

**TRANSFER PRICING: AN EVALUATION OF SECTION 31 OF THE INCOME TAX ACT****BY****KIRSTY ANN DEAN****DNXKIR001**

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## ABSTRACT

The focus of this paper is on South Africa's implementation and application of the international principles relating to transfer pricing in its domestic legislation as encapsulated in section 31 of the Income Tax Act No. 58 of 1962.

Transfer pricing is currently one of the more important short term international tax considerations, specifically in the South African context where recent amendments, particularly with regard to thin capitalisation, have created a degree of commercial uncertainty for multinational enterprises. With regard to the South African context, this paper seeks to illustrate the increased compliance burden placed on South African taxpayers as a result of the 2012 amendment to section 31 of the Income Tax Act. While the revised section is aimed at reducing transfer pricing manipulation, the impact thereof on taxpayers is significant from both an administrative as well as financial perspective.

In addition to evaluating the international principles and South Africa's use thereof, this paper will also look at the extent to which developing countries are disadvantaged by the current transfer pricing framework. It is posited that the lack of access to resources, skills and expertises makes developing countries particularly vulnerable to base erosion and profit shifting by multinational enterprises.

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## Chapter I

### 1. TRANSFER PRICING

#### 1.1 INTRODUCTION

Transfer pricing refers to cross border transactions undertaken between connected parties<sup>1</sup>. The price of the transaction set by either party for the buying, selling or otherwise sharing of resources is referred to as the “transfer price”<sup>2</sup>. Transfer pricing rules are in place primarily to deal with any arbitrages created between the allocation of profits and the distribution of risks, assets and functions across connected party transaction which occur in different tax jurisdictions. The focus of this paper is on the international pricing framework provided by the Organisation for Economic Development and Co-operation (“**OECD**”), the application of transfer pricing in the South African context, and an evaluation of difficulties arising in the application and implementation of transfer pricing principles in the developing country context.

Apart from determining the allocation of profits among connected parties, the transfer price can also be used as a mechanism with which to manipulate<sup>3</sup> the price at which goods or services are transferred by either acquiring or disposing of goods or services for a non-market related price. The scope this paper will be confined to an analysis of the internal transfer pricing framework and the amendments occasioned to section 31 of the Income Tax Act No. 58 of 1963 (“**ITA**”).

Transfer pricing has received increased attention both in South Africa and internationally because of its potential to influence the tax base of the host country<sup>4</sup>, and has become increasingly significant over the past two decades primarily due to the technological advancements which have allowed Multinational Enterprises (“**MNEs**”) to readily relocated goods, services, capital and resources to various tax jurisdictions<sup>5</sup>. In addition, globalisation has focused attention on transfer pricing, its potential manipulation and the consequences attended thereof<sup>6</sup>. Improved technology and economic

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<sup>1</sup> A W Oguttu “Transfer Pricing and Tax Avoidance: Is the Arm’s-Length Principle Still Relevant in the e-Commerce Era” (2006) 18 *SA Merc LJ* at 139

<sup>2</sup> *Ibid* at 139

<sup>3</sup> *Ibid* at 139

<sup>4</sup> *Ibid* at 139

<sup>5</sup> OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) Organization for Economic Co-Operation and Development pg17

<sup>6</sup> OECD *Transfer Pricing Guidelines* OP cit 5at 1

integration has given MNEs greater flexibility in accessing world markets<sup>7</sup>. A significant portion of world trade is conducted between connected parties; this unprecedented market share<sup>8</sup> has made MNEs the force that “drives globalization forward”<sup>9</sup>. The unparalleled growth in cross border transactions has significantly contributed to the complexity surrounding transfer pricing policies<sup>10</sup>.

Globalization has enabled MNEs to use cross border transactions as a vehicle for tax savings through the use of subsidiaries in tax havens or low tax jurisdictions<sup>11</sup>. Countries are becoming increasingly aware of the lost revenue resulting from distorted transfer prices. Tax administrations in both developed and developing countries have an interest in protecting their respective tax bases, hence the proliferation in transfer pricing policies and regulations among countries at different stages of economic and social development.

Underlying transfer pricing is the notion of “connected” or “related” parties transacting together in cross border arrangements. The component parts — parent and subsidiary companies or companies under a degree of common control<sup>12</sup> — of a Group entity are referred to as an associated enterprise<sup>13</sup>, governed by Article 9 (the “**Associated Enterprise Article**”) of the OECD 2003 *Articles of Model Convention with Respect to Taxes on Income and on Capital* (the “**MTC**”). The MTC codifies various bilateral and multilateral treaties, and condenses these into a single document accepted and applied by both OECD member and non-member countries. The Associated Enterprise Article contains important pronouncements on the taxation of associated enterprises, as well as the acceptance of the arm’s length principle as the mechanism for determining the appropriateness of the price of the transaction.

The arm’s length principle is fundamental in the transfer pricing rhetoric<sup>14</sup>, and refers to the market price ordinarily achieved between unrelated parties transacting independently of one another (the “**Uncontrolled Transaction**”)<sup>15</sup>. The basic premise is that commercial transactions between independent parties will necessarily be subject to external market factors — the valuation of the

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<sup>7</sup> United Nations *Practical Manual on Transfer Pricing for Developing Countries* (2013) New York at 1.1.2 available at [https://www.un.org/esa/ffd/documents/UN\\_Manual\\_TransferPricing.pdf](https://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf) [accessed 05/02/2014]

<sup>8</sup>A 2012 Article published on the tax justice network, available at [http://www.taxjustice.net/cms/front\\_content.php?idcat=139](http://www.taxjustice.net/cms/front_content.php?idcat=139) [accessed 15/10/2013] suggests that the extent of international trade conducted between members of the same group could be as high as 70%

<sup>9</sup> A W Oguttu “Transfer Pricing and Tax Avoidance” op cit 1 at 140-141

<sup>10</sup> United Nations *Practical Manual* op cit 7 at 1.1.4

<sup>11</sup> A W Oguttu “Transfer Pricing and Tax Avoidance” op cit 1 at 140-141

<sup>12</sup> OECD “Commentary on Article 9 Concerning the Taxation of Associated Enterprises” at 1

<sup>13</sup> United Nations *Practical Manual* op cit 7 at 1.5

<sup>14</sup> United Nations *Practical Manual* op cit 7 at 1.1.7

<sup>15</sup> L Olivier, M Honiball “*International Tax A South African Perspective*” (2011) 5<sup>th</sup> Ed at 620

transaction will reflect market conditions as each party will seek to achieve the most advantageous position. However where connected parties transact (the “**Controlled Transaction**”), the price attributed to the arrangement is not necessarily determined by external market factors<sup>16</sup>. Often the interests of the MNE involved in the transaction will determine the terms and price of the transaction<sup>17</sup>.

The increased attention towards transfer pricing is also due in large part to its potential to distort revenue streams in the host country<sup>18</sup>. As a result, where the transfer price is not concluded in accordance with the arm’s length principle, the relevant tax administration is often empowered under its national legislation to adjust the transfer price to ensure that the parties are adequately compensated in accordance with the risks and functions performed.

Transfer pricing in itself is not illegal or an abuse of tax policy. However, the intentional “mispricing” of a transaction is an abuse and constitutes tax evasion<sup>19</sup>. Incorrectly pricing or mispricing cross border transactions allows for profit manipulation, which occurs in a number of ways and for a variety of reasons. Transfer pricing allows entities to create a lower aggregate tax burden for the MNE by shifting profits to a lower tax jurisdiction; or by utilizing tax deductions in high tax jurisdictions<sup>20</sup>. Transfer pricing therefore enables connected parties to distort revenue streams and manipulate their profit margin in a given country, thereby directly influencing the tax base of the host country<sup>21</sup>.

While transfer pricing may be used for tax evasion or avoidance purposes, the issues arising from cross-border ventures should not be conflated with those of unlawful tax evasion. Where enterprises have intentionally “mis-priced”, “unjustifiably priced”, or “incorrectly priced” the transaction, issues of tax evasion may become relevant<sup>22</sup>. The primary concerns in the international tax arena are the allocation of income, determination of the transfer price, and double taxation.

Transactions which occur in multiple tax locations raise issues relating to jurisdiction and the allocation of profits<sup>23</sup>, which determine the extent to which countries are able to tax the profit streams of MNEs located therein. Ordinarily, the principal basis for asserting taxing rights is either residency

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<sup>16</sup> OECD *Transfer Pricing Guidelines* op cit 5 at 1.2

<sup>17</sup> United Nations *Practical Manual* op cit 7 at 1.1.5

<sup>18</sup> Ibid at 1.3

<sup>19</sup> L Sheppard “Transfer Pricing is at the leading edge of what is wrong with international tax” available at [http://www.taxjustice.net/cms/front\\_content.php?idcat=139](http://www.taxjustice.net/cms/front_content.php?idcat=139) [accessed 16/10/ 2013]

<sup>20</sup> L Olivier, Ml Honiball “*International Tax: A South African Perspective*” op cit 15 at 620

<sup>21</sup> United Nations *Practical Manual* op cit 7 at 1.2.1-1.2.5

<sup>22</sup> United Nations *Practical Manual* op cit 7 at 1.1.7

<sup>23</sup> Ibid at 1.2.2

or source of the income<sup>24</sup>. A country which taxes on the basis of residency will tax all income of natural and juristic persons resident in its jurisdiction, irrespective of the source of the income. Source-based tax empowers the relevant authority to tax income arising exclusively within its tax jurisdiction. OECD member countries advocate the separate entity approach as it facilitates tax parity<sup>25</sup> by mitigating the risk of double taxation by treating each entity within the MNE as a distinct economic unit.

The transfer price determines the income of the parties and influences the tax base of countries hosting the MNEs<sup>26</sup>. Where an MNE is located in more than one tax jurisdiction, the difficulties arise in determining which country is authorised or entitled to tax the income stream. Where an MNE is liable to pay tax in multiple jurisdictions on the same income stream it will be subject to double taxation. Double taxation is problematic insofar as it increases operating costs, thereby making it expensive to operate in multiple jurisdictions, which ultimately impacts on foreign direct investments (FDI). If the tax base arises in more than one country, the MNE requires a degree of relief to mitigate the double taxation burden<sup>27</sup>. Double taxation may motivate MNEs to reallocate and manipulate their profits through non-arm's length transfer prices, which would then (depending on the applicable national legislation) constitute unlawful evasion or avoidance<sup>28</sup>. Allocation of income to the MNEs in a given country is therefore critical as the allocation and valuation thereof directly impacts on the tax base in a given country.

Transfer pricing is one of the most significant short term taxation issues<sup>29</sup> — its complex, multifaceted nature makes its appropriate regulation equally important to both MNEs and tax administrations. Various difficulties arise at both the practical and policy making levels, these issues relate primarily to the identification of transfer pricing principles and the application of transfer pricing methodologies. The OECD has contributed, through its publications, towards an increasingly unified approach to the treatment of transfer pricing internationally.

In 1979, the OECD published general guidelines, “*The Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*” (the “**OECD Guidelines**”) to assist countries in the

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<sup>24</sup> OECD *Transfer Pricing Guidelines preface* op cit 5pg 17-18 at 5-6

<sup>25</sup> Ibid pg 17-18 at 5-6

<sup>26</sup> United Nations *Practical Manual* op cit 7 at 1.2.1

<sup>27</sup> Ibid at 1.2.3.

<sup>28</sup> Ibid at 1.2.4.

<sup>29</sup> L Olivier and Michael Honiball “*International Tax: A South African Perspective*” op cit 15 at 621

implementation and application of transfer pricing policies. The OECD Guidelines, which the OECD has undertaken to regularly update to ensure the continued economic relevance thereof, provide a comprehensive framework for both member and non-member countries interacting in the transfer pricing arena. The purpose of the OECD Guidelines is *inter alia* to simplify the application of transfer pricing principles and to ensure uniform implementation to prevent the creation of preferential tax regimes.

The OECD Guidelines are seen as being an authoritative source on transfer pricing by both member and non-member countries alike. South Africa, a non-member country, has incorporated many of the principles encapsulated in the OECD Guidelines into its domestic legislation, specifically in the context of Section 31 of the ITA. Consequently, the focus of the second half of the paper is on the approach South Africa has taken to transfer pricing in light of the international principles contained in the OECD publications. Thereafter this paper will briefly consider the challenges faced by developing countries in their effort to both create and subsequently implement transfer pricing parameters.

## **1.2 RELEVANCE OF TRANSFER PRICING**

Transfer pricing is currently one of the more important short term international tax considerations, specifically in the South African context where recent amendments, particularly with regard to thin capitalisation, have created a degree of commercial uncertainty for MNEs. Transfer pricing can be used as a mechanism for relocating profits to a more favourable tax jurisdiction for the purposes of obtaining a tax benefit. Accordingly, transfer pricing is increasingly being seen as a risk which requires proper management; hence the proliferation in transfer pricing legislation and guidelines in recent years.

Various agencies have undertaken the management and development of transfer pricing material. These include *inter alia* the OECD and United Nations (“UN”), both of which have compiled guidelines to assist tax authorities and MNEs in the regulation of this area of international tax. Overwhelmingly, audits conducted on large MNEs are concerned with the transfer price and whether it reflects market conditions. Transfer pricing over the past two decades has become an increasingly important consideration for both tax administrations and MNEs and will continue to be of consequence for the foreseeable future. Dispute prevention procedures, such as Advanced Pricing Agreements

(“APAs”), may become more prevalent as MNEs and tax authorities are required to reach efficient, cost effective solutions to transfer pricing issues.

### **1.3 OBJECTS OF THE STUDY**

The focus of this study is on the application of the principles contained in the OECD Guidelines in the South African context. The objective of this study is twofold: firstly to identify the internationally accepted transfer pricing principles and methodologies as encapsulated in both the Model Tax Conventions (“MTC”) and the OECD Guidelines, and thereafter, the identification and analysis of the aforementioned principles in the South African context.

The section 31 ITA analysis will include a consideration of the changes brought about to the section by the various amendments enacted by the Legislature and the impact thereof on the transactions of connected persons in their multinational structuring arrangements.

### **1.4 METHODOLOGY USED**

This study is exclusively a desk based one; as such the materials utilized are both primary and secondary sources. The conventions and guidelines published by the OECD, the various manuals issued by the OECD and UN, as well as South African legislation will form the backbone upon which this research paper is based. Where necessary, journal articles, books and internet articles are used to supplement the primary sources.

