaties, permanent establishment, and transfer pricing will be examined to ensure that profits are taxed where economic activities occur and value is created.*
- *Third, more transparency will be established, including through a common template for companies to report to tax administrations on their worldwide allocation of profits and tax.*
- *Fourth, all the actions are expected to be delivered in the coming 18 to 24 months. Developing countries must reap the benefits of the G20 tax agenda* (Russia G20, 2013)*."*

In the 2013 Budget speech, the South African Minister of Finance announced that a tax review committee would be established. On 17 July 2013 the Davis Tax Committee (DTC) was appointed. The committee was instructed to investigate the role of South Africa's tax system " in the promotion of inclusive economic growth, employment creation, development and fiscal sustainability" (BEPS Sub- Commitee, 2014).

From an international perspective, the DTC was mandated to attend to the concerns about base erosion and profit shifting (BEPS), particularly as it relates to company income tax, as identified by the OECD and G20. The DTC set up a BEPS Sub-committee to deal with the matters addressed in the OECD BEPS Action Plans (BEPS Sub- Commitee, 2014). In order to get input from industry on how BEPS should be addressed within the South African context the DTC BEPS Sub-committee met with different stakeholders ranging from business representatives, the trade unions, civil society organisations, tax practitioners, SARS, National Treasury, the South African Reserve Bank, members of international bodies and academics (BEPS Sub- Commitee, 2014).

2.4 Final OECD BEPS Reports

The Final BEPS report was the centre of much discussion and criticism by monitoring groups and social activist groups. The BEPS Reports were expected to bring about the biggest changes to multinational taxation since building blocks of the current framework were introduced in the 1920s (Economist, 2015) .However promoters who oppose corporate-tax avoidance have stated that BEPS is at best a partial success. It is a first step towards something more substantial (Cobham, 2015 (b)). In a 2015 online article published in the Economist the writer states on the OECD BEPS Action Plans:

> "*The biggest disappointment is that, in opting to renovate the existing system, the OECD has stuck with its most deeply flawed pillar: the "independent entity" principle. This rests on the fictitious assumption that the various parent and subsidiary companies in a corporate group act like separate legal persons that transact with each other at arm's length* (Economist, 2015)."

The process, which had been compressed into a 24-month period, was hindered from the beginning. Consensus could not be reached by all the parties involved on how to proceed with the radical overhaul of the international tax laws that was needed to keep international tax laws relevant and relatable to the global economy in which it was being applied. This resulted in a patch-up job offering improvements in certain areas but also failing to deal with the core problems (Economist, 2015).

In October 2015, the OECD released their final BEPS Action Plan report. The overarching intention of the OECD BEPS plans were to bring the location of taxable profits in line with the location of economic activities and value creation, and improve the data that is available to tax authorities to apply their tax laws effectively (BEPS Sub commitee, 2015).

Action Plan 8 – 10: The alignment of transfer pricing with value creation

The work on transfer pricing under the BEPS Action Plan focused on three key areas:

- Action 8 dealt with transfer pricing matters that addressed transactions involving intangibles. This was motivated by the fact that profits generated through valuable intangibles were being misallocated and adding to the problem of base erosion and profit shifting. (OECD BEPS Reports, 2015).
- Action 9 looked at the relationship that exist between the allocation of risk between contracting parties and the associated split of profits in relation to those risks, which do not necessarily correlate to the activities actually carried out. The action plan also considered the relationship that existed between the funding provided by capital rich MNE group members and the level of returns allocated to these funding MNE's which was not reflective of the level of activity undertaken by the particular MNE group member. (OECD BEPS Reports, 2015).

- Action 10 focused on other high-risk areas, including the scope for addressing profit allocations resulting from transactions which are not commercially rational for the individual enterprises concerned (re-characterisation). It also discussed the scope for targeting the use of transfer pricing methods in a way which results in diverting profits from the most economically important activities of the MNE group, and neutralising the use of certain types of payments between members of the MNE group (such as management fees and head office expenses) to erode the tax base in the absence of alignment with value creation (OECD BEPS Reports, 2015).

The revised OECD Transfer pricing guide was issued in July of 2017. What is emphasised in the document for the reader to appreciate is that the intended outcome of Action plans 8 -10 can only be reached if:

- A clear understanding of the substance of the actual transaction between the associated parties can be established.
- This will be achieved by analysing the contractual relation between the parties in combination with the behaviour of the parties.

The common outcome to the revisions in Action 8 -10 is that the actual conduct (what is actually done) will supplement or replace the contractual arrangements (what is said to be done) if the contracts are incomplete or are not supported by the behaviour (OECD, 2017).

This combined with the proper application of pricing methods in a way that prevents the allocation of profits to locations where no contributions are made to these profits, will lead to the allocation of profits to the enterprises that conduct the corresponding business activities. In circumstances where the transaction between associated enterprises lacks commercial substance, the guidance continues to authorise the disregarding of the arrangement for transfer pricing purposes (OECD BEPS Reports, 2015).

The revised guidance for transfer pricing includes two important clarifications relating to risks and intangibles.

- The OECD report stated that the where a party assumes a particular contractual level of risk, and it does not have the financial capability or available resources to exercise meaningful control over the risk, the risk and related profit will be allocated to the party within the group that actually has the resources available to control the risk *(OECD BEPS Reports, 2015).*

- As it relates to intangibles, the guidance clarifies that legal ownership alone does not necessarily generate a right to all or even any of the return that is generated by the use of the intangible (OECD BEPS Reports, 2015).

> "*The group companies performing important functions, controlling economically significant risks and contributing assets, as determined through the accurate outlining of the actual transaction, will be entitled to an appropriate return reflecting the value of their contributions. Specific guidance will ensure that the analysis is not weakened by asymmetry in information corresponded between the tax administration and the taxpayer in relation to hard-to-value intangibles, or by using special contractual relationships, such as a cost contribution arrangement".*[10]

The revision also looked at situations where a capital-rich member of the group provides funding but performs few activities. If it is found that the capital rich member country does not perform any due diligence to ensure that the financial risk it is

[10] Cost Contribution Arrangements (CCAs) are contractual agreements between associated enterprises in an MNE group in which the participants share certain costs and risks in return for having a proportionate interest in the expected outcomes arising from the CCA. CCAs may also include independent parties. CCAs may be used for a broad range of purposes such as acquiring or creating tangible assets, acquiring or creating intangibles, and providing intra-group services. In relation to intangibles, the CCA will set out the interest of each participant in the intangibles to be developed. (UN .org, 2016)

undertaking by providing the funding, then the associated profits will not be allocated to the group member providing the funding . *"The associated enterprise would be entitled to no more than a risk-free return, or less if, for example, the transaction is not commercially rational and therefore the guidance on non-recognition applies (OECD BEPS Reports, 2015).*"

Lastly, the adjustment sought to safeguard that pricing methods used would apportion profits to the most significant economic activities. It will no longer be possible to assign the synergistic benefits of functioning as a group to members other than the ones actually adding to such synergistic benefits. The final report in 2015 included a mandate for follow-up work to be done on the transactional profit split method. Finalisation of this follow up was earmarked for the middle of 2017. During September 2017, a discussion draft titled, "Revised guidance on Profit Splits" was issued for public comment. *"This work has led to detailed guidance on the ways in which this method can usefully and appropriately be applied to align transfer pricing outcomes with value creation, including in the circumstances of integrated global value chains (OECD, 2018).*" This profit split method is aimed at dividing the profit generated in the controlled transaction between the associated enterprises in the same proportion/split that would have been achieved in an arm's length transaction. The profit split method was part of the guidelines since 2010 and could be used where it was proven to be the best method at hand, but the revision significantly expands when the transactional method may be the most appropriate method (OECD, 2018).

Action Plan 13 – Transfer pricing documentation

Transfer pricing analysis depends on access to relevant information. In terms of Country by Country reporting (CbCr) requirements, MNE's must provide information on their functions in every jurisdiction in which they operate. These reports will allow tax authorities to determine the level of transfer pricing risk and other BEPS related risks that may exist with respect to the MNE Groups operating within their borders (OECD BEPS Reports, 2015). This is definitely a step in the right direction. There is still much work being done and much guidance being issued by the OECD regarding the implementation and requirements around this Action plan. As MNE's and tax administrators grapple with and prepare the required documentation for their first round of CbCr submissions, time will tell if the expected outcome of this revision, being access to relevant and reliable data for comparability will be obtained. It is important to remember that the OECD does not pass laws or sign tax treaties, the organisation only

issue guidelines. Governments and their respective tax authorities are the ones who will have to decide to implement BEPS into their domestic tax law and this will likely lead to a significant variation in the timing of implementation and interpretation of how the rules will be applied.

2.5 South Africa after the OECD Final BEPS Reports

In summary, the Davis Tax Committee recommended the following as it relates to the Action plan 8-10 and Action plan 13

> *"Although the OECD report on Actions 8 to10 indicates that further work is still to follow, based on the DTC's analysis of the recommended changes to be made to the Transfer Pricing Guidelines as a consequence of the Action 8 to 10 OECD Report, and in line with the recommendations on the OECD Action 13 Report, in order to reduce the incidence of income not being taxed in South Africa when the risks, functions and values actually take place here, South Africa adopts all the OECD recommendations pertaining to transfer pricing rules and documentation (BEPS Sub Committee, 2015)."*

In the 2017 Budget Review delivered on 22 February 2017, the South African Minister of Finance set out South Africa's position on the Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) Action items.

Regarding: **Action 8 – 10: Transfer pricing (alignment of outcomes with value creation)**

> *"The South African Revenue Service (SARS) is updating the Transfer Pricing Practice Note in line with OECD Transfer Pricing Guidelines to include new guidance on the arm's-length principle and an agreed approach to ensure appropriate pricing on intangibles that are difficult to value."*

Regarding **Action 13: Transfer pricing documentation**

> "The *Tax Administration Act* provides the legal basis for country-by-country reporting CbCr, where the term "international tax standard" has been included, covering CbCr. Regulations were gazetted in December 2016. For multinational enterprises with fiscal years starting on or after 1 January 2016, the first CbCr will be required to be filed with SARS from 31 December 2017."

In addition, the DTC advises that the country-by-country report for South Africa should include extra transactional information about related party interest payments, royalty payments and especially related party service fees. This will allow SARS to perform risk

assessments where it is challenging to get information on the processes of a multinational business (BEPS Sub Committee, 2015).

