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Transfer Pricing in South African Income Tax Law

Research dissertation presented for the approval of Senate in fulfilment of part of the requirements for the Post Graduate Diploma in Income Tax Law in approved courses and a minor dissertation. The other part of the requirements for this qualification was the completion of a programme of courses.

I hereby declare that I have read and understood the regulations governing the submission of Post Graduate Diploma in Income Tax Law dissertations, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to those regulations.

Signed:

Date:

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CHAPTER 1: INTRODUCTION

'...transfer pricing continues to be, and will remain, the most important international tax issue facing MNEs.'¹

The term 'transfer pricing' is used to describe arrangements involving the transfer of goods or services, at an artificial price, in order to transfer income or expenses from one enterprise to an associated enterprise in a different tax jurisdiction.² This results in the income derived at for each enterprise being disproportionate to their relative economic contributions, and thus impacting the relevant tax jurisdictions' fair share of tax.³ Tax authorities are therefore focusing their attention on transfer pricing rules and practices to ensure the correct attribution of income and expenses of related-party transactions.⁴

Another key issue, closely related to transfer pricing, is that of double taxation. Multinational enterprises, engaging in cross-border transactions, are at risk of having a single source of income taxed in two jurisdictions as a result of an incorrect application of transfer pricing rules.⁵

The purpose of this research is to evaluate South Africa's approach to transfer pricing, as well as compare it to the approaches as adopted by selected countries, namely Australia, the United Kingdom and Canada, with the aim of identifying the areas that South Africa could learn from practices in foreign jurisdictions.

¹ Ernst & Young '2005-2006 Global Transfer Pricing Surveys – Tax Authority Interviews: Perspectives, Interpretations and Regulatory Changes' at 5. Available at [http://www.ey.com/Global/download.nsf/International/Tax - Global Transfer Pricing Survey Part 3/\\$file/EY_GlobalTPSurvey3_Sep2006.pdf](http://www.ey.com/Global/download.nsf/International/Tax_-_Global_Transfer_Pricing_Survey_Part_3/$file/EY_GlobalTPSurvey3_Sep2006.pdf) [Accessed 18 January 2007].

² Keith Huxham and Phillip Haupt *Notes on South African Income Tax* 24ed (2005) 346.

³ Magola Tsibogo Makola *Transfer Pricing in South Africa* (2003) 1.

⁴ Dale Clinton Cridlan *Transfer pricing in South Africa: a comparative examination of the legislative, administrative and judicial approaches to combat this form of tax avoidance* (2001) 1.

⁵ C Richardson *Transfer pricing: applying the arm's length taxation principle* (2001) 3.

Specific issues dealt with include acceptable transfer pricing methods for determining an arm's length price, documentation requirements and non-compliance penalties, the use of Advance Pricing Agreements ("APA"), and the effects of e-commerce in applying the arm's length principle.

The first issue relates to the criteria for the selection of the most suitable method in ensuring an arm's length outcome. Because the South African market is considered to be lacking in comparables, compliance with the arm's length principle will be determined by evaluation of the facts and circumstances of each case.⁶

The second issue looks at the transfer pricing policy documentation required to be prepared, the benefits of preparing such documentation, and the imposition of penalties on taxpayers failing to do so. The lack of statutory documentation requirements and specific penalty provisions in the South African legislation is also addressed.

The third issue evaluates the use of APAs in resolving transfer pricing disputes. This technique is adopted by Australia, the United Kingdom and Canada, and therefore an assessment is made, taking into account both advantages and disadvantages of the technique, to determine whether it would be beneficial to South Africa to be able to agree in advance to transfer pricing methods to be applied to transactions with connected parties, thus reducing the potential for expensive and time consuming disputes with the South African Revenue Service ("SARS").⁷

The fourth and final issue explores the challenges facing tax jurisdictions as a result of an increase in electronic trade. The relevance of the arm's length principle is assessed and recommendations for South Africa are made.

⁶ Cridlan op cit note 4 at 3.

⁷ Ibid.

CHAPTER 2: TRANSFER PRICING LEGISLATION IN SOUTH AFRICA

2.1 BACKGROUND AND HISTORY

Before the introduction in South Africa of the revised section 31 of the Income Tax Act 58 of 1962 (“the Act”), as amended, which took effect from 19 July 1995, transfer pricing was regulated by the compliance with article 9 of the OECD Model Tax Convention Treaty or its equivalent. Profits were either adjusted in terms of the general deduction formula if expenditure was grossly excessive, or in terms of section 103(1) of the Act for general anti-avoidance. Where property was disposed of for a consideration not constituting an arm’s length amount, the Commissioner could deem it to be a donation in terms of section 58 of the Act, resulting in the deemed donation being subject to donations tax at a rate of 20%.⁸ Prior to the easing of exchange controls, the shifting of profits from South Africa to associated companies in lower tax jurisdictions could have been prevented by the restrictions imposed by exchange controls.⁹

In its First Interim Report, the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa (“The Katz Commission”) articulated the fact that there was a lack of protection against the abuse of transfer prices.¹⁰ The Katz Commission noted that the South African tax system needed legislative teeth with which to protect itself against excessive price manipulation between related parties.¹¹ The Second Interim Report listed the following four approaches, as developed by the worlds’ tax systems, from which the South African Legislative had a choice to implement in order to counteract transfer pricing:

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

⁹ Keith Huxham and Phillip Haupt cited in Olivier and Honiball (note 8) at 400-401.