## Chapter II

### 2. INTERNATIONAL TRANSFER PRICING PRINCIPLES

The focus of Chapter II is on the international treatment of transfer pricing. The OECD advocates the arm's length approach to transfer pricing in both the Associated Enterprise Article (Article 9 of the MTC) as well as in the OECD Guidelines. As such a detailed analysis of this cornerstone principle is required. Chapter II will focus on the origins of the arm's length principle, the methodologies for its calculation, factors affecting its application, and criticisms levelled against it. The final analysis contained in Chapter II will involve a consideration of global formulary apportionment, an approach perceived by critics as being an alternative to the arm's length principle. Further, this paper will illustrate why global formulary apportionment has not received international application by outlining the fundamental criticisms levelled in relation to this theory.

#### 2.1 BACKGROUND TO TRANSFER PRICING

International bodies have played an important role in developing, shaping and harmonizing transfer pricing material; as such an overview of the approaches taken by these organisations is critical.

The OECD's predecessor the Organisation for European Economic Co-Operation ("OEEC") was established in 1947 to implement and facilitate the US led Marshall Plan<sup>30</sup> which was aimed at the reconstruction of post-WWII Europe. The success of the OEEC resulted in Canada and the United States of America ("USA") joining the original members of the multi-country forum. In furtherance of international economic collaboration, the OECD Convention was signed in December 1960. By 1961, the Convention was accepted, and by the 30<sup>th</sup> of September 1961 the OECD was established<sup>31</sup>. The OECD, as well as its predecessor the OEEC, was instrumental in forcing countries to recognise the interdependent nature of their respective economies, and as a result by 1964<sup>32</sup> various other countries

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<sup>30</sup> "OECD History" available at [www.oecd.org/history](http://www.oecd.org/history) [accessed 28/12/2012]

<sup>31</sup> Ibid

<sup>32</sup> Ibid

had begun to join the founding OECD member countries in a collective effort to stimulate international economic co-operation.

The stated purpose of the OECD is to utilize all the information at its disposal to assist governments in combating poverty and promoting prosperity through economic growth and integration<sup>33</sup>. The primary function of the OECD remains its publications which are instrumental in circulating the organisation's "intellectual output"<sup>34</sup>. In addition the OECD is also involved in various administrative roles such as conducting peer reviews, implementing standards and recommendations and facilitating multilateral agreements.

The OECD's 1979 report on *Transfer Pricing and Multinational Enterprises* was instrumental in laying the groundwork for transfer pricing governance. The 1979 report was followed by another report in 1995, which provided clearly defined economic parameters within which to locate transfer pricing regulations. Since then, the report has been updated on a number of occasions to ensure that it keeps abreast with economic realities. The 2010 edition of the OECD Guidelines is the latest amendment to the original 1979 report. The OECD Guidelines provide detailed information on the application of the arm's length principle, its status in international law, methodologies for its calculation, factors affecting its application, required documentation and dispute resolution procedures. To date, the OECD Guidelines remain one of the most comprehensive documents on transfer pricing and have been accepted by both member and strategically significant non-member countries such as South Africa and Russia.

In addition to the OECD reports, the OECD has produced and facilitated the implementation of a number of founding transfer pricing documents, most notably the MTC. The MTC is the culmination and codification of various bilateral and multilateral treaties and finds application among both OECD member and non-member countries. The primary significance of the OECD MTC is its encapsulation of the arm's length principle, which provides the framework for the taxation of MNEs.

Along with the OECD, the UN has played an important role in clarifying transfer pricing issues, specifically those relating to the developed/developing context. From as early as the 1980s, the UN began to publish reports on transfer pricing, starting with the 1988 report on *International Income Taxation and Developing Countries* which looked at the manipulation of transfer pricing by MNEs to

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<sup>33</sup> "What we do and How" available at <http://www.oecd.org/about/whatwedoandhow/> [accessed 28/12/2012]

<sup>34</sup> Ibid

the detriment of developing host countries<sup>35</sup>. The 2003 United Nations *Model Double Tax Convention between Developed and Developing Countries* (“**UN Model Convention**”) cemented the arm’s length principle in the developing country rhetoric. The UN reports address specific developmental issues, such as the lack of skills, resources and regulation, which arise in the developing country context and seek to provide solutions to some of the problems identified. Other relevant material produced by the UN includes its Transfer Pricing Manual for Developing Countries. The value of this manual has been questioned by critics as the OECD Guidelines are already viewed as being an authoritative source of transfer pricing by both member and key non-member countries such as South African and Russia. The UN approach to transfer pricing endorses the OECD arm’s length approach, providing a coherent body of material and expertise from which developing countries may draw upon.

The move toward a more unified approach to transfer pricing is facilitated by the approaches taken in both the UN Model Convention and the OECD Guidelines, which have greatly influenced international treaty practice and have contributed to tax parity in transfer pricing<sup>36</sup>. The Associated Enterprise Article (Article 9) found in both the OECD and UN Conventions have endorsed and entrenched the arm’s length principle in international tax law.

Accordingly, recent international practice in the context of developed countries has largely been uniform in its treatment of transfer pricing. As such, the remainder of the chapter will deconstruct the cornerstone of transfer pricing—the arm’s length principle.

## **2.2 THE ARM’S LENGTH PRINCIPLE**

### **2.2.1 DEFINITION**

Black’s Law dictionary defines the arm’s length principle as:

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<sup>35</sup> United Nations *Practical Manual* op cit 7 at 3.10

<sup>36</sup> United Nations *Model Double Tax Convention between Developed and Developing Countries* (1979) at 2

*“A transaction in good faith in the ordinary course of business by parties with independent interests commonly applied in areas of taxation when there are dealings between related corporations”<sup>37</sup>.*

## 2.2.2 ARTICLE 9 OF THE OECD

The Associated Enterprise Article<sup>38</sup> provides that:

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

The significance of the Associated Enterprise Article is that it provides a basis, in the form of the arm’s length principle, for the evaluation of transactions concluded between connected parties. Where the transactional price is not market related, the relevant Tax administration is empowered to adjust the

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<sup>37</sup> Black, H.C, *Black’s Law Dictionary* 6<sup>th</sup> Ed (1990) at 109

<sup>38</sup> Article 9 OECD Model Tax Convention:

“9(1) Where

a. an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

b. the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

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

9(2) Where a Contracting State includes in the profits of an enterprise of that State—and taxes accordingly—profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise for the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, the other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting State shall if necessary consult each other.”

price accordingly. The Associated Enterprise Article has largely been incorporated into South African domestic legislation through Section 31 of the Income Tax Act.

### **2.2.3 BASIS FOR APPLICATION OF THE ARM'S LENGTH PRINCIPLE**

The significance of the arm's length principle is that empowers tax authorities to adjust the income of the taxpayer in appropriate circumstances where there has been a transaction concluded between connected parties on a non-arm's length basis<sup>39</sup>. The principle is premised on equivalent transactions achieving the same price, and where those prices differ, the Associated Enterprise Article empowers tax authorities to adjust the profit and thereafter tax the adjusted amount. Arm's length trading is premised on two independent parties trading together. Consequently the use of the arm's length standard to evaluate transactions concluded between connected parties necessarily requires an evaluation of surrounding market conditions. A price obtained as a result of a transaction between associated enterprises is more likely to be affected by factors other than external market conditions. Therefore, the comparable uncontrolled transaction is the standard against which the price of the controlled transaction is gauged.

Article 9(1) empowers the relevant tax authority to adjust a controlled transaction so as to reflect a price within the arm's length range, provided special conditions were made or imposed which would not ordinarily have been present in a transaction concluded on normal commercial terms<sup>40</sup>.

Article 9(1) applies in the determination of any contract concluded between related parties. It governs the purchase or transfer of property (corporeal and intangible property) or services; interest on loans (including whether the amount itself constitutes a loan or any other form of payment); as well as rules relating to the application of thin capitalisation<sup>41</sup>.

The notion of associated enterprise(s) is an essential element of the arm's length definition. Two or more enterprises are considered to be "associated" where there is an element of i) common control which exists where "one enterprise participates directly or indirectly in the management, control or

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<sup>39</sup> OECD *Transfer Pricing Guidelines* op cit 5 pg 33 at 1.6

<sup>40</sup> Commentary on Article 9 op cit 12 pg 141 at 3

<sup>41</sup> Ibid pg 141 at 2

capital of the other enterprise”<sup>42</sup>; or ii) if the same person “participates directly or indirectly in the management, control or capital”<sup>43</sup> of both enterprises. The extent of common control exercised over the associated enterprises can significantly affect the price of the transactions under consideration. In contrast, an arrangement between unconnected enterprises would not be subject to such constraints as they are ordinarily determined and regulated by external market factors.

The power of a tax administrator to adjust the transaction arises from Article 9(2) of the OECD Model Tax Convention, which states that:

*“Where a Contracting State includes in the profits of an enterprise of that State—and taxes accordingly—profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise for the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, the other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting State shall if necessary consult each other.”*

Article 9(2) governs the implementation of Article 9(1). Where an adjustment is required, it may result in double taxation. Article 9(2) allows for an “appropriate adjustment” of tax charged to limit the extent of the double taxation. The adjustment to the profits in the second contracting state is not automatic; it will only be implemented where the second state deems that the re-written profits reflect the amounts which would have been present had the transaction been concluded at arm’s length<sup>44</sup>.

The implication of the above is that where the adjusted profits are deemed excessive, the second contracting state is not obliged to affect any changes. Further the adjustment to relieve the double taxation burden is only applied where the amount, in light of the arm’s length principle, justifies its amendment<sup>45</sup>. Sub-paragraph 2 does not prescribe the amount or manner in which the adjustment must be corrected; it merely stipulates that it must reflect an “appropriate” alteration. This gives contracting states considerable autonomy in revising the profits and taxes imposed on associated enterprises.

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<sup>42</sup> OECD *Transfer Pricing Guidelines* op cit 5 pg 19 at 11

<sup>43</sup> Ibid pg 19 at 11

<sup>44</sup> Commentary on Article 9 op cit 12 at 6

<sup>45</sup> Ibid at 6

The statement of the arm's length principle in the UN Model Convention<sup>46</sup> reiterates the approach taken by the OECD. The arm's length principle has been accepted as an authoritative mechanism for calculating and adjusting profits among associated enterprises.

## 2.3 ORIGINS

The arm's length principle has its origins in both European treaty law and American contract law. Continental European countries first utilized the concept when shareholders or directors received excessive benefits from their companies instead of declaring dividends on profits<sup>47</sup>. The arm's length principle operated by amending the hidden profit distributions obtained through the tax benefits received by shareholders. The application of the arm's length principle in Europe was focused on domestic corporate regulation rather than international treaty law.

The USA and the United Kingdom (“UK”) have successfully exported the principle through multilateral treaties<sup>48</sup>. The USA in particular has been a driver of the arm's length principle, using it

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<sup>46</sup> UN Model Convention Article 9:

“1. *Where:*

*a. Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or*

*b. The same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.*

*2. Where a Contracting State includes in the profits of an enterprise of that State—and taxes accordingly—profits on enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of the Convention and the competent authorities of the Contracting States shall, if necessary, consult each other.*

*3. The provisions of paragraph 2 shall not apply where judicial, administrative or other legal proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises concerned is liable to penalty with respect to fraud, gross negligence or wilful default.”*

<sup>47</sup> H, *Black Blacks Law Dictionary* 6<sup>th</sup> Ed (1990) at 109

<sup>48</sup> B Lebowitz, “Transfer Pricing and the end of International Tax” 84 *Tax Notes* 1523 at 4

both in its domestic law and international negotiations<sup>49</sup>. The USA has used the principle effectively to protect its tax base from erosion in part by pregnating international forums with the principle, thereby further insulating its domestic tax bases against transfer pricing manipulation<sup>50</sup>.

## **2.4 TRANSFER PRICING METHODS**

### **2.4.1 FACTORS INFORMING THE SELECTION OF AN APPROPRIATE TRANSFER PRICING METHOD**

The selection of an appropriate transfer pricing method is an integral part of the evaluation of the transaction. Selection of the appropriate methodology depends largely on the information available to the taxpayer. In the developing country context, access to comparable uncontrolled information is a significant obstacle to the taxpayer. Transfer pricing works by selecting an appropriate benchmark transaction where the price is undisputed against a controlled transaction. Significant price differences between the controlled and benchmark transactions is usually an indicator that the former has not been concluded on an arm's length basis. Consequently, the accuracy of the transfer pricing analysis depends in part on the comparability between the controlled and uncontrolled transactions. The comparability analysis serves to highlight the extent to which the uncontrolled transaction is comparable to the controlled transaction. Where minor differences exist between the two, adjustments can be made to the extent that it eliminates any material differences. Once the uncontrolled transaction is comparable to the controlled transaction, an appropriate transfer pricing method can then be selected based on the information available. If an inappropriate method is selected and implemented, the result obtained will be an inaccurate reflection of the value attributed to the transaction in the open market.

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<sup>49</sup> B Lebowitz, "Transfer Pricing and the end of International Tax" 84 Tax Notes 1523 at 4

<sup>50</sup> B Lebowitz, "Transfer Pricing and the end of International Tax" 84 Tax Notes 1523 at 4

## 2.4.2 THE COMPARABILITY FACTORS

The application of the arm's length principle is premised on the controlled and uncontrolled transactions being sufficiently similar; this necessarily requires that there can be no material differences which would affect the conditions under consideration<sup>51</sup>. Transactions are considered to be comparable if there are no material differences which would affect the underlying factor being accounted for in the transaction method; or if the difference can be reasonably adjusted for to eliminate the materiality of same. The primary purpose for performing the comparability analysis is to determine the appropriateness of the transfer price between connected parties against the price achieved between independent parties.

Economic theory is premised on independent parties striving to obtain the most advantageous transaction. This means that an independent enterprise will only enter into the most favourable transaction available<sup>52</sup>, and that independent parties do not have to consider group interests when transacting. Market factors play an important role in determining the potential comparability of the controlled and uncontrolled transaction. The use of the arm's length principle to determine the appropriateness of the price concluded between associated enterprises necessarily requires an evaluation of the surrounding market conditions<sup>53</sup>.