2.6 Post BEPS and the Arm's length principle:

The BEPS plans were finalised and released in 2015.The OECD's intended outcome of the BEPS project was to provide assurance to tax authorities and the global community that profits are taxed where the economic activity creating the profit is generated and the value is created. Of the fifteen action plans, three of these action plans (8 -10) as discussed earlier in this chapter focused on aligning transfer pricing outcomes with value creation (Mansori & Sanshagrin, 2016).The project was a reactive response by the OECD (which consist of the worlds' major and emerging economies), to the wide perception that the global MNE's are not paying their fair share of taxes in the global economy in which it operates.

In a journal article by Mansori and Sanschagrin, two key reasons were identified why the primary objective of the BEPS project, which was the alignment of transfer pricing outcomes with value creation, may not result in the OECD's intended outcome. Instead it could potentially go against the arm's length principle in a number of ways (Mansori & Sanshagrin, 2016).

The first shortcoming identified is the fact that value creation is not defined in the BEPS plans. This means that a transfer price is being aligned to an undefined concept. This could lead to different interpretations of the meaning of value creation and ultimately the distortion of an arm's length transfer price. With value creation being left undefined, tax authorities might interpret the concept to be similar to value added.

Mansori and Sanshagrin explain it as follows:

> "*Value added is measured simply by comparing the value of inputs with the value of outputs; the difference between the two is the value added by that step in the value chain. The concept is straightforward and particularly easy to apply to traditional manufacturing companies. And since the central concept of the OECD's prime directive is left undefined, it is not difficult to imagine that many will instead focus on the well-understood concept of value added when examining taxpayers' transfer pricing outcomes. This is particularly likely in tax jurisdictions where relatively high value-added pieces of the production process are located. But the value created within an MNE may involve far more than what is happening at any given stage in the value chain, especially for many of today's companies whose outputs may be services, information, technologies, know-how, brand awareness, and ideas. MNEs amass and put at risk large quantities of capital, set strategic objectives, assemble unique teams of personnel*

with highly specialized abilities from across the globe, and develop market and bargaining power far beyond the reach of most individuals. These attributes of modern MNEs are often tremendously important profit drivers, even though there may be no stage in the value chain where they are directly measurable (Mansori & Sanshagrin, 2016)*."*

Another shortcoming identified in the measurement of value creation is from whose perspective the measure needs to be valued. Should it be measured from the customer's perspective, the shareholders perspective or some other measure that the MNE's uses to generate taxable profits. Value creation extends beyond transfer pricing, as stated in the Economist. In the same article it goes on to ask what potentially would be the best measure; would it be the stock market value, the balance sheet value or even some other value like future performance (Economist, 2009).

Economic factors such as supply and demand, risk tolerance and bargaining powers are also factors to be considered when considering adherence to the arm's length principle. Another factor / concept that business and tax experts identify as being an important feature of arms' length pricing is value capture. This is a completely different concept to value creation. Value capture is described as "*the ability to extract rents without necessarily creating value. Bargaining power and risk appetite play key roles in value capture* (Mansori & Sanshagrin, 2016) *."* An example of value capture would be "*a parent/ holding company that own a valuable intangible. This company would have greater bargaining and negotiating powers when negotiating a favourable outcome with local country businesses such as retailers and distributors, who might be looking to have the product in their store, based on consumer demand (Mansori & Sanshagrin, 2016)."*

The following example was used in the article by Mansori and Sanchagrin to illustrate how the prime objective in a post BEPS environment of matching profits to where value is created in MNE's might be at odds with the arms' length principle.

"*Suppose a pharmaceutical company hires a research team to develop a new drug, analogous to a contract research and development entity. If things go well, the value added by the research team will be far greater than its compensation. In fact, that is the goal of the corporation. Yet even though the compensation paid by the MNE to the research team is hoped to be much less than the value captured by the company, the arrangement is, by definition, arm's length. Why don't the researchers demand and receive compensation equal to the value they add to the firm? Or put another way, why don't they independently develop the new drug so that they can capture more of the value they have created for themselves? Because the other ways in which the enterprise creates value by putting capital at risk, by assembling a team with the other functions,*

institutional know-how, and corporate culture supporting innovation necessary to derive value from a new drug, and by having the market clout to fully capitalize on the new product make the entire endeavour more successful for both the firm and the team when they work together (Mansori & Sanshagrin, 2016)*. In the absence of a clear definition of the term "value creation," a transfer pricing analysis that follows the OECD's prime directive may well note that the bulk of the value added for this firm is in the R&D and marketing departments, with perhaps a small ("routine") amount attributable to corporate functions. The analysis, without considering a broader perspective that would include value capture, may conclude that the MNE's profits should be distributed likewise* (Mansori & Sanshagrin, 2016)*."*

"*Now consider where the "central company" outsources all the functions such as R&D, administration and marketing. Each of these companies would be compensated in line with what they would routinely earn for similar services and the majority of the profits earned from selling the product would then lie with the central company taking all the risks, as this company now has the greatest bargaining power. These transactions would all be arm's length and the outcomes could not be disputed by any tax authority* (Mansori & Sanshagrin, 2016)*."*

Therefore, while it is agreed that value creation is an important factor in determining the arm's length nature of a controlled transaction, it should not necessarily be the key factor. With undefined value creation as the central measure, the OECD transfer pricing guidelines is creating unintended burdens for the MNE, due to the widely different interpretations of what is meant by value creation and how it could be applied in transfer pricing analysis by various tax authorities.

2.7 Chapter summary

In summary, this chapter looked at the OECD as an organisation, and its significant influence on global policy setting across many sectors.

The chapter addressed the challenges faced by emerging economies as well as developed economies as it relates to transfer pricing and BEPS by MNE's. South Africa's relationship with the OECD was discussed as well as the impact of BEPS on the country's domestic revenue. The chapter also discussed the Davis Tax Committee, its role in the BEPS action plan review and its recommendation to National Treasury to consider incorporating the revisions as recommended in the BEPS Action plans for transfer pricing into South Africa's domestic tax law. It looked at how concerns and frustrations raised by the G20 in 2012 led to development of these OECD BEPS Action plans to address the international tax challenges.

A review of the BEPS action plans as finalised in 2015 was made and certain weaknesses in the post BEPS transfer pricing environment were highlighted. The key weakness being that value creation was not defined in the BEPS Action plans which has left the meaning of this concept open to interpretation by MNE's and tax authorities alike. This means that the very achievement of an arm's length transfer price that is aligned to value creation could potentially become even more distorted as tax authorities and MNE's could apply their own interpretation and meaning of value creation. It highlights the fact that the OECD BEPS team and MNE tax practitioners will have to look to develop more frameworks that encourage the use of more profit drivers not just value creation, to determine arms' length prices as transfer pricing arrangement gets developed and implemented (Mansori & Sanshagrin, 2016).

Having identified and addressed some of the challenges faced with the arm's length principle, and those new ones created with the implementation of BEPS, it leads to the question , are there alternate methods available that could be used? Some alternative methods to the arm's length pricing method as advocated by the OECD were identified and suggested by the Tax Justice Network (TJN) earlier in this chapter. The TJN have been lobbying for a complete overhaul of the international tax for a number of years. This outcry by the TJN is based on the fact that the organisation is of the opinion that there are oalternativer methods available other than the arm's length principle that could create a far more equitable split of profits amongst group companies for tax purposes and prevent the profit shifting practices that is possible with the arm's length pricing methods. The following chapter will address one of the methods, namely formulary apportionment.

CHAPTER 3: FORMULARY APPORTIONMENT

This chapter will look at formulary apportionment as a possible alternative to arm's length pricing. The advantages and disadvantages of this method will be discussed as well as how it differs to the arm's length principle and its overall suitability as an alternative or supplementary method in the international taxation environment.

3.1 What is formulary apportionment?

Formulary apportionment is a method of allocating profit earned or losses incurred by a company or a group of companies to a particular tax jurisdiction in which the company or group has a taxable presence (Avi-Yonah & Benshalom, 2011). Formulary apportionment allocates the group's total worldwide profit (or loss) to each jurisdiction, based on factors such as the proportion of sales, assets or payroll in that jurisdiction (Altshuler, 2010).The method does not look to separate accounting as the arm's length principle does. When applied to a corporate group, formulary apportionment requires combined reporting of the group's results. The parent and all of its subsidiaries are viewed as though they were a single entity and it would pay domestic company taxes on the share of its worldwide income that is allocated to each jurisdiction (Altshuler, 2010). The domestic taxation laws applicable in each tax jurisdiction will be used to calculate the tax obligation for a particular MNE in a particular jurisdiction. In this manner there is still compliance with the domestic tax legislation. The formula only aims to provide an equitable share of the MNE's profits or losses to a particular tax jurisdiction, regardless of its status as a high or low tax jurisdiction (Durst, 2015).

> *"The central principle of formulary apportionment is that income should be attributed, for tax purposes to the locations where business activities are performed. The core function of formulary apportionment allows income only to be allocated to places where real business activity takes place and in quantitative proportion to the extent of that activity. So the very application of formulary apportionment to a taxpayer's income from all sources would by its very nature eliminate BEPS completely"* (Durst, 2015).

Formulary apportionment is a much-debated topic amongst tax commentators and there are varying opinions on how and to what extent formulary apportionment can be integrated with the current arm's length method for transfer pricing.

The OECD Guidelines for Transfer Pricing 2017 do not recognise formulary apportionment as a realistic alternative to the arm's length principle (OECD, 2017, p. par1.32:pg46). The OECD is of the opinion that the system will not adequately protect against double taxation, while at the same time ensuring single taxation. In their opinion

"*a move to global formulary apportionment would require a level of international co-operation that is unrealistic in the field of international taxation* (OECD, 2017, p. par 1.24:page 41)." Affected parties in a transaction would each want to include factors that would advantage them, and this could lead to a situation where agreements on the basis of the formula may not be reached. So, it would seem that one of the problems with formulary apportionment would be that affected parties would want to show results that best advantage them by including factors into the pre-agreed formula that would favour their particular organisation. The current problem with arms' length is that taxpayers are making adjustments to comparables by considering factors that is favouring their enterprises. So there appears to be a problem with taxpayers serving their self- interest regardless of the method.