On a controlled transaction, additional considerations may influence the transaction. One of the parties to a controlled transaction may suffer a disadvantage as a direct result of having concluded the transaction, however, this may still result in an overall benefit for the group as a whole. In an uncontrolled transaction the same is not true — both parties will seek to achieve the best possible results for themselves, if the net result of the transaction is a disadvantage, then independent parties are more likely not to contract with one another.

Comparability is primarily determined with regards to the characteristics of the particular transaction, the functional analysis, and the surrounding economic circumstances. There are various comparability factors which must be considered when selecting a test transaction, and where necessary be adjusted for, these include<sup>54</sup>:

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<sup>51</sup> OECD *Transfer Pricing Guidelines* op cit 5 pg 41-42 at 1.33

<sup>52</sup> PWC *International Transfer Pricing 2012* available at [www.pwc.com/internationaltp](http://www.pwc.com/internationaltp) [accessed 20/12/2013] at 56

<sup>53</sup> Ibid at 55

<sup>54</sup> OECD *Transfer Pricing Guidelines* op cit 5 at 1.38 to 1.63

- Characteristics of the property / services;
- The functional analysis;
- Contractual terms;
- Economic circumstances; and
- Business strategies.

One of the many difficulties experienced by South Africa as a developing country<sup>55</sup>, and Africa in general, relates to the lack of domestic comparables against which to peg the controlled transaction<sup>56</sup>. Presently, there are no databases available which contain information on comparable data relating to developing countries.

The evaluation of highly specialised products, such as intellectual property, is often difficult to evaluate for tax purposes<sup>57</sup> as few comparables exist against which to compare the tested transaction. The term intellectual property is widely defined in the OECD Guidelines and includes patents, trademarks, trade names, designs or models. The arm's length principle dictates that an appropriate uncontrolled comparable be used as a benchmark against which the controlled transaction is tested. However, transactions involving intellectual property are often unique due to the special nature and characteristics of the product<sup>58</sup>. Apart from making it difficult to find the appropriate comparable, the nature of the intellectual property often makes it difficult to determine the value of the property at the time of the transaction<sup>59</sup>

One of the primary difficulties with applying the arm's length principle to transaction involving intellectual property is that the arm's length pricing must be determined from both the transferor and transferees perspective<sup>60</sup>. Part of this analysis includes calculating the expected benefit which would be obtained with the use of the intellectual property. This undertaking is administratively intensive for the taxpayer and requires access to information which is not readily available. Some of the factors which

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<sup>55</sup>European Aid report at pg 55 lists South Africa as a developing country. available at [http://ec.europa.eu/europeaid/what/economic-support/documents/transfer-pricing-study\\_en.pdf](http://ec.europa.eu/europeaid/what/economic-support/documents/transfer-pricing-study_en.pdf) [accessed 02/02/2014]

<sup>56</sup> United Nations *Practical Manual* op cit 7 at 410

<sup>57</sup> OECD *Transfer Pricing Guidelines* op cit 5 at 6.1

<sup>58</sup> Ibid at 6.13

<sup>59</sup> Ibid at 6.13

<sup>60</sup> Ibid at 6.14

inform the arm's length price and which the taxpayer may not have access to include the calculation the anticipated benefit associated with the use of the intellectual property, the geographical location of its use, the exclusivity of the right<sup>61</sup> and valuing the property at the time of the transaction<sup>62</sup>.

The selection of the appropriate comparable is difficult in the context of simple transactions, however, it becomes even more complicated when the transaction concerned involves highly specialised products such as intellectual property. This is primarily due to the lack of information available regarding appropriate uncontrolled transactions. This problem is compounded exponentially in the context of developing countries which lack access to commercial databases, expertise and other resources required to complete a transfer pricing analysis.

The lack of access to information is one of the many challenges more prevalent in the developing country context. Given the lack of access to information available relating to other developing countries, taxpayers are forced to use data obtained from developed countries, which necessarily requires that adjustments be made to account for market, political and geographical differences<sup>63</sup> which is often a complicated undertaking. The South African Revenue Service ("SARS") has attempted to account for these differences and alleviate some of the burden placed on its taxpayers by implementing comparability adjustments, however, these are only applied in certain circumstances.

### 2.4.3 CHARACTERISTICS OF PROPERTY / SERVICES

Characteristic differences in property/services to an extent account for the different values attributed to same in the open market. Broadly speaking, characteristics which may be important to consider include:

- in the case of corporeal property, physical features which play an important role in determining the value of the property. Relevant features may include the durability, quality and availability of the property<sup>64</sup>. In addition, economic theory dictates that scarce products

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<sup>61</sup> OECD *Transfer Pricing Guidelines* op cit 5 at 6.20

<sup>62</sup> Ibid at 6.28 to 6.33

<sup>63</sup> United Nations *Practical Manual* op cit 7 at 410

<sup>64</sup> OECD *Transfer Pricing Guidelines* op cit 5 at 1.39

are more valuable. The more favourable the outcome in terms of quality, durability and scarcity, the more value is attributed to the property in the open market; and

- in respect of intangible property, the value depends in part on the type of property sold, as well as the duration and extent of the protection afforded in terms thereof<sup>65</sup>.

The various methodologies places emphasis on different aspects of a transaction, consequently, the selection of the methodology will influence the range of the transfer price to an extent. Traditional transaction methods place more emphasis on the product than transactional profit split methods. The comparable uncontrolled price (“CUP”) method places the most emphasis on the characteristics of property or services<sup>66</sup>, and as a result thereof, minor characteristic differences must be adjusted for in order to produce an appropriate comparable. In contrast, the transactional profit split methods focuses more on profit indicators in the transaction as opposed to the characteristics of the product or services.

#### 2.4.4 FUNCTIONAL ANALYSIS

The functional analysis determines the comparability of controlled and uncontrolled transactions, as well as the comparables which must be adjusted<sup>67</sup>. It also provides a means of understanding the nature of the transaction and the surrounding information by looking at the functions, risks<sup>68</sup>. and comparability of the transactions for the purposes of determining the allocation of same between the associated enterprises under the affected transaction<sup>69</sup> and improving the selection of an appropriate transfer pricing method. The scope, nature and extent of the functional analysis will vary according to the specific transaction under consideration<sup>70</sup>. Adjustments need to be made for material differences which would affect the transaction and the potential comparability of the two transactions. The functional analysis should include an evaluation of, and where necessary adjust for, factors such as the

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<sup>65</sup> OECD *Transfer Pricing Guidelines* op cit 5 at 1.39

<sup>66</sup> Ibid at 1.40

<sup>67</sup> Ibid at 3

<sup>68</sup> ENS “Transfer Pricing- Back to Basics” available at [www.ens.co.za/news\\_article.aspx?iID=611&TYPE=4](http://www.ens.co.za/news_article.aspx?iID=611&TYPE=4) [accessed 08/07/2013]

<sup>69</sup> PWC *International Transfer Pricing 2012* op cit 52 at 57

<sup>70</sup> ENS “Transfer pricing-Back to Basics” op cit 68

type of assets utilized in the transaction, valuable intangible resources, financial assets, risks assumed, and the nature of the assets used<sup>71</sup>.

The functional analysis plays an important role in determining which transfer pricing method should be selected and applied to the controlled transaction<sup>72</sup>. Thus, a functional analysis is necessary for:

- understanding the controlled transaction<sup>73</sup>;
- determining whether controlled and uncontrolled transactions are comparable<sup>74</sup>; and
- identifying characteristics in a particular transaction which would make it a suitable comparable and highlighting any potential differences which may require appropriate adjustment<sup>75</sup>.

Risks undertaken by the parties must be allocated and compensated for in the functional analysis. Where one party carries a greater degree of risk, the party assuming that risk would anticipate a larger return in the open market as that party will carry the associated losses should the risk materialize<sup>76</sup>. The types of risk to be considered include market risks, risks associated with loss of investments or loss sustained to property and equipment, as well as financial risks such as those associated with fluctuations in currency<sup>77</sup>, interest rates and funding considerations.

Economic circumstances play a significant role in determining the comparability of the controlled and uncontrolled transaction, and consequently forms part of the initial analysis. The economic environment affects the arm's length price; the market conditions must therefore be sufficiently similar in order for the controlled and uncontrolled transactions to be alike for the purposes of determining comparability<sup>78</sup>. The availability of the particular product/service, the relative bargaining positions of the parties to the transaction and the risks assumed influence the economic market conditions within which the transaction is located<sup>79</sup>.

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<sup>71</sup> OECD *Transfer Pricing Guidelines* op cit 5 at 1.44

<sup>72</sup> United Nations *Practical Manual* op cit 7 pg 191

<sup>73</sup> Ibid pg 191

<sup>74</sup> OECD *Transfer Pricing Guidelines* op cit 5 at 1.42

<sup>75</sup> United Nations *Practical Manual* op cit 7 pg 191

<sup>76</sup> Ibid pg 117

<sup>77</sup> OECD *Transfer Pricing Guidelines* op cit 5 at 1.45

<sup>78</sup> Ibid at 1.55

<sup>79</sup> OECD *Transfer Pricing Guidelines* op cit 5 at 1.55

Where the market conditions are cyclical, multiple year data must be used to determine the similarity of the controlled and uncontrolled transactions. The geographical location of the market affects the arm's length range, assessing the similarity of markets is a factual consideration which the taxpayer undertakes which performing its transfer pricing analysis. In some jurisdictions, large industries stretching across multiple countries may prove to be sufficiently similar, while in other jurisdictions internal domestic markets may differ considerably. The nature of the transaction, product and economic environment will inform the comparability of the geographical market, which in turn will inform the comparability of the controlled and uncontrolled transaction.

The functional analysis needs to differentiate between physical and intangible property utilized in and / or forming part of the transaction<sup>80</sup>. Capital assets such as property, and plant and equipment would usually enjoy a greater long term return. In contrast, intangible assets are useful insofar as they allow enterprises to sustain their competitive advantage in the market place. The analysis performed must necessarily distinguish the party which carries the legal risk from the party which carries the economic risk based on the terms of the transaction<sup>81</sup>.

Increased economic integration has resulted in MNEs sharing both the risk and ownership of the assets<sup>82</sup>. This has added a level of complexity to the attribution of profits to a particular tax jurisdiction. The affect of increased assimilation means that in certain instances one party may perform the function while another party to the transaction accepts the costs attended thereof<sup>83</sup>.

The integrated nature of MNEs has resulted in functions, risks and assets being shared between the different entities across various tax jurisdictions<sup>84</sup>. The functional analysis is able to deconstruct the different roles played by the parties in the transaction; thereby identifying benefits enjoyed by the respective parties and allocating the tax implications accordingly<sup>85</sup>.

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<sup>80</sup>United Nations *Practical Manual* op cit 7 pg 118

<sup>81</sup> Ibid pg 118

<sup>82</sup> Ibid pg 118

<sup>83</sup> Ibid pg 118

<sup>84</sup> Ibid pg 191

<sup>85</sup> Ibid pg 192

## 2.4.5 CONTRACTUAL TERMS

The contractual terms in an uncontrolled transaction are generally explicitly defined in the relevant agreement, and are not subsequently amended unless there are clear benefits for both parties in doing so. In contrast, the terms of a controlled transaction may be varied at any stage if it is in the interest of the MNE<sup>86</sup>. Information pertaining to the contractual terms of an uncontrolled transaction is not readily available as it is of a sensitive and confidential nature; this is particularly true where an external comparable is used.

The contractual terms outline the financial and commercial conditions imposed on the associated enterprises entering into the transaction. These terms might favour one party in the group over the other, and may include terms which would not ordinarily be present between independent parties. In order for the controlled and uncontrolled transaction to be deemed comparable, the terms upon which the parties agree must be similar. The extent to which contractual terms and the availability thereof affects the transfer price will depend on the particular transaction and the transfer pricing method selected. However, as indicated above, obtaining sufficient information relating to the contractual terms of the controlled transaction is often difficult as the reporting requirements and public databases may vary significantly between countries.

The evaluation of contractual terms appears to be somewhat artificial in the context of permanent establishment (“**PE**”) which, unless incorporated as a subsidiary, is essentially the foreign branch of the MNE in a given country. Unlike with the creation of subsidiaries, branches do not have independent legal personality, as such it is treated as an extension of the non-resident parent. To the extent that an entity earns or derives income from a PE situated within the Republic, the income attributable thereto is subject to income tax at the appropriate rate. The parties to both sides of a controlled transaction involving a PE is effectively the offshore entity, consequently, assessing the terms from the perspective of the connected parties is therefore fruitless.

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<sup>86</sup> OECD *Transfer Pricing Guidelines* op cit 5 at 1.52 to 1.53

#### 2.4.6 ECONOMIC CIRCUMSTANCES

The economic market governing the transaction affects the price of the products. As a result, the arm's length price will vary between economic markets even where the transactions are in respect of or for the same product or service<sup>87</sup>. To ensure that the transactions are comparable, the markets in which the transactions occur must be sufficiently similar so as to ensure that there are no material differences which will affect the price of the product.

Factors which may be applicable in determining market comparability include the geographical market; the size of the markets; the relative competitive position of both the buyer and seller; the availability of the product; the extent and nature of governmental regulation; and the costs associated with manufacturing the product<sup>88</sup>.

Selecting a transaction from an appropriate geographical market is an important step in determining comparability as it plays an important role in determining the price of the product or service. Evaluating the appropriateness of the geographical market is a factual exercise. As indicated previously, differences in the geographical market may vary across different industries — large regional markets which stretch over a number of different countries may be fairly homogenous, while in other sectors there may be significant difference within a domestic market<sup>89</sup>. The suitability of the geographical market must be determined with reference to the particular product/service in question. Where the market is relatively homogenous, it is acceptable for the entity compiling the transfer pricing documentation to incorporate transactions from multiple countries which have similar market conditions in its analysis.

#### 2.4.7 BUSINESS STRATEGIES

The business strategies of the entity involved in the uncontrolled transaction must also be evaluated when determining the potential comparability of a transaction for the purposes of transfer pricing. Business strategies are important because they take into account factors such as new product development, market penetration strategies, diversification of the product and risk aversion. These

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<sup>87</sup> OECD *Transfer Pricing Guidelines* op cit 5 at 1.55

<sup>88</sup> Ibid at 1.55

<sup>89</sup> Ibid at 1.57

factors may have a direct impact on the potential profitability of the product/service, which in turn impacts on the taxable income.

A taxpayer engaging in market penetration schemes may result in the entity suffering an initial loss in the market; however this loss will be subsequently offset by the demand the product may create for other products/services sold by the company in question. A taxpayer entering a new market may initially incur higher costs for its products than that which would be expected from an established environment<sup>90</sup>. This would have a direct impact on the short terms profits attributable to the taxpayer, however it could create greater long term opportunities which would justify the initial expenses.

Whilst business strategies play an important role in determining the comparability of a transaction, this information may not readily be available to the taxpayer for the purposes of calculating the appropriate transfer price as the information is often of a sensitive and confidential nature.

#### 2.4.8 TYPES OF COMPARABLES

The taxpayer may utilise either internal or external comparables in its assessment of the uncontrolled transaction. An internal comparable refers to a transaction between one party to the controlled transaction and an independent party; an external comparable refers to a transaction concluded between two independent parties<sup>91</sup>. The use of internal comparables must comply with the comparability requirements outlined in paragraph 2.4.2.

The selection of an appropriate external comparable is necessarily more complicated than the selection of an internal comparable, and depends largely on the amount of publicly available information. Commercial databases can be a cost effective way of identifying external comparables<sup>92</sup>. Commercial databases are platforms which have been compiled by administrative bodies. Taxpayers making use of commercial databases must be aware that they were not compiled for transfer pricing purposes; and further that that information contained therein differs among countries depending on the reporting requirements of the specific country concerned<sup>93</sup>. Importantly not all commercial databases record the

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<sup>90</sup> OECD *Transfer Pricing Guidelines* op cit 5 at 1.60

<sup>91</sup> Ibid at 3.24

<sup>92</sup> Ibid at 3.29

<sup>93</sup> Ibid at 3.31

same level of detail, which may impact on the ability to select an appropriate transfer pricing method. More significantly, commercial databases are compiled to compare the results of companies as a whole as opposed to specific transactions<sup>94</sup>. Whilst commercial databases may be used, the information obtained from them must be carefully scrutinised to ensure that it is appropriate for transfer pricing purposes.

Confidentiality requirements necessarily restrict the amount of information publicly available in respect of an external comparable<sup>95</sup>. The taxpayer will need to supplement information obtained from a commercial database with other publicly available information. Access to sufficiently detailed information remains one of the many obstacles which a taxpayer has to overcome when conducting a transfer pricing analysis.

## **2.5 OECD METHODOLOGY FOR CALCULATING AN APPROPRIATE ARM'S LENGTH PRICE**

The OECD Guidelines identify various methods which may be used to test whether the transfer price is concluded on an arm's length basis<sup>96</sup>. There methods can broadly be categorized in terms of the (i) traditional transaction methods and the (ii) transactional profit methods.

The OECD Guidelines do not require the use of multiple methods. Instead the selection of the appropriate method is informed by a combination of factors including the results of the comparability analysis and information available. The OECD has taken cognisance of the difficulty imposed on a taxpayer in compiling the relevant transfer pricing information and documentation. As different methods require different types of information, the taxpayer is only required to perform a transfer pricing analysis using the most appropriate method in light of the information available<sup>97</sup>. However, in particularly complicated transactions, the taxpayer may use information obtained from multiple methods to supplement available information<sup>98</sup>. Whilst the OECD Guidelines outline both the potential advantages and difficulties associated with the use of various sources of information, the inclusion or

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<sup>94</sup> OECD *Transfer Pricing Guidelines* op cit 5 at 3.31 to 3.32

<sup>95</sup> Ibid at 3.37

<sup>96</sup> United Nations *Practical Manual* op cit 7 pg 116

<sup>97</sup> OECD *Transfer Pricing Guidelines* op cit 5 at 2.2

<sup>98</sup> Ibid at 2.6-2.7

exclusion thereof is left at the discretion of the taxpayer, subject only to the proviso that the information selected is sufficiently comparable to justify its application<sup>99</sup>.

## 2.5.1 TRADITIONAL TRANSACTION METHODS

Chapter II of the OECD Guidelines outlines the traditional transaction methods and how they apply in relation to the arm's length principle. The traditional transaction methods places a greater emphasis on the price attributed to the products under the transaction, consequently they are particularly sensitive to product variance and market conditions. The traditional transaction methods, which include the comparable uncontrolled price, the resale price method and the cost plus method, provide for the direct substitution of prices between the controlled and uncontrolled transactions.

### 2.5.1.1 COMPARABLE UNCONTROLLED PRICE METHOD

The CUP method compares the price charged in respect of a property or service in a controlled transaction to the price achieved in a similar uncontrolled transaction. Significant differences between the two prices, as illustrated by the direct substitution of prices, may indicate that the financial and commercial conditions imposed in the controlled transaction do not reflect an arm's length range<sup>100</sup>.

In order to apply the CUP method, the controlled and uncontrolled transaction in respect of the product or service must be similar and must occur in comparable economic environments. The accuracy of this method depends on the similarities between the characteristics of the product or service. This necessarily entails that the products being compared are similar in terms of the level of product, quality, quantity, and geographical market<sup>101</sup>. Any variance with regards to the product or the conditions under which it is sold will have a significant impact on the price; this makes it particularly difficult to find an appropriate uncontrolled transaction using the CUP method.

The CUP method is the preferred method where an enterprise sells the same product to that sold between the two connected enterprises. In order to apply the CUP method in a manner which complies

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<sup>99</sup> OECD *Transfer Pricing Guidelines* op cit 5 at 2.11

<sup>100</sup> Ibid at 2.13

<sup>101</sup> Ibid at 2.16

with the arm's length principle as encapsulated in the Associated Enterprise Article, the independent transaction must be similar in terms of the product or service, level of production, quality, quantity, characteristics, and geographical markets; and where any material differences exist they must be removed by an appropriate adjustment. If a reasonably accurate adjustment cannot be made then the reliability of the CUP method will significantly diminished<sup>102</sup>.

The difficulty with applying the CUP method is that any variance between the products in the controlled and uncontrolled transaction will have a significant impact on the price of the transaction. Therefore, while in theory the CUP method is the less complicated method, in practice the vulnerability of the method to product variance makes its application problematic.

The advantage to using the CUP method is that if an appropriate comparable can be found, the CUP method provides for the direct substitution of the price achieved in the controlled transaction with that obtained in the uncontrolled transaction. However, one of the biggest problems with this methodology in the developing country context is that many industries simply do not have access to the required information to enable them to perform the analysis<sup>103</sup>. Whilst in theory this method is the simplest option as it provides for direct price substitution, few industries in the market place satisfy the comparability requirements. Given how sensitive this methodology is to product variance, it is simply not a commercially realistic option given the lack of access developing countries have to both resources and information.

### 2.5.1.2 RESALE PRICE METHOD

The resale price (“**RP**”) method compares the price at which tangibles are purchased from a connected party against that achieved when it is resold to an independent party. The financial ratio used in calculating the arm's length price is the gross profit margin (gross profit to net sales ratio<sup>104</sup>) which is expressed as a percentage<sup>105</sup>. The resale price is subsequently reduced by an appropriate gross

<sup>102</sup> OECD *Transfer Pricing Guidelines* op cit 5 at 2.19

<sup>103</sup>C Silberstein “Transfer Pricing: A Challenges for Developing Countries” OECD Observer [http://www.oecdobserver.org/news/archivestory.php/aid/3131/Transfer\\_pricing:\\_A\\_challenge\\_for\\_developing\\_countries.html](http://www.oecdobserver.org/news/archivestory.php/aid/3131/Transfer_pricing:_A_challenge_for_developing_countries.html) [accessed 15/02/2014]

<sup>104</sup> United Nations *Practical Manual* op cit 1 pg 131

<sup>105</sup> Ibid pg 131

margin<sup>106</sup> (resale price margin). The amount remaining after the subtraction of the resale price margin and adjustments for other necessary costs constitutes the arm's length price of the transaction<sup>107</sup>.

As the gross profit margin is weighted against the gross profit to net sales ratio, the controlled and uncontrolled transactions must utilise the same or similar accounting standards. If the entity involved in the uncontrolled transaction utilises a different accounting standard, the RP method would not be appropriate as the gross profit margins between the two entities would not be comparable<sup>108</sup>.

The accuracy of the RP method depends on i) comparability of functions performed, ii) the level of costs at which the product is bought and subsequently sold and iii) the calculation of an appropriate resale margin<sup>109</sup>. Where one or more of the aforementioned factors are missing or unidentifiable, the RP method is not capable of producing an accurate calculation of the arm's length price.

Whilst physical product difference can be accounted for under this method, the likelihood of functional differences arising increases exponentially with the product variation<sup>110</sup>.

The resale margin of the associated enterprise may be determined with reference margins obtained by an independent party (internal comparable); or it with reference to independent entities in a comparable uncontrolled transaction (external comparable)<sup>111</sup>.

The RP method is most appropriate where parties do not add significant value to the product prior to reselling, consequently, where either and/or both parties further process the product to the extent that a new product is created, the calculation of the transfer price would be difficult.

### 2.5.1.3 COST PLUS METHOD

The cost plus ("CP") method calculates the transfer price by adding an appropriate cost plus mark-up to the costs incurred by the party selling the product in the controlled transaction. The cost plus mark-up, which is expressed as a percentage, must reflect the assets used and the risks assumed by the tested

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<sup>106</sup>The gross margin refers to the difference between revenue and costs. The gross margin includes a mark-up (incorporating operating and sales costs) which the seller would endeavour to earn.

<sup>107</sup> OECD *Transfer Pricing Guidelines* op cit 5 at 2.21

<sup>108</sup> United Nations *Practical Manual* op cit 7 at 132

<sup>109</sup> OECD *Transfer Pricing Guidelines* op cit 5 at 2.28

<sup>110</sup> *Ibid* at 2.25

<sup>111</sup> *Ibid* at 2.22

party<sup>112</sup>. The CP method compares the gross profit mark-up achieved by the tested party against the gross profit mark-up earned by an independent party in an uncontrolled transaction. The mark-up reflects the percentage of profits which the tested party could be expected to earn after deducting the direct and indirect costs associated with manufacturing the product<sup>113</sup>.

The gross profit mark-up is expressed as the ratio of the gross profit earned by the tested party to the costs of the goods sold. The gross profit is the amount earned from the sale of the product / service less the cost of the goods. As this method uses the costs of the products as a component of the gross profit ratio, the controlled and uncontrolled transaction must utilise similar accounting standards. Where the accounting standards differ substantially, adjustments must be made to ensure that the gross profit is calculated consistently<sup>114</sup>.

There are various advantages associated with the selection and implementation of the CP method for transfer pricing purposes. Primarily, the CP method allows, similar to the RP method, for greater product differentiation. The basis of comparability in the CP method is that of functional similarity, and as a result less emphasis is placed on the physical characteristics of the product<sup>115</sup>. The second significant advantage with the CP method is that it is based on internal information to which the tested party necessarily has access to as opposed to the two previous methods which require access to information which is less likely to be publicly available.

The disadvantages attendant on this transfer pricing method relate primarily to the calculation of costs. As the determination of costs is fundamental to calculating the gross margin mark-up, any accounting differences will have a significant impact on the range achieved using the CP method. Difficulties may arise when the tested party incurred the costs of the product in the preceding financial year but sold the product in the following year as this will impact on the accounting treatment<sup>116</sup>.

The CP method is not the appropriate mechanism for determining the transfer price where the tested party is a complex manufacturer which owns valuable intangible property used in the manufacturing process of the product. This is primarily because the calculation of the gross margin mark-up is central to the application of the CP method. Where both parties to the controlled transaction perform value-

<sup>112</sup> United Nations *Practical Manual* op cit 7 g 123

<sup>113</sup> OECD *Transfer Pricing Guidelines* op cit 5 at 2.47

<sup>114</sup> United Nations *Practical Manual* op cit 7 pg 142

<sup>115</sup> *Ibid* pg 143-144

<sup>116</sup> *Ibid* pg 145-146

add functions, it becomes complicated to allocate the profits earned between the appropriate parties. Furthermore, in practice, it is difficult to find an appropriate external comparable against which to judge the controlled transaction<sup>117</sup>. The optimum circumstances for the application of the CP method is where one party assumes the majority of the risk, performs the more complex functions under the agreement and controls the assets, while the other party to the transaction (the tested party) performs a relatively simple manufacturing processes.

Whilst the CP method does provide a mechanism for calculating the transfer price in relation to the arm's length transaction, it is not the preferred method for doing so. The selection of the CP over the RP method, or vice versa, will depend entirely on the facts available regarding the controlled transaction and the comparable uncontrolled transaction. One of the bases for preferring the CP method over the RP method is that the amount reached using the former is more readily accepted by tax and customs authorities as it provides some indication that the transfer price approximates the cost of the item and therefore its market value.

### **2.5.2 TRANSACTIONAL PROFIT SPLIT METHODS**

Where the parties perform highly integrated functions or where both parties add value to the product before on-selling, the transactional profit split methods are the more reliable options for the purposes of calculating the transfer price. As with the traditional transaction methods, the profit based methods must conform to the Associated Enterprise Article in order for it to be compliant with the OECD Guidelines.

Transactional profit split methods focus on the allocation of profits between connected parties, while the traditional transaction methods compare prices achieved in the controlled transaction against that earned in the uncontrolled transaction.

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<sup>117</sup> United Nations *Practical Manual* op cit 7 pg 146

### 2.5.2.1 TRANSACTIONAL NET MARGIN METHOD

The transaction net margin (“**TNM**”) method calculates the transfer price by examining the net profit in relation to an appropriate base. The net margin can be weighted to either sales earned, the costs of producing the goods or the assets owned. This method is similar to the RP and CP method in the sense that the calculation and application of the financial ratio must be applied consistently across both the tested party and the comparable uncontrolled transaction<sup>118</sup>.