The UN Tax Model, like the OECD Tax Model supports the arm's length principle as the basis for establishing an arm's length price. Unlike the OECD Transfer Pricing Guidelines 2017, The UN Transfer Pricing Manual does not reject global formulary apportionment as a transfer pricing method. It acknowledges and recognises that there could be instances where formulary apportionment could be used as an alternative to the arm's length principle (The United Nations, 2017, p. B1.4.14;page 37).

3.2 The European Union (EU) and formulary apportionment

The European Union[11] consists of 28 member states. The union serves as a unified trade and monetary body. These states all maintain their sovereignty and independence but in areas where it makes sense to make joint decisions for the benefit of the union, they have created shared institutions that facilitates a democratic decision making process on specific matters of common interest to the member states (Commission, 2018).

> *"Several institutions are involved in making decisions at EU level, in particular:*
>
> - *the European Parliament, which represents the EU's citizens and is directly elected by them;*
> - *the European Council, which consists of the Heads of State or Government of the EU Member States;*
> - *the Council, which represents the governments of the EU Member States; and*
>
> *the European Commission, which represents the interests of the EU as a whole* (Commission, 2018)."

[11] European Union : A union borne out of a deep desire for peace in a war torn and divided post World War II European continent. The union currently consist of 28 states

The EU as a body is not responsible for setting tax rates and collecting taxes, the national governments of the member states are responsible for these functions. The member states are free to design and implement tax laws that will serve their national priorities but in doing this they still need to ensure compliance with some of the fundamental principles of the EU. These would be non-discrimination and respect for free movement of goods and services in the single market[12]. Although the Member States are free to develop their own tax laws, there is an expectation that the laws will not allow people or business to escape paying their fair share of taxes in another state. The EU acknowledged that addressing the issues of tax avoidance and even tax evasion, these matters required action and input from all the member states. It is a requirement that on matters such as tax issues all the member states needs to agree on any decisions made to ensure that the interest of every EU country is considered. With issues such as BEPS on the rise the EU member states work together to try and ensure that taxation stays fair (Commission, 2018).

In September 2004 discussions around the implementation of a common tax base for members of the EU started to take place (D Pirvu, 2011, p. 199). "*The aim of this initiative was to create a common tax base through the use of formulary apportionment for the activities of a transnational company. The income and expenses will be consolidated in one state, where the parent company is located, and the taxable profits will then be calculated in this one state. The tax will be paid in that one state and subsequently distributed to the other states where the parent company has activities* (D Pirvu, 2011, p. 199)."

The European Union (EU) adopted a formulary approach, which can be implemented at the option of the taxpayer to harmonise its corporate taxes under the Common Consolidated Corporate Tax Base (CCCTB) initiative.[13]

The easiest way to explain the effects of the CCCTB proposal is to examine how it works in practice, which is demonstrated by means of the following examples:

[12] The Single Market refers to the EU as one territory without any internal borders or other regulatory obstacles to the free movement of goods and services. A functioning Single Market stimulates competition and trade, improves efficiency, raises quality, and helps cut prices. The European Single Market is one of the EU's greatest achievements. (Commision, 2017)

[13] "Common Consolidated Corporate Tax Base (CCCTB) initiative: The Common Consolidated Corporate Tax Base (CCCTB) is a single set of rules to calculate companies' taxable profits in the EU. With the CCCTB, cross-border companies will only have to comply with one, single EU system for computing their taxable income, rather than many different national rulebooks. (The European Union, 2016)"

Example 1

> *"Member State A allows assets to be depreciated over ten years, for tax purposes, while member State B allows for depreciation over five years. Member State A allows for a deduction for all entertainment expenses, while Member State B does not. A common corporate tax base means that these rules would be the same throughout the European Union and companies would only need to do their calculations based on one set of tax rules. Without consolidation, the company would need to make a separate calculation and file a separate tax return for each Member State in which it has a taxable presence. This would still be easier than today, however, as the rules for this calculation would be uniform across all Member States. Under the proposed consolidation, all profits and losses from the companies of a group in different Member States would be totalled in order to calculate a net profit or loss for the group's entire EU activity. Based on this net figure, common rules would be used to determine the final tax base of the group* (Hoffmanns, et al., 2017)."

Example 2

> *"A group consists of companies A, B, C and D, each in a different Member State. Companies A and B have profits of EUR 10 million each, Company C has a profit of EUR 5 million and Company D has a loss of EUR 8 million. The consolidated tax base (net profit) of this group is A + B + C –D = EUR 17 million. This profit must then be apportioned between the relevant member States* (Hoffmanns, et al., 2017)*."*

The CCCTB project was initially launched in 2011 but it was seen as being too aggressive in its dual implementation of consolidation and formulary apportionment. By their own admission the EU stated that they were not too sure what the resultant impact would be on member states' domestic revenue with the implementation of this approach. This raised wide spread concern and member states showed a great level of resistance. A Common Corporate Tax Base (CCTB) was then proposed, removing the consolidation step (Roder, 2012, p. 131).

In the relaunch in 2016, the CCCTB and the CCTB were launched together. The CCCTB is mandatory for MNE's that earn income exceeding a certain threshold and it's optional to any other member state, who might not necessarily meet the income threshold but wishes to comply with the CCCTB (Kolbe, 2017, pp. 18 - 23). In 2016, the European Commission published a communication called the "Fair and Efficient

Corporate Tax system in the European Union".[14] The aim of the document was to set out how the OECD/G20 BEPS measures can be implemented within the EU (The United Nations, 2017, p. B1.3.12:page 32).

3.3 Differences between Formulary Apportionment and Arm's Length Pricing.

The fundamental difference between these two methods is that the arm's length pricing method is founded on the principle that one is to respect the internal divisions that multinational corporations create in the form of subsidiaries, holding companies, parent companies etc. and attempt to regulate transactions between them (The United Nations, 2017, p. B1.4.1: page 35). Formulary apportionment disregards those legal distinctions and looks at a company as a large, single unit, and then determines a top-down division of its income into countries based on agreed-upon factors (Reuven, 2010). The aim of this method is to tax portions of a multinational company's income without referring to the group structure in any way. In addition, multinational enterprises, with the same total income, are generally treated the same under this method (Gharky, 2012).

3.4 Challenges of Formulary Apportionment

The following reasons have been given by a number of critics of the method as the reasons for finding the formulary apportionment method unfavourable in the context of international taxation. A general opinion is that it is found to be inflexible. Some commentators are of the opinion that individual facts and circumstances are disregarded in the formulary approach and as a results acts in an arbitrary manner *(Gharky, 2012)* The system would not protect against double taxation. It would require a high level of international coordination amongst parties and consensus amongst countries would be necessary. All countries would have to agree on a predetermined formula and on all the factors contained within it (Reuven, et al., 2009). There are also a number of factors that the formulary approach cannot accommodate for, such as the issue of intangibles, and the difficulty in determining where the income is produced with intangibles. So this implies that intangibles would not be used in the formula and that then eliminates the formulary approach for e-commerce transactions (Cockfield, 2004).
Another challenge is the fact that different countries have different accounting and tax rules which regulate definitions of income as well as deductions for everything from interest to depreciation to pension contributions. These rules reflect the political, social

[14] Fair and Efficient Corporate Tax system in the European Union: The Action Plan aims to establish a new approach to corporate taxation in the EU to tackle tax avoidance, ensure sustainable revenues and foster a better business environment in the Single Market.

and economic climate of each particular country. For formulary apportionment to work, the tax and accounting rules of each country would need to be standardised in order to arrive at a uniform definition of the taxable base subject to apportionment (Reuven, 2010). To achieve this, countries would have to give up control over a major portion of their domestic policy. It is highly unlikely that this loss of control would be politically acceptable by any country (Gharky, 2012, pp. 10-11).

3.5 Countries currently applying formulary apportionment.

Formulary apportionment and unitary taxation[15] originated in the United States over a century ago. It was in a response to the difficulties that U.S. states were having in taxing railroads (Durst, 2015). The formulary principle may be applied in multiple ways. Versions of the method are used to assign taxing rights over enterprises between the states of the United States and the provinces of Canada. The formulas historically used by some US states involve sales, payroll expenses and the value of plant and equipment. Currently many US states use only sales as a single factor (Durst, 2015).
In Canada the system that is used generally divides companies' income among the provinces according to a two-factor formula using sales volumes and payroll expenses. An equal weighting is given to both factors. By doing this the tax obligation of a company to any one provincial government is determined by the proportion of total company sales and payroll costs that is made in that province (Durst, 2015).

It is important to note, for the purpose of distinction, that formulary apportionment and unitary taxation is not equivalent. Formulary allocation is a method used to allocate income and losses. This method does not seek to determine the market price of the relevant associated transactions that produced the income or losses. Unitary taxation is a method whereby all the MNE income sources get consolidated. This method is beneficial to corporations as it allows them to consolidate losses and income from different tax jurisdictions (Avi-Yonah & Benshalom, 2011, p. 381).

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[15] Unitary Taxation: Unitary systems are typically used as a way to allocate the corporate tax base between states in federations (e.g., Canada and the United States).

"Even though a consolidated unitary setting requires an allocation formula – allocation formulas could be used also in other settings. A formulary allocation can be applied to a specific source of MNE income (Avi-Yonah & Benshalom, 2011, p. 382)*."*

3.6 Voices for a change from current international transfer pricing practices

Joseph Stiglitz, a Nobel-prize winner and one of the most outspoken critics of global economic inequality recommends scrapping the arms-length principle. He is of the opinion that small tweaks to the guidelines will not prevent aggressive, artificial moves by MNE's to divert earnings and profits to low-tax countries. Another disadvantage to the arm's length method is that countries that lack the ability to keep up with sophisticated and complex profit manipulation is exploited (Parker, 2014). The Tax Justice Network has always been strong lobbyist for reform of the international practices surrounding transfer pricing. The organisation has been a strong supporter of formulary apportionment, unitary taxation and country-by-country reporting. On 14 March 2012, at the meeting on Transfer Pricing sponsored by the UN Financing for Development Office at the UN in New York, David Spencer, a senior advisor to the Tax Justice Network delivered a statement which read as follows .