One of the strengths of the TNM method is that the net profit indicator is less affected by transactional differences because the ratio is weighted against sales, costs or assets. Whilst functional difference is still important, it is less of a consideration with the TNM method as opposed to the RP and CP methods which rely almost exclusively on the functional analysis for their accuracy<sup>119</sup>. As with the CP and RP methods, the TNM method is only applied to one party to the transaction (the tested party). As a one sided method, it cannot therefore account for transactions where both parties add value to the product before reselling it. The net profit margin earned by the tested party in the controlled transaction is compared to the net margin earned by an independent entity in the comparable uncontrolled transaction. Any significant differences which exist between the two figures could potentially be an indication that the controlled transaction has not been priced on an arm’s length basis.

One of the weaknesses with the TNM method is that the net profit indicator could be affected by factors such as the relative competitive positions of the parties, which cannot easily be adjusted for. The successful application of the TNM method depends on the calculation of the net profit indicators, if these figures are not available or cannot be calculated for a comparable uncontrolled transaction, this method should not be used<sup>120</sup>.

### 2.5.2.2 TRANSACTION PROFIT SPLIT METHOD

The transaction profit split (“**TPS**”) method is premised on the entities involved in the controlled transaction performing highly specialised functions of an integrated nature. Given the integrated nature

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<sup>118</sup> OECD *Transfer Pricing Guidelines* op cit 5 at 2.58

<sup>119</sup> Ibid at 2.63

<sup>120</sup> Ibid at 2.71

of the functions performed by the parties, it would not be realistic or practical to separately calculate the respective performances.

The TPS method identifies the profits which will be split between the respective parties, and thereafter allocates the profits on an economically justifiable basis<sup>121</sup>. The division and allocation of profits approximates earnings which would have been achieved, in proportion to the respective contributions of the parties, had the transaction been concluded in accordance with the arm's length principle<sup>122</sup>.

The advantage of the TPS method, unlike the traditional transaction methods and the TNM method, is that it can account for highly integrated transactions where both parties participate in value-add activities<sup>123</sup>. The TPS method makes allowances for conditions which are unique to the controlled transaction and would therefore not be present in an uncontrolled transaction, while remaining an arm's length approach as it reflects the price and allocation of profits which would have been achieved<sup>124</sup>.

## 2.6 THE ARM'S LENGTH RANGE

The selection of one of the abovementioned methods depends on the information available in respect of the independent comparables, as well as the nature of the controlled transaction. It must be noted that the application of one of the transfer pricing methods will not yield a single amount which the controlled transaction must replicate, rather it represents a range within which the transfer price must be located. If the transfer price falls within in the arm's length range, the price should be considered as being in accordance with the arm's length principle. Different transfer pricing methods will produce different ranges, and as such, the available information should inform the selection of the suitable method.

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<sup>121</sup> OECD *Transfer Pricing Guidelines* op cit 5 at 2.108

<sup>122</sup> Ibid at 2.110

<sup>123</sup> Ibid at 2.109

<sup>124</sup> Ibid at 2.112

### 2.6.1 CRITICISMS OF THE ARM'S LENGTH APPROACH

The arm's length approach has been criticized as being fundamentally flawed insofar as it cannot account for situations where there is no comparable uncontrolled transaction. This is particularly the case in industries characterised by the presence of oligopolies.

Further, critics of the arm's length approach emphasize that the written contracts concluded between the parties are accorded undue priority when evaluating the transfer price. This is problematic as the written contracts are concluded between connected parties; consequently the same party's interest is therefore reflected on both sides of the contract.

The transfer pricing treatment of intangibles, particularly intellectual property, raises unique challenges for both tax administrations and MNEs. In the South African context, pressing issues which must be overcome relate *inter alia* to the valuation of intangibles and issues of economic versus legal ownership<sup>125</sup>.

The removal of proceeds relating to the sale of intellectual property developed in the Republic is subject to exchange control regulations which disallow the relicensing of the intellectual property back into South Africa<sup>126</sup>. The purpose of this is to prevent the removal of funds from South Africa through excessive royalty payments to South African owners of intellectual property where licensing rights are sold to non-residents. The South African entity may continue to perform certain functions relating to the maintenance and development of the intellectual property and therefore still participate in any profits earned. While the connected party may be the legal owner of the intellectual property, the South African entity, from a SARS perspective, is still the economic owner of the property.

In light of the true substance of the transaction, the connected party should be compensated as a service provider by receiving registration and maintenance fees as opposed to royalties associated with ownership<sup>127</sup>, while the South African entity should be taxed as the true owner of the property. Section 23I of the ITA has been implemented to counter arrangements where a South African entity develops and subsequently on-sells intellectual property to a non-resident for use in the Republic. The effect of section 23I, which essentially constitutes a specific anti-avoidance mechanism, is to disallow the deduction of the royalty payments.

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<sup>125</sup> United Nations *Practical Manual* op cit 7 pg 411

<sup>126</sup> Ibid pg 411

<sup>127</sup> OECD *Transfer Pricing Guidelines* op cit 5 pg 411

Location saving remains a problem for both developed and developing countries. Location saving allows MNEs to earn large profits by outsourcing operations to jurisdictions in developing countries which have less sophisticated labour law structures and more favourable tax regimes<sup>128</sup>, such that profits are shifted in a manner where they erode the tax base of the developing host country.

Where an MNE outsources its operations to a third party in a developing country, it is unlikely that the MNE will pay location saving returns. This is partly due to the host countries unwillingness to request the returns as it could result in the MNE transferring its operations to a different developing country which does not require location saving returns<sup>129</sup>. In this manner developing countries are exploited by MNEs, which utilise developing countries to minimise costs. The result of this is base erosion and profit shifting (“**BEPS**”), which impacts heavily on developing countries as their tax bases are considerably smaller than their developed country counterparts.

The OECD has published a report, entitled *Addressing Base Erosion and Profit Shifting*<sup>130</sup> as well as its action plan<sup>131</sup>, aimed at addressing BEPS. The report indicates that the current provisions on intangibles are inadequate and would have to be addressed in the transfer pricing rules<sup>132</sup>. The report further highlights that MNEs are structuring their operations in such a manner that they are effectively avoiding tax liabilities in developing countries<sup>133</sup>. This has far reaching consequences for the country concerned.

Apart from base erosion implications, businesses located within the developing country also suffer indirectly as a result of BEPS by MNEs. This is primarily because of the level of interconnectedness which exists — by attempting to increase their competitive positions, MNEs are effectively pricing local businesses outside of the market as they incur higher costs to produce the same end product. BEPS therefore has long term consequences both for the tax base of the relevant country as well as its broader commercial environment.

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<sup>128</sup>S Wagh “Globalisation: why are location savings not applicable to transfer pricing economics” available at <http://www.neurope.eu/kn/article/globalisation-why-are-location-savings-not-applicable-transfer-pricing-economics> [accessed 14/02/2014]

<sup>129</sup> Ibid

<sup>130</sup> OECD (2013), *Addressing Base Erosion and Profit Shifting*, OECD Publishing, available at <http://dx.doi.org/10.1787/9789264192744-en> [accessed 05/02/2014]

<sup>131</sup> OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing <http://dx.doi.org/10.1787/9789264202719-en> [accessed 05/02/2014]

<sup>132</sup> OECD *Addressing Base Erosion and Profit Shifting* op cit 130 pg 10

<sup>133</sup> Ibid pg 13

The treatment of intellectual property in the transfer pricing context is an important consideration which must be addressed more effectively to limit the exploitation of developing countries. In this regard, South Africa is slightly less vulnerable because of the inclusion of section 23I of the ITA which acts as a disincentive to developing, selling and subsequently relicensing intellectual property into the Republic. The OECD, through both its report and action plan, has acknowledged the importance of the treatment on intellectual property, and has reaffirmed its commitment to addressing the issue appropriately.

The current international tax standards have failed to keep pace with the rate of globalization. MNEs are able to earn significant profits from a developing country without having a corresponding taxable presence<sup>134</sup>. Unfortunately, the arm's length standard is unable to address these difficulties because of the slightly outdated international tax principles upon which it is based. However, notwithstanding the shortfalls associated with the arm's length principle, it remains an internationally accepted standard against which to judge transfer pricing transactions. Because of its near universal application, the arm's length principle has greatly contributed towards tax parity in the transfer pricing remains, and remains a preferable alternative to global formulary apportionment which is mechanistic and static.

## 2.7 A NON-ARM'S LENGTH APPROACH

Global formulary apportionment has been proffered as an alternative to the arm's length principle. This method has however not enjoyed widespread application and further, it has not displaced the arm's length approach as the accepted international standard. Global formulary apportionment is premised on the apportionment of profits based on a predetermined global formula<sup>135</sup>

Global formulary apportionment allocates profits to MNEs across various tax jurisdictions on the basis of a single formula. Profits would be allocated to a MNE on a consolidated basis<sup>136</sup>. This method therefore abandons the separate entity approach. As a result, global formulary apportionment does not have the flexibility to account for situations where a division of the MNE in one tax jurisdiction enjoys a profit while another division of the same MNE incurs losses in a different tax jurisdiction, as the profits are calculated on a consolidated basis.

<sup>134</sup> OECD *Addressing Base Erosion and Profit Shifting* op cit 130 pg 7

<sup>135</sup> OECD *Transfer Pricing Guidelines* op cit 5 at 1.18

<sup>136</sup> *Ibid* at 1.29

Supporters of global formulary apportionment advocated this method on the basis that it would substantially reduce compliance costs for taxpayers as in theory only one set of accounts would need to be compiled for the group<sup>137</sup>. Further, they contend that global formulary apportionment would be in keeping with economic realities and would provide greater economic and administrative certainty<sup>138</sup>.

Global formulary apportionment has been rejected by both the OECD and its member countries. Chapter I of the OECD Guidelines specifically excludes this method as a mechanism for calculating the transfer price on the grounds that it would *inter alia* result in double taxation. The OECD has further stated that one of the inherent difficulties with a formula based approach is that countries and taxpayers could potentially manipulate the formula by emphasising or disregarding certain aspects of the formula which would result in a benefit for the entity concerned. In addition, one of the biggest shortfalls of global formulary apportionment is that countries would have to agree on a specific formula. Failing such agreement MNEs could potentially be burdened with having to comply with different formulas in different tax jurisdictions<sup>139</sup>.

The advantage of using the arm's length principle is that it allows MNEs to select the appropriate transfer pricing method based on the information available and the nature of the transaction. This allows for considerable flexibility; with an approach which takes into account the specific controlled transaction as well as the surrounding economic environment. In contrast, global formulary apportionment would result in considerable compliance costs as information would have to be compiled and presented in respect of all the tax jurisdictions in which the MNE operates, taking into account the different currencies and government policies in relation thereto. Further, the mechanistic nature of global formulary apportionment cannot account for differences which naturally occur across different geographical markets.

The various disadvantages associated with the application of global formulary apportionment has resulted in its rejection<sup>140</sup> and dismissal by the OECD as an alternative to the arm's length principle which is able to provide greater flexibility in the calculation of the transfer price. The arm's length principle in contradistinction to global formulary apportionment, provides a uniform yet flexible

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<sup>137</sup> OECD *Transfer Pricing Guidelines* op cit 5 at at 1.20

<sup>138</sup> *Ibid* at 1.19

<sup>139</sup> *Ibid* at 1.24 to 1.25

<sup>140</sup> *Ibid* at 1.32

approach to the calculation and treatment of transfer pricing without becoming mechanistic in its application like global formulary apportionment.

## Chapter III

### 3. TRANSFER PRICING FROM A SOUTH AFRICAN PERSPECTIVE:

Transfer pricing legislation in South Africa is largely premised on the OECD Guidelines. The focus of Chapter III is on the regulation of transfer pricing in the South African context through the application of section 31 of the ITA. The emphasis in this chapter will be on the change occasioned by the Taxation Laws Amendment Bill 2011 (“**TLAB 2011**”) which resulted in the amendment to section 31 and the impact thereof on the taxpayer.

#### 3.1 BACKGROUND

Comprehensive transfer pricing and thin capitalisation regulations was achieved through section 31 (“**Old Section 31**”) of the ITA, which was implemented in South Africa as early as July 1995. In addition, SARS issued practice notes on the application of both transfer pricing and thin capitalisation.

Prior to the introduction of the Old Section 31, transfer pricing was primarily regulated through a combination of exchange control regulations and general anti-avoidance provisions contained in section 103(1) of the ITA. Exchange control regulations coupled with high customs duties on imported products served to prevent the export of capital from South Africa. However, the drafting of the wording of section 103(1) allowed taxpayers to circumvent the regime and bypass the applicable levy<sup>141</sup>.

Section 103(1) only operated to the extent that a transaction or arrangement was entered into “solely”<sup>142</sup> for the purposes of avoiding tax. If the proposed transaction or arrangement had an alternative purpose in addition to the avoidance of tax, the section would be rendered inoperable. In many instances, the reduction of liabilities in relation to exchange control and customs duty would provide the taxpayer with the requisite underlying business motive and thereby serve to circumvent the

<sup>141</sup>W Horak “Transfer Pricing: A South African Perspective” available at <https://www.itpa.org/wp-content/uploads/2012/07/horak.rtf> [visited 21/12/2012]

<sup>142</sup> Section 103(1) Income Tax Act No. 58 of 1962

application of section 103(1). In recognition of the inherent failures of section 103(1), and the ease with which it could be avoided, the Legislature enacted a specific anti-avoidance provision in the form of section 31, designed to counter transfer pricing abuses.

The Old Section 31 of the ITA was subsequently implemented to protect the South African tax base from erosion through transfer pricing manipulation. The section underwent a complete overhaul in April 2012 (“**Revised Section 31**”) to further eliminate arbitrages under the old wording of the section.

The Explanatory Memorandum to the Taxation Law Amendment Bill 2011 (“**Explanatory Memorandum TLAB 2011**”) states that the purpose of the amendment to section 31 of the ITA was *inter alia* to modernise South Africa’s transfer pricing regime and align it internationally accepted practice, as encapsulated in the OECD Guidelines<sup>143</sup>. The Explanatory Memorandum TLAB2011 further states that the reason for the amendment of the Old Section 31 was that the wording of the section created “structural problems and uncertainties”<sup>144</sup>. The previous version placed undue emphasis on the literal wording of the contract which allowed taxpayers to pursue artificial arguments based on the literal interpretation as opposed to the substance of the transaction. The amendment remedied this oversight by providing that the substance of the transaction must take precedence when evaluating whether it has complied with the transfer pricing principles as opposed to the literal terms of the specific transactions<sup>145</sup>.

In the 2013/2014 Strategic Plan<sup>146</sup>, SARS noted that, given the current global tax environment, multinational corporations are creating and implementing increasingly sophisticated tax avoidance and evasion schemes<sup>147</sup>. The 2013 OECD report on Base Erosion and Profit Shifting<sup>148</sup>, cited by SARS in the Strategic Plan, highlights the increasingly sophisticated techniques used by taxpayers to reduce their tax liability which include utilising sophisticated cross-border structures, transfer pricing, and intra-group transactions to minimise tax obligations in high tax jurisdictions.

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<sup>143</sup>Explanatory Memorandum to the Taxation Law Amendment Bill 2011, available at [www.sars.gov.za/AllDocs/LegalDoclib/Exp/Memo](http://www.sars.gov.za/AllDocs/LegalDoclib/Exp/Memo) [accessed 10/10/2013] at page 116

<sup>144</sup>Ibid pg 75

<sup>145</sup>Ibid pg 75

<sup>146</sup> SARS 2013/14-2017-18 Strategic Plan available at <http://www.sars.gov.za/AllDocs/SARSEntDoclib/Ent/SARS-Strat-10%20-%20SARS%20Strategic%20Plan%202013-14%20to%202017-18.pdf> [accessed 18/10/2013]

<sup>147</sup> SARS Strategic Plan op cit 146 pg 15at 3.3.4

<sup>148</sup>Explanatory Memorandum to the TLAB 2011 op cit 143 pg 76

The amendment resulted in a change of emphasis. Previously, accordingly to the Explanatory Memorandum TLAB 2011, the literal meaning of the terms of the transaction, operation, scheme or undertaking carried more weight than the substance of the overall transaction, operation, scheme or undertaking. The revised wording would take into account whether a *benefit* was achieved for either party to the connected transaction. Section 1 of the ITA defines a tax benefit as being “[...] *any avoidance, postponement or reduction of any liability for tax*”. The wide definition of a tax benefit results in the ability of SARS to adjust the terms of the transaction, operation, scheme or undertaking where either party, which is connected to the other as defined, has avoided, postponed or reduced its tax liability because of the non-arm’s length nature of the terms of the transaction, operation scheme or undertaking<sup>149</sup>.

The Explanatory Memorandum TLAB 2011 states that apart from emphasising the literal interpretation of the terms, excessive weight was placed on the “price” attributed to the transaction as opposed to whether a profit was achieved. This approach was not in keeping with that adopted in the tax treaties<sup>150</sup>. Accordingly, the amendment of the Old Section 31 was intended to align South Africa’s transfer pricing framework with that contained in the OECD Guidelines.

The above view taken by SARS in the Explanatory Memorandum TLAB 2011 is understandable insofar as the wording of the Old Section 31 unjustifiably placed undue emphasis on the terms of the particular transaction as opposed to the overarching profit arrangement achieved, the subsequent amendment significantly increased the taxpayer’s compliance burden. Whilst the Revised Section 31 is more aggressive in its protection of the South African tax base as it targets the profits as opposed to the price of a given transaction, it has also created difficulties for the taxpayer which is now required to show that the arrangement viewed in its entirety complies with the provisions of the Revised Section 31. While this limits the potential for profit manipulation and other avoidance arrangement which may be exploited by some taxpayers, it will also create an increased financial and administrative burden for all taxpayers engaged in a transfer pricing analysis in light of the reverse onus of proof created by the Revised Section 31.

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<sup>149</sup>Explanatory Memorandum to the TLAB 2011 op cit 143 pg 76

<sup>150</sup>Ibid pg 75

### 3.2 THE TREATMENT OF TRANSFER PRICING UNDER THE OLD SECTION 31

Transfer pricing was included in South African tax legislation as early as July 1995. Under the Old Section 31, transfer pricing and thin capitalisation was dealt with separately under sections 31(2) and 31(3) respectively<sup>151</sup>, while the relevant definitions of the concept were contained in section 31(1).

The Old Section 31 provided the Commissioner of SARS (“**Commissioner**”) with a discretionary power, as evidenced by the use of the word “may” in the proviso to section 31(2), to adjust the taxable income of the taxpayer where the transaction between connected parties had not been concluded in accordance with the arm’s length principle<sup>152</sup>. The excessive portion of the consideration was deemed to be a dividend and, in terms of section 64(C)(2)(e) of the ITA, subject to Secondary Tax on Companies (“**STC**”) at a rate of 10%<sup>153</sup>.

The purpose of the deemed dividend provisions was to account for the removal of value from South Africa through transfer mispricing<sup>154</sup>. The wide drafting of the definitions attributed to “goods”<sup>155</sup>, “services”<sup>156</sup> and “connected persons”<sup>157</sup> ensured that the Commissioner was able to adjust prices in respect of both intra-group transactions and those entered into between natural persons<sup>158</sup>. By

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<sup>151</sup> Section 31(2) and 31(3) of the Income Tax Act ; M Honiball and T Montsho “Changes to Transfer Pricing Legislation” *Without Prejudice* Nov 2010 pg 14

<sup>152</sup> C Wiesener “2011 Transfer Pricing Proposals- Will We Pay Double Tax?” KPMG Tax talk magazine page 17

<sup>153</sup> J Brodbeck and C Gers “South Africa: The new South African transfer pricing rules may be risky” *International Tax Review* pg 1; L Olivier and M Honiball *A South African Perspective* op cit 15 pg 623; the STC rate was 10% in 2011

<sup>154</sup> Explanatory Memorandum to the TLAB 2011 op cit 143

<sup>155</sup> In section 31(1) of the Income Tax Act “goods” is defined including “any corporate moveable thing, fixed property and any real right in any such thing or fixed property”.

<sup>156</sup> Section 31(1) of the Income Tax Act defined “services” to include “anything done or to be done, including, without limiting the generality of the foregoing—

(a) the granting, assignment, cession or surrender of any right, benefit or privilege;

(b) the making available of any facility or advantage;

(c) the granting of financial assistance, including a loan, advance or debt, and the provision of any security or guarantee;

(d) the performance of any work;

(e) an agreement of insurance; or

(f) the conferring of rights to or the use of incorporeal property.”

<sup>157</sup> Section 1 of the Income Tax Act read together with the Old Section 31(1) provided a very wide definition of “connected person”. Essentially the wording provided the Commissioner with the power to adjust the transfer price in respect of both intra-group transactions and transactions concluded between individuals. A company (which is broadly defined) will be a connected person for the purposes of the definition in relation to its holding company/ its subsidiary/ or any other person that is not a company and holds at least 20% of the equity capital or voting rights. The definition of connected person in relation to a natural person is comprehensively dealt with in the definition. The underlying element in the definition of “connected person” in respect to both natural and juristic persons is a common element of control. Please see Practice Note 7 at paragraph 1.4; Section 1 of the Income Tax Act; and L Olivier, M Honiball “International Tax A South African Perspective” op cit 15 pg 625-626

<sup>158</sup> L Olivier, M Honiball “International Tax A South African Perspective” op cit 15 pg 624-625

confining the application of the Old Section 31 to “international agreement[s]”, the Legislature ensured that the section would only operate in respect of cross-border transactions.

Under the Old Section 31, the onus was on the Commissioner to show that the transaction, operations scheme or undertaking did not comply with the arm’s length basis. This required the Commissioner to perform the transfer pricing analysis. The position under the Old Section 31 created considerably less compliance challenges for the taxpayer. Where the Commissioner was satisfied that the transaction, operation or scheme violated the provisions of the Old Section 31 he was permitted to adjust the consideration payable. The Old Section 31 did not provide any scope for voluntary transfer pricing adjustments by the taxpayer<sup>159</sup>.

### 3.2.1 SARS INTERPRETATION NOTE 7

SARS issued Interpretation Note No. 7<sup>160</sup> on 6 August 1999 to assist with the interpretation of the Old Section 31. While the various interpretation notes issued by SARS provide guidance on the mechanisms and application of the section, they remain the Commissioner’s interpretation of how the rules ought to be applied in practice and therefore do not constitute binding rules or guidelines. Each transfer pricing case is decided based on the individual merits in light of the particular business strategies and commercial objectives of the taxpayer<sup>161</sup>.

Interpretation Note 7 confirmed the status of the OECD Guidelines as an influential document which reflected unanimous undertakings by member countries for the implementation of transfer pricing standards<sup>162</sup>. The Interpretation Note acknowledges the OECD Guidelines as an important and influential source of transfer pricing, notwithstanding South Africa not being a member state of the OECD, in the light of the relevant importance accorded to the OECD Guidelines<sup>163</sup>. In addition, it provides that the OECD Guidelines are to be followed in the absence of specific instructions to the

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<sup>159</sup> J Brodbeck, C Gers “South Africa: The new South African transfer pricing rules may be risky” op cit 153

<sup>160</sup> Interpretation Note No. 7 19 9Determination of the Taxable Income of Certain Persons from Internal Transactions

<sup>161</sup> SARS Practice Note 7 at 3.1

<sup>162</sup> Ibid at 3.2.1

<sup>163</sup> Ibid at 3.2.1

contrary from either Interpretation Note 7 or the tax treaties entered into between South Africa and the relevant country<sup>164</sup>.

Interpretation Note 7 accepts the methods set out in the OECD Guidelines for determining an arm's length price, namely the comparable uncontrolled price method, the resale price method, the cost-plus method, the profit split method and the transactional net margin method. The practice note analyses each of these methods, indicating when it is appropriate to apply such methods them and pointing out the practical problems arising from the application of each of the particular methods. The CUP method is cited as being the preferred methodology “as it looks directly to the relevant product or service and is relatively insensitive to the functions performed by the entities being compared”<sup>165</sup>. It must be noted that Interpretation Note 7 applied to the application of the Old Section 31. While it may still be relevant in the context of the amended section 31, it does require updating in order for it to retain its commercial relevance.

### **3.3 REVISED SECTION 31**

Unlike the Old Section 31, the Revised Section 31 differs from its predecessor insofar as it imposes an obligation, as opposed to the discretion provided for under the previous section 31(2), to adjust the transfer price where the price is not indicative of an arm's length.

#### **3.3.1 DEFINITIONS**

Section 31(1) contains the definitions applicable to the section. The definition of “connected person” and the inclusion of “affected transaction” are particularly important as the provisions of the Revised Section 31 and the powers accorded to the Commissioner are triggered only in respect of an affected transaction.

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<sup>164</sup> SARS Practice Note 7 at 3.2.3

<sup>165</sup> Ibid at 9.3.4

### 3.3.1.1 AFFECTED TRANSACTION

Section 31(1) defines an affected transaction as being:

*“any transaction, operation, scheme, agreement or understanding where-*

*(a) that transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected between or for the benefit of either or both*

*(i) (aa) a person that is a resident; and*

*(bb) any other person that is not a resident;*

*(ii) (aa) a person that is not a resident; and*

*(bb) any other person that is not a resident that has a permanent establishment in the Republic to which the transaction, operation, scheme, agreement or understanding relates;*

*(iii) (aa) a person that is a resident; and*

*(bb) any other person that is a resident that has a permanent establishment outside the Republic to which the transaction, operation, scheme, agreement or understanding relates; or*

*(iv) (aa) a person that is not a resident; and*

*(bb) any other person that is a controlled foreign company in relation to any resident,*

*and those persons are connected persons in relation to one another; and*

*(b) any term or condition of that transaction, operation, scheme, agreement or understanding is different from any term or condition that would have existed had those persons been independent persons dealing at arm's length”.*

The inclusion of affected transactions in the Revised Section 31(1) has considerably widened the scope of its application, given the broad construction of the definition<sup>166</sup>. The definition of affected transaction read together with section 31(2) simply requires that a transaction be concluded on terms which would not have been present had the parties been dealing in accordance with the arm's length principle<sup>167</sup>. The transaction under review could have been entered into directly or indirectly, for the benefit of either i) a resident and a non-resident; ii) a non-resident and another non-resident with PE situated in the Republic; and iii) a resident together with another resident which has a PE situated outside of Republic to which the transaction relates; or iv) a non-resident and a controlled foreign company as defined.

The new rules and the inclusion of the definition of affected transaction change the focus of section 31 from one which previously focused on the price of the transaction to one which emphasises whether a tax benefit was achieved by either connected party. The wording of the old section 31(2)(c)<sup>168</sup> only permitted the Commissioner power to adjust the transaction for the purposes of calculating the taxable income to the extent that the price of the transaction was less or greater than what it could be expected to fetch in an arm's length transaction.

The shift in focus from the "supply of goods and services" to "transaction, operation, scheme, agreement or understanding" has negated the need for the Commissioner to identify a particular transaction for the supply of goods or services<sup>169</sup>. This permits the Commissioner to focus on the economic substance of the transaction as opposed to the specific wording of the terms and conditions of the agreement.

The inclusion of affected transaction in section 31(1) also means that MNEs are no longer able to engage in benchmarking exercises. The entire transaction must comply with the arm's length principle as opposed to a mere facet thereof. Consequently, the amendment reverses the burden on taxpayer as both parties have to show that the transfer price, in light of the functions performed and risks undertaken, accord with the arm's length principle<sup>170</sup>.