"The Tax Justice Network calls for objective analysis of Transfer Pricing issues, especially in the context of the needs of developing countries. The Tax Justice Network ("TJN") does not agree with the OECD about several transfer pricing issues, including for example the following: First, the OECD continues to assert that the arm's-length principle developed decades ago is still "sound in theory." TJN believes that the OECD's theory of the arm's-length principle no longer applies to multinational enterprises which are highly integrated, and that comparables in many, if not most cases cannot be found. Second, the OECD is asserting orthodoxy, as evidenced by (a) its deletion of Article 7(4) of the OECD Model Income Tax Treaty, (b) the OECD's continued opposition to the Brazilian transfer pricing method, and (c) the OECD's continued insistence on imposing the OECD's Transfer Pricing Guidelines on developing countries. As U.N. Assistant Secretary General Jomo K. Sundaram pointed out quite clearly in his presentation at the meeting on transfer pricing here at the UN in June 2011, the OECD Guidelines have been developed by a small group of countries, which are rich. Third, the OECD Transfer Pricing Guidelines are so complex that even the tax administrations of many developed countries cannot adequately administer those rules. Therefore, how can developing countries, especially the least developed countries, be expected to administer adequately those rules? Fourth, in effect the OECD continues to assert that there are only two options: (1) the OECD's arm's-length principle, or (2) global formulary

apportionment which the OECD rejects. TJN believes that the arm's-length principle is broader than the OECD's Transfer Pricing Guidelines, and also that there is a spectrum of transfer pricing methods, including for example, combinations of (a) an arm's-length principle when comparables can easily be determined and (b) formulary apportionment concepts in other situations."

Mr. David Rosenbloom, former International Tax Counsel at the U.S. Treasury Department has called the arm's-length system as it operates today basically unusable. However given treaty obligations and problems of international continuation he conceded that we are bound to it. He is of the opinion that there must not be a separation between the arm's-length and formulary methods (Sullivan, 2010). He suggested a possible solution whereby the US tax collection services (could be applied to other tax administrations also) would by default apply a formulary apportionment of profits but taxpayers would be allowed to refute the formulary method with reference to arm's-length principles. Rosenbloom commented that this could be a variation of the Brazilian system, that was implemented in 1997. The system is reliant on formulary methods and fixed-mark-up safe harbours. This approach is not regarded as compliant with the OECD's arm's-length standard (Sullivan, 2010).

The Independent Commission for the Reform of International Corporate Taxation (ICRICT) has launched a roadmap to taxing multinationals. The commission was established by a broad coalition of civil society and labour organisations, including TJN, with the aims of:

- *promoting the international corporate tax reform debate through a wider and more inclusive discussion of international tax rules than is possible through any other existing forum;*
- *to consider reforms from a perspective of public interest rather than national advantage; and*
- *to seek fair, effective and sustainable tax solutions for development. (Cobnam, 2018 (a)).*

In the opinion of the ICRICT, this roadmap serves as an important intervention that not only confirms the failure of current tax rules to deliver fair outcomes internationally, but sets the course for a specific alternative that would significantly strengthen fiscal sovereignty for countries at all income levels through unitary taxation with formulary apportionment. (Cobnam, 2018 (a)).

In an article, written by Alex Cobnam and published on the TJN website in February 2018 regarding the ICRICT roadmap for taxing multinationals, he wrote the following:

> *"Three months ago, the Paradise Papers have prompted again the citizens' indignation against the way multinational corporations avoid paying their fair share of taxation. ICRICT is launching today a new publication presenting concrete solutions to reorient the existing system of international taxation away from serving the wealthy few and to focus it instead on addressing the needs of the vast majority of the population. After evaluating many alternatives, ICRICT proposes a solution to a failing system. Global formulary apportionment, coupled with a minimum corporate tax rate, is the only effective way for all countries to collect a fair share of tax revenue from multinational enterprises and avert a race to the bottom"* (Cobnam, 2018 (a)).

3.7 Is formulary apportionment a viable alternative or at least another approach to consider?

In an article by Kash Mansori titled – "there must be a better way" he poses the following question, *"Wouldn't life be simpler for both taxpayers and tax authorities if they didn't have to worry about finding arm's length prices to apply to all of the transactions that take place within a multinational group? (Mansori, 2014)."*

He proceeds to answer his question and states that formulary apportionment appears to be the tempting alternative to arm's length for a variety of reasons, mainly the removal of complex exercises to determine comparable prices, and the elimination of the complex weaves of intragroup structures. However, he acknowledges that an effort to move toward formulary apportionment would almost certainly create at least as many challenges as it would resolve. An effective corporate tax system should prevent the introduction of distortionary information into the economic decision-making process, so that projects or transactions occur when they have economic merit and not when they don't. But unless there is an international agreement on the use of apportionment, as well as on the factors to be used in the specific formula, the application of formulary apportionment could create very distortionary results. (Mansori, 2014).

The concept of formulary apportionment and exactly how it operates in a trading environment can have many challenges. Consider a scenario where, one country uses apportionment while its' trading partner country does not. In this situation it is inevitable that a company doing business in both these tax jurisdictions would contend with a number of situations where certain activities would result in no tax, while other activities would result in double-taxation (Mansori, 2014). This could lead to a situation where

activities that makes commercial sense and is economically worthwhile would never happen, while other activities would occur simply for the tax benefit it will provide. These actions by MNE's would inevitably lead to the misallocation of resources and ultimately a loss to society in an attempt to maintain or reduce an enterprises' overall tax liability. (Mansori, 2014). The impact exchange rates could have on the allocation of profits and inevitably tax is also highlighted in the article by the following statement made by the author, "*Under formulary apportionment, exchange rate movements would alter how much tax a multinational owed in each country by affecting any elements of the allocation formula that are measured in units of currency, such as sales or assets. For example, if China's currency were to continue to strengthen against the dollar over time, China would be able to claim a larger and larger share of the income of multinationals doing business there, even if those multinationals had no change in their sales or transactions* (Mansori, 2014)."

One of the biggest pitfalls created by formulary apportionment is the two extreme outcomes that could occur, either double taxation or non- taxation in certain instances. Let's consider a business environment where formulary apportionment is internationally accepted. This would require that all the countries involved should come to an agreement on a common formula to be used to split up the multinationals income. It would be a natural and expected response to have the tax administrators of the different countries' lobbying for the inclusion of elements in the formula that would benefit them specifically. And if in some way a common formula can be agreed on, it could and would most likely lead to situations where the MNE's would manipulate the elements of the formula by engaging in economic activity with no real economic rationale. This in turn would result in distortion of real economic activity in order to get the best outcome in the common formula (Mansori, 2014). The apportionment method could also create a number of accounting challenges for multinationals. These MNE's would have to compile and present data on the worldwide activities of the group to each of the countries in which the MNE's operates. This information will have to be in compliance with the specific book and accounting rules required in that particular jurisdiction (Mansori, 2014). Formulary apportionment is regarded as compatible with country-by-country reporting (CbCr); a concept developed by TJN's co- founder and senior adviser, Richard Murphy in 2003 and could serve as the accounting basis for formulary apportionment. It should be noted that a version of CbCr as developed by Richard Murphy has been incorporated into the OECD Guidelines for Transfer Pricing as part of the BEPS project. What's interesting to note though is that there are commentators, like

former Treasury official David Ernick who are of the opinion that the OECD's support for the arm's length principle is starting to waver and that country by country reporting as implemented in terms of BEPS Action plan 13 will encourage global companies to allocate their profits based on a formula anyway. Ernick is quoted as follows on the matter, *"That information is really not relevant to determining transfer pricing risk, if your transfer pricing is based on the arm's-length principle. The question they're essentially asking is 'Does your allocation of profits around the world line up as it would if you had used a formulary approach?' They're kind of mixing apples and oranges* (Parker, 2013)." So it would appear as if CbCr could be clearing the path for formulary apportionment (Parker, 2013).

Michael Durst, an advocate for formulary apportionment is of the opinion that country by country reporting as adopted by the OECD, *"would show the presence and extent of any disconnects between where business activity is conducted and where income is treated as earned for tax purposes"* (Parker, 2013). This is fundamentally what formulary apportionment aims to eliminate at the end of the day, and commentators like Michael Durst whom are of the opinion that the arm's length principle is too easily manipulated acknowledges that the implementation of country by country reporting might be the first modest step in that direction (Parker, 2013) .

Reuven Avi-Yonah, director of the international tax program at the University of Michigan Law School, holds a different view. He does not think that CbCr would create a fundamental shift in the current transfer pricing methods. He is quoted as saying "*It's not information that internationals don't have. They have to file these returns, based on transfer pricing principles. All that country-by-country reporting will do is to make this public. It doesn't have anything to do with formulary apportionment. It's based on the arm's-length system* (Parker, 2013)."

It is acknowledged and accepted that the current arm's length principle has its noted shortcomings and allows for a large degree of economic distortion. However until such time that the formulary apportionment method shows to be an unambiguous improvement on the current system, the enormously expensive and complex task of shifting the world economy to formulary apportionment will not be considered as a rational solution either (Parker, 2014). Aside from the challenges that will indeed be created if the formulary method should ever be implemented, moving to formulary apportionment may not really be able to produce a system that is any more fair to countries than the current arm's length one. It could ultimately prove to be just as

difficult for developing countries to enforce this method as the arm's-length standard. And the prospect of reaching an agreement on a universal formula among all of the world's nations seems like a daunting, if not impossible task (Parker, 2014).

There are many commentators who are in support of the formulary approach and recognize the need for a change, but they are not necessarily convinced that a complete shift toward formulary apportionment and away from arm's length method would necessarily provide the relief and outcome that is required (Avi-Yonah & Benshalom, 2011). Neither the formulary apportionment system nor the arm's length pricing system is perfect. It has been proposed by some advocates of formulary apportionment that a hybrid regime be created. In this proposed regime the arm's length method is applied when there are adequate market comparables available to do so, and the formulary approach will be applied when the arm's length system cannot provide equitable results (Avi-Yonah & Benshalom, 2011). This hybrid system was also referred to by David Spencer in his statement at the meeting on Transfer Pricing held at the UN Financing Development Office in New York on 14 March 2012 as quoted earlier in this paper.