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<sup>166</sup> J Brodbeck, C Gers "South Africa: The new South African transfer pricing rules may be risky" op cit 153

<sup>167</sup> Brodbeck, C Gers "South Africa: The new South African transfer pricing rules may be risky" op cit 153; section 31(2)(b)(i) and (ii) of the Income Tax Act

<sup>168</sup> Section 31(2) substituted by section 44(1)(d) Act No 35 of 2007, deemed to have come into operation on 1 October 2007

<sup>169</sup> J Brodbeck "South Africa a new chapter in transfer pricing" *International Transfer Pricing Journal* Sep/Oct 2010

<sup>170</sup> J Brodbeck, C Gers "South Africa: The new South African transfer pricing rules may be risky" op cit 153

### 3.3.1.2 CONNECTED PERSON

The second important definition is that of “connected person”. The meaning and ambit of connected person is contained in section 1 of the ITA, read together with section 31(4) and SARS’ interpretation note<sup>171</sup> 67 (“**Interpretation Note 67**”). Section 1 of the ITA provides that a connected person is:

- “(a) *in relation to a natural person-*
  - (i) *any relative; and*
  - (ii) *any trust (other than a portfolio of a collective investment scheme in securities) of which such natural person or such relative is a beneficiary;*
- (b) *in relation to a trust (other than a portfolio of a collective investment scheme in securities)-*
  - (i) *any beneficiary of such trust; and*
  - (ii) *any connected person in relation to such beneficiary;*
- (bA) *in relation to a connected person in relation to a trust (other than a collective investment scheme in property shares managed or carried on by any company registered as a manager under section 42 of the Collective Investment Schemes Control Act, 2002, for purposes of Part V of that Act and other than a portfolio of a collective investment scheme in securities), includes any other person who is a connected person in relation to such trust;*
- (c) *in relation to a member of any partnership-*
  - (i) *any other member; and*
  - (ii) *any connected person in relation to any member of such partnership;*
- (d) *in relation to a company-*

<sup>171</sup> SARS Interpretation Note No. 67 (2012) Connected Persons

- (i) *any other company that would be part of the same group of companies as that company if the expression "at least 70% of the equity shares of" in paragraphs (a) and (b) of the definition of "group of companies" in this section were replaced by the expression "more than 50% of the equity shares of or voting rights in"*
- (ii) *deleted;*
- (iii) *deleted;*
- (iv) *any person, other than a company as defined in section 1 of the Companies Act, 2008(Act No. 71 of 2008), who individually or jointly with any connected person in relation to himself, holds, directly or indirectly, at least 20 per cent of*
  - (aa) *the equity shares in the company, or*
  - (bb) *the voting rights in the company;*
- (v) *any other company if at least 20 per cent of the equity shares of or voting rights in the company is held by the other company, and no shareholder holds the majority voting rights in the company;*
- (vA) *any other company if such other company is managed or controlled by-*
  - (aa) *any person who or which is a connected person in relation to such company; or*
  - (bb) *any person who or which is a connected person in relation to a person contemplated in item (aa), and*
- (vi) *where such company is a close corporation-*
  - (aa) *any member;*

- (bb) any relative of such member or any trust (other than a portfolio of a collective investment scheme in securities) which is a connected person in relation to such member; and*
- (cc) any other close corporation or company which is a connected person in relation to-*
  - (i) any member contemplated in item (aa); or*
  - (ii) the relative or trust contemplated in item (bb); and*
- (e) in relation to any person who is a connected person in relation to any other person under the foregoing provisions of this definition, such other person:*

*Provided that for the purposes of this definition, a company includes a portfolio of a collective scheme in securities"*

Section 31(4) further restricts the meaning of connected person in relation to a company by disregarding paragraph (d)(v) of the definition. As a result, when performing the connected person enquiry in the context of a company involved in an affected transaction in terms of section 31(4), it is not necessary for the shareholder concerned to hold the majority voting rights in the company<sup>172</sup>.

However, it is important to note that the definition of connected person in the context of the Revised Section 31 is not especially problematic compared with the amendments occasioned to other aspects of the section, as the term has always been defined fairly comprehensively to ensure that all of the correct relationships targeted by the provisions are covered.

### **3.3.1.3 TAX BENEFIT**

The inclusion of tax benefit in the Revised Section 31 will have far reaching consequences for the taxpayer. A tax benefit is defined in section 1 of the ITA as including “any avoidance, postponement

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<sup>172</sup> Section 31(4) Income Tax Act

or reduction of any liability for tax”. Similarly, tax is widely defined as meaning a “tax or penalty imposed”<sup>173</sup> in terms of the ITA.

Where a transaction concluded between connected persons results or will result in a tax benefit, the Commissioner is authorised and obliged under section 31(2) to adjust the taxable income or tax payable by the relevant party to ensure that the benefit is effectively eliminated. The inclusion of a tax benefit increases the application and ambit of the Revised Section 31. Previously the provisions only applied to the extent that there was a price difference; in contrast they will now find application in any instance where the taxpayer has avoided, postponed or reduced its liability to pay tax as a result of the transaction.

The provision of a tax benefit is included in other sections of the ITA, such as in the context of the general anti avoidance rules. Based on the case law<sup>174</sup>, the reduction, postponement or avoidance of tax does not necessarily only refer to an existing liability, but also includes a foreseeable obligation<sup>175</sup>.

Certain critics have indicated that the difficulty with the tax benefit rhetoric is that it places the onus on the Commissioner to show that income, but for the transaction, would otherwise have accrued to the taxpayer. This necessarily entails that the Commissioner identify the income and the amount thereof by which the party’s taxable income must be adjusted<sup>176</sup>.

### 3.3.1.4 FINANCIAL ASSISTANCE

“Financial assistance<sup>177</sup> includes the provision of any—

- a) debt; or
- b) security or guarantee”.

<sup>173</sup> Definition of “tax” as contained in section 1 of the Income Tax Act

<sup>174</sup> CIR v King 1947 (2) SA 196 (A)

<sup>175</sup> J Brodbeck “South Africa a new chapter in transfer pricing” op cit 169

<sup>176</sup> J Brodbeck “South Africa a new chapter in transfer pricing” op cit 169

<sup>177</sup> The definition of financial assistance has been amended by Taxation Law Amendment Act of 2013 with effect from 1 April 2014 to read:

“Financial assistance includes any—

- a) debt; or
- b) security or guarantee”.

Financial assistance as defined has been extended by the Revised Section 31. Under the old wording, financial assistance was included in the meaning of “services” to mean “the granting of financial assistance, including a loan, advance or debt, and the provision of any security or guarantee”. The new construction of financial assistance has widened as it now also applies in respect of thin capitalisation.

This means that the provision of funding to a taxpayer must comply with the transfer pricing rules as contained in section 31 viewed in its entirety.

### **3.3.2 AMBIT AND IMPACT OF THE REVISED SECTION 31**

The application of the Revised Section 31 is automatic where a transaction, operation, scheme, agreement or understanding as contemplated under the concept of an "affected transaction" exists. One of the fundamental differences between the Old Section 31 is the duty imposed on the Commissioner to effect a primary and possibly secondary adjustment to the taxable income of, or tax payable by, the connected party. The Revised Section 31(2) states that the Commissioner “must” recalculate the taxable income or tax payable as if the benefit had not existed; peremptory wording which imposes an obligation on the Commissioner<sup>178</sup>. In contrast, the Old Section 31(2) stated that the Commissioner “may” adjust the consideration in the determination of the taxable income; permissive wording which granted the Commissioner a discretion under the Old Section 31.

The primary adjustment refers to the adjustments effected to the “allocation of taxable profits between a South African taxpayer and its foreign connected person to reflect an arm’s length price. In addition, a secondary adjustment achieves the result that the excess profits represented by the primary adjustment are treated consistently with the position had the original transaction been entered into at arm’s length”<sup>179</sup>. The secondary adjustment allows the Commissioner to re-characterise the excessive portion of the transaction and treat it as if had been concluded on an arm’s length basis. For example, in the context of thin capitalisation, the proportion of funding deemed to be excessive would be subject to a secondary adjustment in terms whereof the Commissioner would re-characterize the difference as a loan subject to interest at the arm’s length rate. The inclusion of a secondary adjustment mechanism

<sup>178</sup>Section 31(2) proviso of the Income Tax Act

<sup>179</sup>C Wiesener “2011 Transfer Pricing Proposals- Will We Pay Double Tax?” op cit 152 pg 17

in the Revised Section 31 provides the Commissioner with means to eliminate the tax benefit achieved and adjust the income of the taxpayer to reflect the removal of the tax benefit (unlike under the Old Section 31 where only a primary adjustment was permitted).

The taxpayer's taxable income under the South African transfer pricing regime will thus potentially be subject to both a primary and secondary adjustment. The primary adjustment<sup>180</sup>, provided for in the proviso to Revised Section 31(2), effectively neutralises the tax benefit achieved by the transaction<sup>181</sup>.

The purpose of the primary adjustment is to ensure the appropriate allocation of profits<sup>182</sup> for the purposes of calculating tax. However, under the Old Section 31, the primary adjustment was inadequate as it only accounted for taxable income as opposed to actual income<sup>183</sup>, which resulted in a tax arbitrage as the Old Section 31 could not account for any differences between taxable and actual income.

However, it must be noted that the primary adjustment afforded under section 31(2) of the Revised Section 31 only applies in respect of profits obtained from a South African source or attributable to a South African PE. South Africa adopts a source based approach to the taxation of non-residents. To the extent that income is earned by a non-resident which is attributable to a South African source, it can only be taxed in proportion to the amount attributed to the PE.

The primary adjustment, authorised in terms of the Revised Section 31(2), only applies where there has been a "tax benefit". To the extent that there is a difference between the initial transfer price and the adjusted amount, the Commissioner is empowered to impose a secondary adjustment under the Revised Section 31(3). The Revised Section 31(2) empowers the Commissioner to adjust the transfer price, with the difference constituting a deemed loan which would attract interest at an arm's length rate. The adjusted or disallowed amount will constitute a deemed loan advanced to the other person, generally by a resident to the non-resident counterparty. Interest will be deemed to accrue to the resident in respect of such deemed loan until it is settled unless the loan is repaid in full within the same tax year<sup>184</sup>. South African residents are taxed on their world wide income, while non-residents

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<sup>180</sup> Section 31(2) of the Income Tax Act

<sup>181</sup> J Brodbeck, C Gers "South Africa: The new South African transfer pricing rules may be risk" op cit 153 ; C Wiesener "2011 Transfer Pricing Proposals: Secondary adjustments will we pay double tax?" op cit 152 pg 17; section 31(2) of the Income Tax Act

<sup>182</sup> Explanatory Memorandum to the TLAB 2011 op cit 143 pg 116

<sup>183</sup> Ibid pg 116

<sup>184</sup> Explanatory Memorandum to the TLAB 2011 op cit pg 117

are only taxed on their South African income to the extent that it is attributable to a South African source. As a result the Revised Section 31(2) would presumably only apply to loans made by a South African resident to a non-resident.

The Revised Section 31 places an obligation on the taxpayer to show that the transaction, operation or scheme complies with the transfer pricing rules, and also obliges that taxpayer to effect the transfer pricing adjustment in its returns<sup>185</sup>. The shift in onus has created greater burden for the taxpayer in terms of complying with the provisions of the Revised Section 31. Previously, under the Old Section 31 the transfer pricing analysis was performed by the Commissioner who was obliged to prove that the consideration payable for the transaction, operation or scheme was not in accordance with an arm's length price. The position has subsequently changed under the Revised Section 31, the taxpayer is now required to compile the necessary documentation to substantiate that the transaction accords with the arm's length price.

Accordingly, the treatment of the primary transfer adjustment has changed under the Revised Section 31, which provides that it will constitute a deemed loan<sup>186</sup> which will attract interest at an arm's length rate, whereas under section 31(2) of the Old Section 31 the transfer pricing adjustment was treated as a deemed dividend and subject to STC at the applicable rate<sup>187</sup>, on the basis that the deemed dividend accounted for the removal of value occasioned by the unjustified transfer price<sup>188</sup>.

The secondary adjustment<sup>189</sup> under the Revised Section 31 results in the adjusted loan constituting an affected transaction which is subject to the arm's length principle. Whilst the primary adjustment reallocates the taxable profits, the secondary adjustment achieves the result that the difference between the adjusted and initial amount is treated as if the initial transaction had been concluded on an arm's length basis<sup>190</sup>.

Under the Old Section 31, undue emphasis was placed on the literal wording of the transaction, operation or scheme. This allowed taxpayers to circumvent the application of the section provided that the individual transaction did not violate the transfer pricing rules contained in the Old Section 31. The position in this regard has changed under the Revised Section 31 which requires an evaluation of the

<sup>185</sup> J Brodbeck, C Gers "South Africa: The new South African transfer pricing rules may be risky" op cit 153

<sup>186</sup> Section 31(3) Income Tax Act

<sup>187</sup> J Brodbeck, C Gers "South Africa: The new South African transfer pricing rules may be risky" op cit 153

<sup>188</sup> Explanatory Memorandum to the TLAB 2011 op cit 143 pg 116

<sup>189</sup> Provided for in section 31(3) Income tax Act

<sup>190</sup> C Wiesener "2011 Transfer Pricing Proposals: Secondary adjustments will we pay double tax?" op cit 152 pg 17

entire arrangement as opposed to one facet of the transaction. The Revised Section places less emphasis on the literal interpretation of the terms and conditions of the transaction and places more emphasis on the substance of the transaction. To the extent that the terms and conditions of the transaction, operations or undertaking viewed in its entirety violates the provisions of the Revised Section 31, the Commissioner is obliged to adjust the consideration payable. This applied even if the particular of the specific transaction is innocuous. The shift in focus has imposed a greater compliance burden on the taxpayer which will now be required to show that the overall arrangement concluded between connected parties complies with the provision of the Revised Section 31.

The consequence of the application of Revised Section 31 is that the transfer price is adjusted to either allocate more income or capital proceeds to a taxpayer or to disallow the excessive portion of an expense.

The objective of the Revised Section 31 is to ensure that a South African resident taxpayer is placed in a position *sans* price manipulation. Consequently the transaction is treated as if the taxpayer simply advanced the adjusted amount to the non-resident as an interest bearing loan<sup>191</sup>. This ensures tax neutrality from a South African perspective.

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<sup>191</sup> Section 31(3) ITA

## CHAPTER IV

### 4. THIN CAPITALISATION

Thin capitalisation refers to the funding of a business with a disproportionate degree of debt in relation to equity, which enables the foreign investor to receive interest income<sup>192</sup>, and confers on the company the benefit of deducting the interest paid (relative to the non-deductibility of dividends paid on equity capital). Thin capitalisation measures are designed to limit the deduction of interest on excessive debt funding structures. Prior to the Revised Section 31, thin capitalisation was governed by the Old Section 31(3) read together with SARS Practice Note 2<sup>193</sup>.

The significance of debt or equity funding is in the tax treatment of the different funding structures. With the latter, interest payments incurred in the production of income by a person carrying on a trade are deductible. In contrast, the distribution of profits, either in the form of dividends or returns of capital, is not permitted as tax deductions.

The previous thin capitalisation regime (the Old Section 31(3)) allowed for a 3:1 debt equity safe harbour ratio. Provided that the taxpayer's funding did not exceed the ratio, the structure would not be subject to review by SARS. The subsequent amendment of section the Old Section 31 dramatically altered this position as the Revised Section 31 dispensed with the safe harbour provisions and required that the funding structure be tested against the arm's length principle as contained in the Revised Section 31.