The global economy is constantly changing and this requires that policymakers adapt with the changes and adopt the best available methods to allocate income generated by MNE activity in an equitable manner. The key advantage of the formulary approach is that it constrains income to activity and promotes transparent and consistent treatment of intra-group transactions (Avi-Yonah & Benshalom, 2011). These advantages should not be ignored and it has been suggested by commentators that the formulary method could be applied on a selective basis, like any other transfer pricing method. It need not be applied to all the income generated by MNE's. In this manner it becomes an option that a taxpayer has access to and an alternative method that can be applied to income (Avi-Yonah & Benshalom, 2011).

Earlier in the chapter the distinction between a formulary approach and a unitary tax regime was made. Understanding the fundamental difference between these two concepts is a key factor in understanding how the formulary approach could co-exist with arm's length transfer pricing. Keeping in mind the underlying reason for seeking alternative or supplementary methods to arm's length pricing is to create an environment where profit shifting is constrained, it becomes very reasonable to accept that as flawed as the proposed hybrid regime could be, this proposal could be the closest form to an attainable solution that could exist (Avi-Yonah & Benshalom, 2011).

3.8 Chapter summary

This chapter introduced the concept of formulary apportionment and the manner in which the method is applied. It is clear that formulary apportionment and the arm's length method are two fundamentally different approaches to transfer pricing. Unlike the arm's length approach which is based on the principle of separate accounting, formulary apportionment can be combined with consolidated MNE group income, to tax MNE's on the basis of unitary taxation (Avi-Yonah & Benshalom, 2011).

It also highlighted the fact that the formulary approach, as a method, can be applied to MNE income as a whole or to portions of MNE income. It addressed the fact that the arm's length principle was not able to remain optimally functional in the globalised and fast paced economy, where the global trading platform has changed significantly and transactions have become so unique in its nature that comparable information simply does not exist in many instances. The chapter also identified another issue with the arm's length principle, which lies in the method's inability to allocate the residual income that is created from mobile assets and activities whose risks are born by the entire MNE group. It was concluded that it's these assets and activities that created most of the avoidance opportunities for MNE's and where transfer pricing compliance and administrative costs were spent (Avi-Yonah & Benshalom, 2011).

It is this residual income created through these synergies that the arm's length principle is not able to value, as it is not specific to any one transaction and comparable information for such income cannot be found. It was proposed that formulary apportionment forms part of the arm's length transfer pricing method and function as a transfer pricing method. Even though the OECD rejects the implementation of the formulary approach and Unitary Taxation, other bodies like the United Nations and the EU are willing to accept the possibility that the formulary method could be incorporated into the international tax framework for MNE's and co-exist with the arm's length principle (Picciotto, 2016).

This chapter also discussed country by country reporting, which is Action plan 13 of the OECD BEPS project and also a reporting method created by Richard Murphy of the TJN in 2003. The reporting method was discussed in light of the fact that country by country reporting which is founded on the basis of a formulary apportionment is being used as a tool to represent and proof the fair application of arm's length principles.

The proposal presented to combine the formulary approach and the arm's length approach, could therefore be a closer reality than we think. By incorporating the formulary approach into the existing arm's length framework, this hybrid regime could potentially provide a system for taxing MNE's that allows the arm's length principle to be applied where comparable data is available and where a comparable price for a transaction cannot be determined, the formulary method can then be used to allocate this income. This could potentially provide a solution to the challenges faced in South Africa and many other developing countries. It could provide a measure of assurance to the tax authorities that their jurisdictions will not lose out on tax collections, where complex transactions without comparables is entered into by MNE's. The only challenge in using formulary apportionment as an alternative to arm's length in certain situations is that this method cannot address synergistic benefit or intangible income which cannot necessarily be allocated to a specific area. So this eliminates the method for industry sectors such as technology and pharmaceuticals (Tax Policy Network, 2016).

The next chapter of the dissertation will address the Brazilian transfer pricing approach. This method functions on the basis of predetermined margins and serves as our second alternative or supplementary method to the arm's length approach in certain instances that will be discussed.

CHAPTER 4: BRAZIL'S TRANSFER PRICING POLICY

The purpose of the dissertation is to determine if South Africa should be looking to adopt an alternative or supplementary method to the arm's length principle when addressing the matter of transfer pricing. The two methods selected at the beginning of the process was formulary apportionment and predetermined margins as implemented in Brazil. In the previous chapter the formulary apportionment alternative was reviewed. The rest of this chapter will be a review of the Brazilian transfer pricing policy which is based on the use of predetermined margins to set upper and lower limits for income and expenses when determining transfer prices for import and export transactions (The United Nations, 2017, p. D1.1.2 page 527).

4.1 Transfer Pricing Policies in Brazil

Prior to December 1995 Brazil took a territorial approach[16] to the taxing of MNE's (Gossler, 2017, p. 51). This meant that MNE's were only taxed on the source of income generated within the Brazilian territories. The result of this was that any foreign income earned by an enterprise located in Brazil would not be taxed. However as the importance of foreign income in the Brazilian economy grew, the approach changed and in December 1995 Brazil promulgated Law 9,249 which made it a requirement to include profits, and all other income earned outside of Brazil in the tax base of the resident MNE (Gossler, 2017, p. 52). So taxes were no longer being calculated on the source basis, instead the residence basis was being applied to resident MNE's.

Transfer pricing rules were introduced in Brazil in 1996 through the enactment of Law 9,430 (Valadao, 2013).

Brazil's double tax agreements are modelled on the provision contained in paragraph 1 of Article 9 of the OECD and UN Model Conventions. "*Article 9 established the possibility of an adjustment in the transfer prices of transactions between related companies resident in the contracting countries, according to the arm's length standard* (Gossler, 2017, p. 49)." However, Brazil's double taxation agreements of which there are 32 as at end of July 2017, do not include the provision contained in paragraph 2 of Article 9. This means that

[16] According to the territorial principle, there is a taxation only of the income derived from sources located in the territory of the taxing State, irrespective of other characteristics which may be involved, such as nationality or residence. In order to apply a territorial taxation of MNEs, the criterion for the delimitation of tax jurisdiction used was that of material connection, that is, the effective source of income. Therefore, Brazil only allowed the taxation of the income sources that were originated within its territorial limits.

Brazil has not committed itself to the obligation of granting the correlative price adjustment. This means that Brazilian legislature does not commit to adjusting any prices to accommodate for double tax (Rocha, 2017, p. 155). Unlike the arm's length principle followed in the OECD Tax Model & the UN Tax Model which seeks to find a comparable price, the Brazilian transfer pricing rules were created to determine / limit the maximum tax deductible costs or expenses on imports and the minimum taxable price on exports (Gossler, 2017, p. 59).

> "*Since the determination of the profits and margins that independent parties would have in similar transactions is one of the main difficulties of the Arm's length principle, the Brazilian solution of establishing predetermined margins seems to have recognized that it would not be possible to acquire this information from either taxpayers or tax authorities. In this context it is possible to realise that the adoption of predetermined margins represents a 'compromise between the arm's length standard and practicability especially because the use of such margins is not mandatory* (Gossler, 2017, p. 59)."

Brazilian legislation as it relates to transfer pricing deviates from the OECD guidelines in the following ways:

- It uses fixed / predetermined margins independent of the specific situation of the taxpayer or the specialised nature of the relevant industry (Medaglio, 2014).
- Advance pricing agreement procedures are generally not allowed (Medaglio, 2014).
- The transfer pricing rules is not restricted to cross border transactions between related parties as defined. If a Brazilian company trades with a non-related company that is situated in a low tax jurisdiction or a tax free regime, then the transfer pricing rules are still applied to the transactions (Medaglio, 2014).
- The rules do not allow taxpayers to adopt the transactional net margin or profit split methods (Medaglio, 2014).
- There is no functional analysis based on the functions performed, the assets used and the risks assumed by each party in a controlled transaction (Meyer, 2018).

> "*In terms of Law 9.430, the following are subject to transfer pricing rules:*
>
> - *cross-border transactions carried out by legal entities incorporated in Brazil when they are entered into with related parties;*
> - *cross-border transactions carried out between a Brazilian resident and a company resident in a low-tax jurisdiction or benefiting from a privileged tax regime irrespective of whether they qualify as related parties; and*
> - *inbound and outbound loan transactions in these conditions" (Medaglio, 2014)*

The Brazilian Transfer pricing rules are limited to the extent that the rules are not applicable to cross-border payments of royalties and payments for technical, administrative and scientific assistance services including those involving the transfer of know-how made by or in favour of Brazilian companies, if such transactions are registered with the Brazilian Intellectual Property Agency (Medaglio, 2014).

4.1.1 Parameter and Practice prices

As a rule, the Brazilian transfer pricing legislation calls for a comparison of two prices, namely "practice prices" and "parameter prices". The practice price is the actual price paid or received by the Brazilian taxpayer entering into an affected transaction (Gilleard, 2015). The parameter price is the price determined when applying one of the transfer pricing methods. Whenever the parameter price is lower than the practice price in affected import transactions, the difference represents an adjustment to the Brazilian tax basis and whenever the parameter price is higher than the practice price in an affected export transaction, the adjustment represents an adjustment to the Brazilian tax basis (Gilleard, 2015).

SIMPLIFIED EXAMPLE:

Import Transaction: Parameter price on good $100 (based on transfer pricing method)
Practice price on good: $ 130

So in this instance the cost would be adjusted to $ 100. This way the tax base is not eroded by deducting a higher expense.

Export Transaction: Parameter price on good sold $150 (based on transfer pricing method)
Practice price on good: $ 120

In this instance revenue recognized for tax purposes would be adjusted to $150.

The highest level of revenue that can be recognized on the transaction will be recognized, and in so doing eliminate any tax base erosion.

Both of these adjustments, for the expense and the revenue, create the biggest benefit to the Brazilian revenue collections by ensuring that the highest sales price is charged and the lowest possible expense is set- off against it.

1. Based on parameter prices:	**2. Based on practice price**
Revenue 150	Revenue: 120
Expense (100)	Expense: (130)
Profit 50	Loss : (10)

Based on the difference in the outcome between 1 and 2 above, the impact of setting parameter prices is illustrated. With the practice prices, a loss of R 10 would have been calculated, but with the predetermined parameter prices, the best result and best tax benefit for the jurisdiction is always determined.

4.2 Transfer pricing methods

- There is no hierarchy of preferred methods (best methods) in the Brazilian transfer pricing law, although some of methods are applicable to specific industries or transactions (Meyer, 2018).
- With the exception of transactions involving commodities, where the Brazilian transfer pricing rules establish mandatory and specific methods, the taxpayer can adopt the most favourable method (Meyer, 2018).
- In respect of export transactions, if more than one method applies the Brazilian taxpayer may adopt the method which results in the lowest export parameter price (Meyer, 2018).
- For import transactions, if more than one method applies the company may elect the method resulting in the highest import price (Meyer, 2018).

4.2.1 Imports

The following methods are available for calculating transfer prices on imports of goods, services and transfers of rights.

- **Comparable Uncontrolled Price method (PCI)**

  With this method a transfer price is determined by using the average price of identical or similar products or services in purchase and sale transactions that is undertaken in the internal or external market under similar payment conditions (Meyer, 2018).

  > "*This means that a comparable price (benchmark) should be verified through the weighted arithmetic average price of the similar or identical goods, services or rights:*
  >
  > *(i) Sold by the same exporting company, to a resident or non-resident unrelated person;*

(ii) *Acquired by the same importing company, from a resident or non-resident unrelated person; and*

(iii) *In a purchase or sale transaction occurring between resident and non-resident unrelated companies"* (Meyer, 2018).

- **Resale price less profit method (PRL)**

  This method would be the Brazilian version of the Resale Price Method (RPM) as per the OECD. With this method a transfer price is calculated by taking the weighted average price for the year of the resale of property, services or rights and reducing it by unconditional discounts, taxes and contributions on sales, commissions and a gross profit margin determined in the tax legislation. This is a very important difference, because unlike the OECD guide that calls for comparable information, at this point, the pre-determined margins applied in terms of the Brazilian method would be used. The range for this margin can vary from 20% to 40% depending on the industry sector the taxpayer operates in, with 20% being the general predetermined margin (The United Nations, 2017, p. 530).

- **Production cost plus profit method (fixed margin of 20%)**

  With this method the average production cost of identical or similar products, services or rights in the country in which such products, services or rights were originally produced plus a fixed profit margin of 20% of the cost; plus any taxes and levies paid in the country of production is used to determine the acceptable transfer price.

  When applying this method production costs is limited to costs of goods, services, or rights sold. Operating expenses, such as R&D, selling and administrative expenses, gets excluded from the production costs of goods sold to Brazil when applying this method (The United Nations, 2017, p. 531).

- **The commodity exchange import price (PCI)**

  In terms of the new Brazilian method which was introduced by Law 12715/12 in 2012, Brazilian entities that import commodities traded on internationally recognised commodity and futures exchanges must use the method of quotation on imports. "*With this method the parameter price is determined by using the average price of the daily medium quotes of commodities negotiated in internationally known commodities and future exchanges, adjusted by the applicable premiums and other variables (Valadao, 2013, p. 6)."*

  It was implemented to serve as a mandatory substitute for the traditional CUP method as implemented in Brazil, when the prices of goods and rights are

available on regulated/organised markets. Its aim is to simplify matters and avoid price discussion and searching for comparable on commodities where prices are available on a global market (Valadao, 2013, p. 12).

In the case of transactions involving commodities that do not have a quote in a commodities exchange market, taxpayers may choose to test the prices on import transactions based on information obtained from independent sources, provided by internationally recognised institutes involved in research of specific sectors (Valadao, 2013, p. 13).

4.2.2 Exports

- **Comparable Uncontrolled Price Method: (PVEx)**

  This is the Brazilian variation of the traditional OECD CUP method." *It is defined as the weighted average of the export sales price charged by the company to other customers or other national exporters of identical or similar property, services, or rights during the same tax year using similar payment terms (The United Nations, 2017, p. 541)".*

- **Wholesale price in country of destination less profit method (PVA)**

  With this method *"the average wholesale price of identical or similar goods, services or rights in the country of destination under similar payment terms, reduced by the taxes included in the price imposed by that country and a profit of 15% of the wholesale price"* is used for transfer pricing purposes (The United Nations, 2017, p. 542).

- **Retail price in country of destination less profit method (PVV)**

  This method employs the use of the average retail price of identical or similar goods, services or rights in the country of destination under similar payment terms, reduced by the taxes included in the price imposed by that country and a profit of 30% of the retail price (The United Nations, 2017, p. 542).

- **Cost Plus method (15 % mark-up)**

  "This method is defined as the average cost of acquisition of exported goods, services or rights increased by taxes and duties imposed by Brazil plus a profit margin of 15%including any exchange gain variances calculated based on the sum of goods and taxes (The United Nations, 2017, p. 542)".

- **The commodity exchange export price (PECEX)**

  Like with import this method only this method can be applied to intercompany export of commodities. "*The parameter price is the average price of the daily medium quotes of commodities negotiated in internationally known commodities and future*

exchanges, adjusted by the applicable premiums and other variables. In the absence of a trading price in commodities and future exchanges, prices could be compared to those obtained from independent data sources provided by internationally known research institutions (The United Nations, 2017, p. 541)."

- **Transfer pricing on intercompany loans:**

  In January 2013 the Brazilian legislation was changed as it related to intercompany loans. In terms of the new legislation all intercomoany loans became subject to pricing control. This was different to the old legislation which required that only loans not registered with the Brazilian Central Bank had to be subject to the transfer pricing control (Medaglio, 2014).

  "*In terms of the legislated changes, from 2013 a maximum interest expense and a minimum interest income for Brazilian borrowers are now defined as follows:*

  - *Transaction in USD at a fixed rate: the transfer pricing rate shall correspond to the market rate of those Brazilian sovereign bonds indexed in USD, issued by the government on the external market.*
  - *Transactions in Brazilian Reais (BRL) at a fixed rate: the transfer pricing rate shall correspond to the market rate of those Brazilian sovereign bonds indexed in BRL, issued by the government on the external market*
  - *Other cases: The transfer price shall correspond to the Libor rate for six month deposits"* (Medaglio, 2014)."

  On top of the rates as listed above, a spread rate will be added to determine the rate for transfer pricing purposes. The spread rate will be defined by the Brazilian treasury. In 2013 the rate was set at 3.5% for regular transactions and 2.5% for transaction with taxpayers on low tax jurisdictions. To date these rates remain unchanged (Medaglio, 2014).

4.2.3 Challenges faced with some of the methods

Under Brazilian legislation, the PCI and PVEX (CUP Methods) methods are the only methods which depend on a comparability analysis of the goods, services and rights. The adoption of these methods relies on the taxpayer having access to documentation and information regarding the particular industry sector. This information may be difficult to obtain, and as a result taxpayers usually end up adopting other methods provided by legislation in which no comparability analysis is made, since the calculation of the transfer price in those cases depends on the

adoption of fixed margins, regardless of particularities of the taxpayer business (Valadao, 2013).

Taxpayers in Brazil also face difficulties in the adoption of the Cost Plus Method (CPL method) since the assessment of the parameter price under this method depends on the taxpayer verifying and proving the average production cost of identical or similar products, services or rights in the jurisdiction in which such products, services or rights were originally produced, and again the taxpayer may not have access to this information (Medaglio, 2014).

4.3 Safe harbour rules

- Companies that fall within the parameters, as set in the safe harbour rules in the Brazilian transfer pricing policy do not have to defend or prove the legality of the transfer prices charged. There are two general safe harbour rules available, and two other rules. These other rules, established under Normative Ruling 1,312/2012**,** were implemented with the intention of simplifying transfer pricing rules and respective inspections. However, these two additional rules are not really regarded as safe harbours due to the fact that the Brazilian tax authorities, in principle, still have the option of assessing the taxpayer if it is not satisfied with the transfer pricing method applied (Valadao, 2013).

  General safe harbour rule #1: *"A taxpayer is deemed to have applied an appropriate transfer price if the average export sales price is at least 90% of the average domestic sale price in the Brazilian market during the same period and on similar payment terms (Meyer, 2018)."*

  General safe harbour rule #2: "*This rule allows a difference of up to 5% (up or down) in relation to the overall transactions and 3% (up and down) in relation to the transactions subject to the PCI and PECEX (commodity exchange price) methods between the adjusted-limit price and the transaction price. (Meyer, 2018)"*

- **The other rules established under Normative Ruling 1,312/2012**

  These rules allow exporters to prove the correctness of the transfer pricing based wholly on the export transaction documentation if:

  - the exporter can show that the net commercial profit received from the export transactions is not less than 10% of the export income, based on the annual average of the calendar year and the two last taxable periods, provided that the net export revenue to related entities does not exceed 20% of the total net export revenue; or

- The exporter can prove that the net export income dis not more than 5% of the total net income in the same calendar year (Meyer, 2018).

The Brazilian transfer pricing rules are simpler to implement than the OECD Transfer Pricing Guidelines, as well as more effective in countering base erosion and profit shifting. A problem does arise though due to the fact that the Brazilian domestic transfer pricing rules are primarily based on predetermined profit margins and Brazil does not include Article 9(2) of the OECD Model Convention in its tax treaties. (Valadao, 2013), so inevitably taxpayers stand the risk of double taxation. Brazil does not apply a correlative adjustment to avoid economic double taxation derived from transfer pricing adjustments. The transfer pricing policies in Brazil will also inevitably lead to the over taxing as well as the under taxing of some transactions. This is due to the fact that the mark-up required by the method used may be higher or lower than the profits derived by taxpayers (Valadao, 2013).

4.4 Strengths of the Brazilian transfer pricing methods:

The strength of this method is that it removes much of the complexity associated with transfer pricing. The method is not based on the use of comparable information. This means that the challenge faced by so many countries in just trying to obtain information is bypassed. The fact that it is based on certain rules and parameters, enables it to be easily implemented by tax authorities and tax payers. It minimises the need for human resources with expert technical knowledge and experience on the matters of transfer pricing. It assists in stabilizing the expectations in terms of tax collections by the tax authorities in a tax jurisdiction (The United Nations, 2017, p. 539).

4.5 Weaknesses of the Brazilian transfer pricing methods

Unfortunately the method does not come without weakness. The method carries the risk of double taxation where there is no access to negotiate double tax relief via a competent authority. In order to implement this method, clear accounting classifications, and conformity in allocation of costs between Cost of Goods and operating expenses needs to be made. Based on the fact that the fixed margins method applies regardless of the cost structures of an organisation, it is unavoidable that some companies could be taxed at tax margins that is not proportionate the profitability (The United Nations, 2017, p. 540).