The shift from the fixed capital test to determining an appropriate funding structure based on the arm's length principle has significant commercial implications for both resident and non-resident entities. The repeal of the safe harbour provisions is problematic insofar as it creates commercial uncertainty. The application of the arm's length principle to funding structures in practice is difficult as there are various considerations which inform the terms of the loan; inherent therein is the relationship between the borrower and the lender. The arm's length principle cannot account for this as it necessarily requires that the relationship between the connected parties be disregarded when evaluating the structure.

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<sup>192</sup> Interest income is currently exempt, however a withholding tax on interest will come into effect on 1 January 2015

<sup>193</sup> Income Tax: Determination of taxable income where financial assistance has been granted by a non-resident of the republic to a resident of the republic, dated 14 May 1996

Under the Old Section 31(3), read together with SARS Interpretation Note 2, a 3:1 loan funding to equity ratio was regarded as acceptable. The test focused on the fixed capital<sup>194</sup> of the taxpayer in relation to its debt. However, under Revised Section 31, the focus shifted away from the fixed capital to whether the terms and conditions upon which it was granted conformed with the arm's length principle and the provisions of the Revised Section 31 viewed in its entirety.

The amended thin capitalisation rules as contained in the Revised Section 31 effectively broadened the scope of thin capitalisation rules to include financial assistance granted by a non-resident to a PE in the Republic or any other person that is not a South African resident<sup>195</sup>.

The increased attention towards thin capitalisation rules is not unique to South Africa. In this regard it is not surprising that SARS has considerably revised its thin capitalisation regime. However, the implication of doing so is commercial uncertainty, particularly in light of the removal of the safe harbour provisions.

SARS has recently produced a draft interpretation note to deal with the changes occasioned to the thin capitalisation regime. In terms of the draft note, certain factors will be taken into account when evaluating the funding structure. The 3:1 guideline will no longer apply, however each funding structure would have to be considered taking into account all relevant factors, such as the financial strategy of the business and the use of comparable data.

#### **4.1 THE OLD SECTION 31(3)**

The granting of financial assistance by a non-resident to a South African resident was previously regulated by two tax adjustment mechanisms contained in the Old Section 31(3)<sup>196</sup>. Financial assistance was defined in relation to services as “including a loan, advance or debt and the provision of security or guarantee”. The first related to the transfer pricing mechanism which applies to the interest rate charged, while the second related to the thin capitalisation adjustment mechanism which operated in respect of the debt in relation to equity<sup>197</sup>.

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<sup>194</sup> Section 31(3) of the ITA as at the 2011 Tax year

<sup>195</sup> J Brodbeck “South Africa a new chapter in transfer pricing” *International Transfer Pricing Journal* Sep/Oct 2010

<sup>196</sup> L Olivier, M Honiball “International Tax: A South African Perspective 2011” op cit 15 pg 651

<sup>197</sup> Ibid pg 651

The Old Section 31(2) empowered the Commissioner to recalculate the price paid for goods and services, it did not enable the Commissioner to re-characterise the transaction<sup>198</sup>. The inclusion of the Old Section 31(3) was to counter thin capitalisation transactions concluded between connected parties<sup>199</sup>.

Where “financial assistance” is granted by a non-resident to a resident connected person, the Old Section 31(3) allowed the Commissioner to adjust the taxable income if he deemed it excessive. Interpretation Note 2 restricted the meaning of “financial assistance” to interest bearing financial assistance for thin capitalisation adjustments<sup>200</sup>. If the interest bearing financial assistance fell within the safe harbour provisions, the Commissioner was not permitted to adjust the consideration in the hands of the resident. If the loan, advance or debt was denominated in South African currency, the interest rate payable was capped at prime plus 2%, while foreign denominated loans could not exceed the inter-bank rate plus 4% in order to fall within the ambit of the safe harbour provisions<sup>201</sup>.

Section 31(3) of the Old Section 31 contained the specific thin capitalisation provisions. To the extent that the Commissioner was satisfied that the financial assistance granted by a non-resident to a resident was excessive in relation to the fixed capital, the Commissioner was allowed to disallow the deduction of any interest in relation to the excessive portion<sup>202</sup>.

The exercise of the Commissioner’s discretion was subject to the Commissioner being satisfied that the financial assistance granted was excessive. Notwithstanding a finding that the assistance was excessive within the context of section 31(3) of the Old Section 31, the Commissioner was still able to allow the deduction provided that the taxpayer could justify the increased financial assistance.

To the extent that the assistance provided was deemed to be excessive, the excessive portion would constitute a deemed dividend and would be subject to STC at the applicable rate in accordance with section 64C93)(e) of the ITA.

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<sup>198</sup> Lynette Olivier and Michael Honiball “International Tax: A South African Perspective 2011” Chapter 21: Transfer Pricing L Olivier, M Honiball “International Tax: A South African Perspective 2011” op cit 15 pg 651; section 31(3) of the Income Tax Act as it read during the 2011 tax year

<sup>199</sup>SARS Interpretation Note 2 at para 3

<sup>200</sup>Ibid at para 1.2

<sup>201</sup>Ibid at para 2.2

<sup>202</sup> Section 31(3) as applicable for the 2011 tax year and SARS Interpretation Note 2 para 3

## 4.2 DRAFT INTERPRETATION NOTE 2

The Revised Section 31 rendered Interpretation Note 2 and its exposition on the treatment of thin capitalisation obsolete. Consequently, the provision of any financial assistance as defined on or after 1 April 2012 now has to comply with the arm's length principle as contained in the Revised Section 31.

Presumably, one of the reasons for broadening the thin capitalisation provisions is to include deductions in respect of indirect funding, such as intra-group transactions supplied either directly or indirectly by non-resident connected persons, within the ambit of Revised Section 31. The funding of a South African resident with excessive intra-group loans, back-to-back financing or intra-group-guarantees has significant implications for the country's tax base because of the deductibility of excessive interest expenditure<sup>203</sup>. Under the Revised Section 31, these transactions would be subject to a primary, and potentially secondary, adjustment if the funding was not provided on an arm's length basis.

Following the 2012 amendment, thin capitalisation is now dealt with under the general transfer pricing provisions of the Revised Section 31(2) and is no longer provided for in a separate sub-section. One of the most significant changes occasioned by the amendment is the shift in onus. Previously, the Commissioner had to show that the funding structure was contrary to the Old Section 31(3), under the Revised Section 31, the taxpayer is obliged to determine the acceptable amount in accordance with the arm's length principle<sup>204</sup>.

One of the more commercially significant changes occasioned by the 2012 amendment relates to the removal of the safe harbour provisions. Previously debt to equity funding falling within the 3:1 ratio would be immune from adjustments. However, with the new requirement that the funding structure comply with the section 31(2) of the Revised Section 31, taxpayers no longer have clear parameters within which to locate their transactions. The draft interpretation note proposes certain risk factors<sup>205</sup> which SARS will use when evaluating if the taxpayer are thinly capitalised. These factors include:

- the extent of the interest bearing debt and whether it can be serviced without external assistance;

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<sup>203</sup> Draft Interpretation Note 2 pg 3

<sup>204</sup> Ibid pg 4

<sup>205</sup> SARS Interpretation Note 2, pg 11

- the lending terms and whether they have been concluded on an arm's length basis; and
- the repayment terms and whether they would have existed in the same form had the transaction been concluded between independent parties.

It is submitted that the changes required by SARS have increased the complexity and cost associated with complying with transfer pricing provisions. The requirement that the taxpayer's funding structure comply with the Revised Section 31, and more particularly the arm's length principle, have created commercial uncertainty and instability. Often, inter-company loans are concluded on terms which would not ordinarily exist between independent parties, such as providing the target entity with a sabbatical from interest payments until it becomes profitable. The old thin capitalisation treatment could and did account for this to the extent that the structure would not be disallowed provided that the interest rate and debt to fixed capital ratio did not exceed the prescribed safe harbour thresholds. The Revised Section 31 cannot account for this as it requires that the terms be the same as that concluded between independent parties.

Under the Revised Section 31, PEs will be viewed as separate enterprises and will be required to comply with the same requirements as South African subsidiaries<sup>206</sup>. However, the position is less stringent for headquarter companies where the financial assistance granted by a non-resident is applied directly to a foreign company in which the headquarter company holds directly or indirectly at least 10%; or where the headquarter company holds directly or indirectly at least 10% of the equity shares in the foreign company to which the financial assistance is supplied<sup>207</sup>.

With the shift in onus, the taxpayer is now required to calculate and demonstrate that the structure accords with the arm's length principle. Previously, the Commissioner had to show that the taxpayer was thinly capitalised. This change in responsibility has significant financial and administrative implications for the taxpayer. The taxpayer, under the draft interpretation note, is required to obtain comparable qualitative and quantitative factors in support of the lending decision<sup>208</sup>. Apart from the monetary implications, this imposes practical difficulties for the taxpayer as there may not be sufficient third party information available against which to judge the structure. To the extent that the

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<sup>206</sup>SARS Interpretation Note 2 pg 13

<sup>207</sup>SARS Interpretation Note 2 pg 1; section 31(5) of the Income Tax Act

<sup>208</sup>Draft Interpretation Note 2 pg 8

structure does not comply with the Revised Section 31(2), the excessive portion will be re-characterised as a deemed loan and will be subject to interest at an arm's length rate.

The new thin capitalisation rules require that the taxpayer determine the amount it would have been able to borrow in the open market as well as the interest rate which would have been payable. Practically speaking this is a difficult endeavour as third party funders engage in a multi-faceted inquiry when determining the extent of financial assistance available to the taxpayer. The revised thin capitalisation rules, which require that the financial assistance comply with the arm's length principle in the same manner as any other transaction, operation or scheme, fails to take cognisance of the commercial realities and the nature of financial assistance. It is posited that the willingness of a lender to fund a structure is not determined in isolation, but with specific regard to the individual circumstances of the taxpayer. The requirement that the structure be analysed in accordance with an arm's length principle therefore ignores commercial realities.

## CHAPTER V

### 5. CONCLUSION

The international tax system has not kept abreast with business realities and technological advancements which allow MNEs to transact in a country without having a taxable presence. Notwithstanding this, the arm's length principle remains the internationally accepted standard against which transaction concluded between connected parties are assessed.

As indicated in chapters III and IV above, the Revised Section 31 considerably increases the compliance burden on taxpayers perform transfer pricing analyses. Transfer pricing has in recent years received increased attention and will continue to attract the spotlight, particularly in the developing country context.

In a recent briefing note published by SARS<sup>209</sup>, SARS indicated that in the 2012/2013 year of assessment, it had investigated and audited 16 cases of transfer pricing manipulation with a combined audit worth of approximately R3.2 billion, with settlement resulting in approximately R650 million worth of collections. In the subsequent 2013/2014 year of assessment, the note referenced particular sectors, such as mining and pharmaceuticals, which would be subjected to careful scrutiny going forward to ensure that affected transactions are correctly priced<sup>210</sup>. Given the significant amounts attached to the transfer pricing audits<sup>211</sup>, coupled with the fiscal instability caused by base erosion, transfer pricing is going to become an increasingly regulated sphere of international tax. As evidenced by the aforementioned audit findings, going forward SARS is targeting unsavoury transfer pricing arrangements with a view to aggressively protecting the South African tax base.

The current intentional tax system creates opportunities for base erosion and profit shifting primarily through the inconsistent tax treatment of intra-group financial and transfer pricing rules which allow for the inappropriate and/or artificial allocation of risk between connected persons<sup>212</sup>. Developing countries, such as South Africa, are particularly vulnerable and more likely to be affected by transfer

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<sup>209</sup>“Update on SARS compliance programme” available at [www.sars.gov.za/Media/MediaReleases/Documents/UpdateonSARSComplianceProgramme201213.pdf](http://www.sars.gov.za/Media/MediaReleases/Documents/UpdateonSARSComplianceProgramme201213.pdf) [accessed 18/11/2013]

<sup>210</sup> Ibid 212 pg 2

<sup>211</sup>SARS estimates that the current transfer pricing audit of 30 entities is worth a combined value of approximately R8 billion [see “Update on SARS Compliance Programme” op cit 212 pg 2]

<sup>212</sup> SARS 2013/14-2017-18 Strategic Plan op cit 146 at 3.3.4 pg 15

pricing manipulation as the current transfer pricing framework favours developed countries over their developing counterparts<sup>213</sup>. Comparable data relating to uncontrolled transactions are more readily available in developed countries, and, coupled with the shortage of transfer pricing skills and expertise<sup>214</sup>, developing countries are particularly susceptible to transfer pricing manipulation resulting in significant base erosion.

Developing countries experience many difficulties in their application of transfer pricing, due in particular to their lack of resources, skills and expertise in the area of international tax. The lack of access to reliable information relating to uncontrolled transactions is a problem experienced by both developing and developed countries alike, however, given the size of developing country economies this difficulty is magnified considerably in the developing country context<sup>215</sup>.

One of the mechanisms being investigated to reduce this hardship is the development of a multi-country forum where African countries can share expertise and experience on an anonymous basis. It is hoped that the pooling of resources will facilitate the implementation and application of transfer pricing provisions by developed countries.

In order to overcome the many difficulties facing developing countries, tax authorities in developing countries must focus on the most common types of transactions and sectors in their economy and seek to build capacity in relation thereto<sup>216</sup>. Safe harbour provisions historically simplified the compliance for small taxpayers. SARS removal of safe harbour provisions is therefore expected to increase the complexity already associated with satisfying transfer pricing requirements<sup>217</sup>.

In light of the above, it is clear that transfer pricing is going to retain the international tax spotlight as countries seek to protect their revenue and MNEs explore innovative ways to reduce their respective tax liabilities, transfer pricing going forward will therefore continue to play an important role in balancing these two competing interests.

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<sup>213</sup> SARS 2013/14-2017-18 Strategic Plan op cit 146 at 3.3.4 pg 18

<sup>214</sup> Ibid pg 18

<sup>215</sup> C Silberztein “Transfer Pricing: A Challenges for Developing Countries” op cit 104

<sup>216</sup> Ibid

<sup>217</sup> Ibid

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