With a closer look at the matters that have been listed as weaknesses in the Brazilian method one comes to realise that many of these weaknesses can be resolved. Firstly in the case of potential double taxation, the affected tax authorities can apply for Mutual Agreement Procedures (MAP) to be written into the articles of the existing Double Tax Agreement between the tax jurisdictions. *"MAP is a procedure which allows the Competent Authorities[17] or designated representatives of the Competent Authorities from the governments of the Contracting States/Parties[18] to interact with the intent to resolve international tax disputes (SARS, 2018)."*

Brazil like many other countries had also adopted the International Accounting Standards and in 2007 a new Law 11638 was enacted and took effect in 2008. This law requires all Brazilian companies, public or private to use local standards which are identical to IFRS (EY, 2010).This means that accounting conformity which has been identified as a weakness becomes less of an issue, because the accounting principles applied by Brazilian companies is based on the internationally accepted standards.
The only identified weakness that remains a real unmitigated risk would be the fact that the transacting enterprises could be taxed at tax margins which exceeds their profitability simply based on the nature and application of predetermined margins which does not consider cost structures. The strengths in the system as identified earlier will proof to be of real benefit in developing economies. The method eliminates a number of barriers that could ensure the tax authorities at least receives some level of tax benefit from the MNE's operating in their jurisdictions. Having reviewed the Brazilian method and the strengths and weaknesses of the system, the question that now arises is whether this pricing system could be the solution or part of the solution to the challenges faced in the developing economies when it comes to transfer pricing. The application of this method eliminates the need for comparable information which is one of the biggest stumbling blocks for the tax authorities of developing countries and developed countries alike.
In the South African context the Comparable Uncontrolled Price could probably be one of the best methods to apply for the export of goods. With this method the price applied

[17] The term "Competent Authority" is used in DTAs and the Multilateral Instrument to identify a position, a person or a body within a Contracting State/Jurisdiction to whom issues can be addressed.
The Competent Authority in South Africa is the Commissioner for SARS and MAP duties have been delegated to designated representatives in the Legislative Research and Development subdivision within Legal Counsel (SARS, 2018).
[18] DTAs or treaties are usually concluded between the governments of two countries. These countries are then referred to in the DTAs as the Contracting States or Contracting Parties to such an agreement (SARS, 2018).
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to intercompany transactions would be the average price charged by the specific enterprise on all its non-intercompany transactions for a particular financial year. Theoretically this should be the fairest price on which to base an intercompany transaction, as it reflects the prices charged by the particular MNE in the absence of comparable information.

4.6 Documentation

4.6.1 Record Keeping

All supporting documentation to substantiate the transfer pricing methods used must be retained for a period of five years after the financial year in which it was applied. This is the period of time that the tax authorities are usually allowed to make assessments (Meyer, 2018).

4.6.2 Level of Documentation

The documentation requirements are not specified. However if documentation is requested by the tax authorities the taxpayer must be able to provide information regarding the method used, and the supporting documentation as evidence of how the price was determined. Where inadequate or no information is provided by the tax payer, the tax authorities may determine a price based on available documentation and the application of one of the transfer pricing methods as prescribed by law (Meyer, 2018).

4.6.3 Country by Country reporting

Brazil has recently introduced the country-by-country report CbCr, by means of Normative Ruling No. 1,651/2016 (Meyer, 2018). Within the OECD countries, the CbCr is part of a three-tiered structure, along with a global master file and a local file, which together represent a standardised approach to transfer pricing documentation. However, in Normative Ruling No. 1,651/2016, Brazil has only introduced the CbCr in itself, without the global master file and the local file. Due to the application of predetermined margins the Brazilian tax authorities will not be able to use the CbCr for transfer pricing purposes (Medaglio, 2014).

4.7 Similarities between the Brazilian and South African economies

South Africa and Brazil form part of the five BRICS countries, the other countries being Russia, China and India. By 2016, the BRICS block had 41% of the world's population and just fewer than 30% of the territory (Bremmer, 2017). The BRICS block can be split

into 2 groups, the countries that used globalisation to take their place in the global supply chain and those that took advantage of globalisation and traded in their natural resources. The former would be China and India and the latter would be South Africa, Brazil and Russia (Bremmer, 2017).The fall in commodity prices over recent years have done damage to the GDP growth in the South African, Brazilian and Russian economies. On the contrary, the Chinese economy has catapulted itself into its current position of second largest economy in the world in terms of nominal GDP and India has recently been ranked 6th in the world in terms of the 2017 World Bank figures (Kaul, 2018).Of the five countries making up the BRICS bloc the two countries with the most similarities in terms of history and economies would be South Africa and Brazil, as the countries share a similar history of colonisation, political activism, poverty and rich cultural diversity.

Brazil's dominant industries

In Brazil the largest portion of the GDP and employment can be attributed to the services industry. This sector is made up of organisations in the hospitality, finance, retail and professional services.

In Brazil the second largest contribution to the GDP comes from the manufacturing sector. This sector has flourished due to its diversified nature. A multitude of products is manufactured in Brazil ranging from aircrafts and chemicals to food products and clothing.

In Brazil the agricultural industry makes up just 5.6% of GDP, but this industry is quite significant as Brazil's biggest exports are that of commodities. Brazil is the world's leading producer of soya beans, coffee, cocoa and sugar and it can also boast as one of the few countries in the world that is self-sufficient in oil (Pajbai, 2018).

South Africa's dominant industries:

South Africa's economic history was also deeply rooted in the primary sector with an abundance of natural resources and agricultural conditions.

However, over the last 20 years there has been a shift to more of a tertiary sector economy with industries such as wholesale and retail trade, tourism and communications taking becoming more of the driving force of the economy. South Africa is striving to become a knowledge based economy with the focus shifting to e-commerce, financial and other services (Tech, 2018).

The current contributors to the GDP and the sectors that are keeping the economic engine running would be manufacturing, mining, agriculture and tourism. South Africa's

main exports like Brazil are also commodities which include corn, diamonds, fruits, gold, metals and minerals, sugar, and wool (Tech, 2018).

> *"South Africa is the world's largest producer of chrome, manganese, platinum, vanadium and vermiculite, the second largest producer of ilmenite, palladium, rutile and zirconium. It is also the world's third largest coal exporter and the second largest producer of gold* (Wikipedia, 2018). "

The 10th annual BRIC summit was held in Johannesburg in July of 2018 and unfortunately the Brazilian and South African economies share in a similar bleak current situation. Brazil's political situation is currently in a tumultuous state, with fierce political divisions, corruption and an unemployment rate of 12.6%. This coupled with the fall in raw material prices and dwindling investor confidence has shaken the Brazilian economy (Willy, 2018). South Africa finds itself in a similar and sometime worse situation. Like Brazil the political state of affairs is tumultuous, the level of poverty and inequality is high and the unemployment rate is double that of Brazil at 27%. Like Brazil the economy has shown slow growth in the last two years (Willy, 2018).

4.8 Chapter summary

After a review of the predetermined margins for transfer pricing as implemented in Brazil, it would be reasonable to conclude that this approach in itself would not be a very prudent choice to make when looking at alternatives or supplementary methods for transfer pricing in the South African environment. Brazil had applied to the OECD for membership status and this indicates that the leadership was clearly willing to negotiate and potentially compromise on some of its transfer pricing policies. Some aspects of the Brazilian transfer pricing law are contrary to the OECD principles, which in turn could have a very negative impact on the investment potential of South Africa to the rest of the world (PWC, 2014). That being said it must be recognised that the Brazilian method has a number of advantages for a developing country, like South Africa such as:

- Using pre-determined margins eliminates the use of broad, general, tax rules, with the aim of reducing avenues for taxpayer abuse.
- It provides Brazil's tax regulators with objective criteria to more easily review and implement transfer pricing adjustments.
- It reduces the number of highly skilled tax administrators that would be required as the process of determining transfer pricing becomes a very objective exercise (PWC, 2014).

After a review of the Brazilian transfer pricing method it would be reasonable to conclude that the method is not without challenge, and like formulary apportionment, will not be able to replace the arm's length method (PWC, 2014). There is however a possibility that some of the principles and formulas applied in Brazil could be used as an alternate or supplementary method in the absence of comparable information.

Like formulary apportionment the method of predetermined margins exposes the taxpayer to potential double taxation of the same revenue. However, where Double Tax Agreements (DTA) exist between two trading parties a Mutual Agreement Procedures (MAP) could be written into the articles of the DTA to provide a method of resolving any double taxation that could arise and in this manner overcome the potential barrier of double taxation (PWC, 2014).

South Africa like all developing countries is looking to attract foreign Investment; therefore it would be reasonable to assume that the tax authorities would not implement international tax practices into its domestic legislation that could hinder this objective. However, like formulary apportionment, when incorporated into a country's domestic legislation as an alternative or supplementary approach, when comparable data is not available, this method could prove to be a very useful when seeking to determine an arm's length price. By determining the predetermined margins the revenue authorities can achieve a level of assurance that the cross border transactions are:

(a) either in line with prices charged to other parties that the MNE transacts with or
(b) determine that the intercompany charge is distorted and base the tax on the adjusted amounts as determined with the parameter prices.

CHAPTER 5: CONCLUSION - A SOLUTION FOR SOUTH AFRICA

Over the last few chapters, three transfer pricing concepts namely the arm's length approach, formulary apportionment and the use of predetermined margins were discussed and reviewed in relation to the advantages and disadvantages associated with each one of these concepts. This was done with the overarching intention of determining if it could be an alternative or supplementary method in instances where comparable information is not available to determine a fair transfer price for MNE cross-border transactions in South Africa. The intention is therefore not to replace the arm's length principle, rather to provide complementary alternatives when comparable data is not available. The current transfer pricing framework used in South Africa is the arm's length pricing method as recommended by the OECD and the UN Model Tax Conventions. The underlying driver for arm's length pricing is that each transaction should be evaluated based on the economic circumstances that are relevant for that specific transaction at hand. However, arm's length pricing is subject to notable and undeniable theoretical shortcomings as well as difficulties in day-to-day application as previously discussed.

In earlier chapters, it was noted that the arm's length approach appears to be the natural choice for most countries, based on the fact that it receives such wide acceptance and support from all over the world. The OECD affected some reforms to the transfer pricing model which stemmed from the work done during the BEPS project, which concluded in 2015. Cumulatively, the reforms introduced by the OECD amount to changes to the current arm's length pricing based system without necessarily changing the underlying problem which is the application of an arm's length price through the use of comparable information. The Davis Tax Committee recommended that South Africa incorporate the changes brought about by the BEPS project as recommended by the OECD into the fiscal policy of South Africa.

Having discussed the formulary apportionment method in an earlier chapter of this dissertation it became quite evident, in that chapter, that the formulary model itself will certainly create an environment that will eliminate the opportunity for MNE's to engage in profit shifting, but not without challenges. A significant disadvantage and criticism of the system is the real possibility of double taxation of MNE's in certain instances and also the need for countries to agree on the formulae to allocate profits that will be

acceptable to all parties involved (Cockfield, 2004). That being said the Mutual Agreement Procedures (MAP) can be used to address the situation where an instance of double taxation should arise. As mentioned earlier MAP is a globally used dispute resolution process where the tax authorities of the two jurisdictions negotiate and agree to terms that would overcome the issue of double taxation.

South Africa is a developing country and its economy is comprised of a number of sectors. International investment into the economy and these sectors is a key requirement for the growth and continued development of the country's economy. With this in mind, it would appear to be a step in the wrong direction to implement a system such as formulary apportionment, even on a supplementary basis that would certainly create caution and limit the number of MNE's looking to invest in the South African economy. Implementing formulary apportionment, for transfer pricing would bring certainty to the revenue collections, but the certainty of collections becomes a moot point if this certainty comes at the cost of potential disinvestment by MNE's in South Africa or the reduction of future investment. The challenge of profit shifting from South Africa by MNE's is a very concerning matter, but not one that would be resolved by a formulary system in any capacity. A formulary system could potentially lead to even more problems for South Africa and similar countries, who could find it negotiating formulas with other tax authorities that could still lead to loss of tax base in an attempt to remain competitive. This could lead to even more distortion in terms of how it relates to the value created for an item or product in a specific jurisdiction. (Ogutta, 2011)

The third system addressed in this document was the predetermined margins as used in Brazil. This system eliminates the use of broad, general, tax rules, with the aim of reducing avenues for taxpayer abuse. It provides Brazil's tax regulators with objective criteria to more easily review and implement transfer pricing adjustments. The system itself is also geared towards commodities. Like South Africa, the export of commodities in Brazil still has a significant impact on the economy of the country. Some aspects of the Brazilian transfer pricing law are clearly contrary to the OECD principles but at the same time the Brazilian method has a number of strengths as discussed in Chapter 4. These strengths could be of benefit to countries like South Africa, who have been subjected to financial losses to Treasury by following the traditional OECD recommended arm's length pricing for MNE's.

South Africa and Brazil's economic profile have many similarities, which is to a large extent driven by and a product of the socio-economic and political environment in these countries. Brazil has been on the path of economic decline, and South Africa is starting to show striking similarities in its own economic journey (Business Tech, 2017).

According to Martyn Davies, Managing director of emerging markets and Africa at Deloitte, just a few years ago both South Africa and Brazil were considered first-tier emerging market economies personified by their inclusion into the BRICS acronym (Martyn Davies, 2017). Currently China and India are the only contributors to the BRICS bloc, with Russia also struggling on an economic front (Business Tech, 2017).

Both South Africa and Brazil are on a declining ratings path; both are vulnerable with their current account deficits; and both face waning confidence from foreign investors (Martyn Davies, 2017). Brazil was named the 2nd most complex jurisdiction when it comes to accounting and taxation complexity by TMF Group's 2017 financial complexity Index[19] (TMF, 2018). Currently Brazil's bilateral accords with other countries represent just 10 percent of the global GDP (Business Tech, 2017). The foreign investment and growth potential in Brazil is far greater than this statistic, but due to the socio-economic and political uncertainty, which is then also exacerbated by very rigid tax policies, makes Brazil a country that is approached with caution by foreign enterprises looking to invest in developing countries. The foreign enterprises that do invest in Brazil have accepted that there will be unfavourable tax implications when doing so and are willing to accept those costs (OECD, 2018).

It is rather telling and significant to note that under the rule of then president, Michael Temer, Brazil had made application to become a full member of the OECD in 2017. This was part of President Temer's effort to try and strengthen ties with Western developed nations. He hoped that OECD membership would help attract foreign investment to the Brazilian economy that is still struggling to recover from its worst recession to date (Fortune, 2017). Despite their differences with OECD policies surrounding transfer pricing, Brazil have always provided the OECD input through work groups and provided much input with the recently concluded BEPS project. If the application to the OECD is approved, Brazil would be the largest emerging economy in the OECD and the third Latin American country to, as well as the first of the BRICS to

[19]TMF Group is a multinational professional services firm headquartered in Amsterdam, the Netherlands. The independent group provides accounting, tax, HR and payroll services to businesses operating on an international scale

become an OECD member (Fortune, 2017). It remains to be seen if the new president elect of Brazil, Jair Bolsonaro will be supportive of the application for OECD membership.

If Brazil were to gain full membership, the tax authorities would be required to start accepting the arm's length standard, or, at least, accept the arm's length standard when required to do so under a treaty MAP provision.[20] This could inevitably require Brazil to adopt the arm's length standard in its domestic legislation. This could prove to be challenging as it would require the Brazilian tax authorities to deal with the subjectivity that the arm's length approach entails instead of the current approach which provides a greater degree of certainty to the Brazilian tax authorities (EY, 2018). Brazil might not necessarily be eager or even willing to abandon all of their current tax policies and the certainty in collections that their current system affords the treasury.

With this in mind a potential alternative to accepting the OECD arm's length approach would be for Brazil to maintain its current transfer pricing legislation and use an alternative approach when a situation of a double tax treaty situation should arise. An alternative approach as recommended in a recent article would be to accept different profit margins, if doing so, would result in a transfer price aligned with that which would have been reached under the arm's length standard (EY, 2018). This could potentially allow a country like Brazil to enhance relations with more MNE's and to a large extent still maintain their current domestic legislation.

Throughout this paper, what has become apparent is that neither the formulary approach nor the predetermined margins approach is necessarily a solution that is definitively better and able to replace the arm's length principle. Both approaches have shortcomings and weaknesses that would create a different series of challenges. But that was not what this paper was seeking to establish. This dissertation seek to establish if either one of these methods could be used as an alternative or supplementary method where the arm's length requirements of comparable information cannot be fulfilled. The answer for South Africa and even the greater Southern Africa could lie somewhere in the middle of these methods. As a continent, Africa has approximately 30 percent of the earth's remaining mineral resources (Al jazeera, 2018).

[20] Mutual Agreement Procedure (MAP) is a procedure which allows the Competent Authorities or designated representatives of the Competent Authorities from the governments of the Contracting States/Parties to interact with the intent to resolve international tax disputes. MAP is provided for in an Article in a Double Taxation Agreement (DTA) and can involve matters containing juridical double taxation cases, as well as inconsistencies in the interpretation or application of a DTA. Action plan 14 of the BEPS report contains a commitment by countries to implement a minimum standard to ensure that treaty related disputes gets resolved in a timely, effective and efficient manner.

Sub-Saharan Africa has six of the world's 10 fastest-growing economies. Yet as a continent, the people of Africa remain poor and the economies fail to grow. Given that developing countries, like Africa, rely heavily on corporate income tax, in particular from multinational enterprises, curtailing tax avoidance is of significant importance. If African countries do not limit corporate tax avoidance, the losses of potential tax revenue that could be used for development will continue to rise and the high levels of poverty and unemployment will not be able to be addressed. (Durst, 2014)

The only African country that is part of the Group of 20 countries and one of the base erosion and profit shifting associate countries was South Africa. In the development of the Base Erosion project, the OECD indicated that it would take into account the perspectives of developing countries. This did not happen when the base erosion and profit shifting agenda was developed. The process was therefore heavily criticized for the lack of focus it showed when considering the needs of developing countries. (United Nations Economics Commission for Africa, 2018).

So maybe it is time that Africa looks inward for a solution to this problem. As a start it could be proposed that the SADC countries[21] should try to address intercompany transfer pricing challenge as a collective. "*The main objectives of Southern African Development Community (SADC) is to achieve economic development, peace and security, growth, alleviate poverty, enhance the standard and quality of life of the peoples of Southern Africa, and support the socially disadvantaged through Regional Integration (SADC, 2018)*."

Through the available and existing mechanisms, the countries could formulate transfer pricing policy into their domestic tax legislation that allows for a hybrid system for cross- border transactions in goods that handles all intercompany transfer transactions with multinationals in a specific manner where comparable data is not available.

This would create a system that still complies with the OECD recommendations and the requirements of Article 9(2). This potential system could allow for the use of predetermined margins as an alternative or supplementary method where value drivers are not necessarily reflected in the transfer price. This could be due to the inherent complexity of the transaction or the lack of comparable data on which to base its reasonableness. It will represent a system that is not seen as hostile and can be regarded as investor friendly to international organisations. It will still comply with the international standards while also allowing the South African tax authorities and the tax

[21] SADC countries: The Southern African Development Community (SADC) is a Regional Economic Community comprising 16 Member States; Angola, Botswana, Comoros, Democratic Republic of Congo, Eswatini, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Tanzania, Zambia and Zimbabwe.

authorities of the other countries in the SADC the right to funds that is more reflective of the functions performed in these countries by MNE's, to derive the income.

So, to conclude, individually all three of these methods discussed have shortcomings. From a South African perspective, there would be great benefit derived from incorporating predetermined margins on the trade of goods into the domestic tax legislation as a method to establish an arm's length price. This method could be available where comparable data cannot be determined due to the uniqueness or complexity of a particular cross border transaction within an MNE. The tax authorities could potentially rank the methods and list this approach as a method of last resort not first choice. In this way tax authorities can still provide a measure of assurance to MNE's that incorporating the method into the domestic tax laws is not with the intention of overtaxing, but merely the provision of an alternative or supplementary method that can be used when an arm's length price cannot be convincingly obtained in any other way.

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