¹⁰ Makola op cit note 3 at 3.

¹¹ Second Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa para 14.6.24.

- a) the most stringent approach has legislative teeth backed up with formal, detailed and binding regulations as to what constitutes acceptable pricing, exemplified by the United States;
- b) a second approach, also with legislative teeth, does not have formal regulations, but does have detailed guidelines as to acceptable pricing, such as the German model;
- c) the third approach also has anti-transfer pricing legislation, but relies on arm's length concepts to dictate acceptable pricing practices, as in the United Kingdom and other countries which rely strongly on OECD guidelines; and
- d) a fourth approach which does not have any specific transfer pricing legislation and relies on normal, general anti-avoidance provisions and tax law to combat transfer pricing, such as in the Netherlands.

The Katz Commission recommended that the third approach, which relied on arm's length concepts as contained in the OECD guidelines, be implemented in South Africa.¹²

The legislation referred to above, to regulate transfer pricing, may still be used by SARS, but the revised section 31 allows SARS to adjust non-arm's length transfer prices for a much broader range of goods or services. Take for example the general deduction formula. In the case of ITC 569 13 SATC 447, the courts held that expenditure that is grossly excessive is not deductible. However, there are no specific guidelines to help identify grossly excessive expenditure other than in the case of *Tobacco Father v COT* 17 SATC 395¹³ in which it was held that the open market price could not be

¹² Second Interim Report op cit note 11 para 14.6.26 and 14.6.27.

¹³ Also cited as 1951(1) SA 150 (SR).

referred to by the court in certain circumstances. It therefore follows that the general deduction formula is limited when used to adjust transfer prices.¹⁴

2.2 TRANSFER PRICING DEFINITIONS AND TERMINOLOGY

Section 1 and section 31(1) of the Act contain the following definitions applicable to transfer pricing:

Goods

Goods are defined to include any incorporeal moveable thing, fixed property and any real right in such thing or fixed property.

Services

Services are broadly defined to include anything done or to be done, plus the following:

- the granting, assignment, cession or surrender of any right, benefit or privilege;
- the making available of any facility or advantage;
- the granting of financial assistance, including a loan, advance or debt, and the provision of any security or guarantee
- the performance of any works;
- an agreement of insurance; and
- the conferring of rights to incorporeal property.

International agreement

Section 31(1) defines the entering into of a transaction, operation or scheme between the following four groups of parties to be an international agreement:

- a) a resident and any other person who is not a resident
- b) a person who is not a resident and any other person who is not a resident for the supply of goods or services to or by a permanent establishment of either of such persons within South Africa

¹⁴ Olivier and Honiball op cit note 8 at 401-402.

- c) a person who is a resident and any other person who is a resident for the supply of goods or services to or by a permanent establishment of either of such persons outside South Africa
- d) two residents where either of such persons is not subject to tax in South Africa as a result of the application of the provisions of a tax treaty

Permanent establishment

Section 1 defines 'permanent establishment' with reference to the definition contained in article 5 of the OECD Model Tax Convention Treaty. The term means 'a fixed place of business through which the business of an enterprise is wholly or partly carried on' and the business profits are taxable where the fixed place of business is based.

Connected person

Section 1 widely defines the term 'connected person' in relation to:

- natural persons;
- trusts;
- partnerships;
- companies; and
- close corporations

Section 31(2) is only applicable if the acquirer and the supplier of goods or services are connected persons in relation to one another.¹⁵

SARS' Practice Note No 7¹⁶ contains the following two important definitions that cannot be found in the Act:

Controlled transaction

SARS' Practice Note No 7 para 1.2.1 defines a 'controlled transaction' as a transaction in terms of which the ownership or control relationship is able to influence the transfer price set. In relation to s 31 a controlled transaction will be any transaction between connected persons, as defined in s 1 of the Act.

¹⁵ Olivier and Honiball op cit note 8 at 404.

¹⁶ South African Revenue Services (SARS') *Practice Note No 7 – Section 31 of the Income Tax Act 1962: Determination of Taxable Income of Certain Persons from International Transactions: Transfer Pricing* (6 Aug 1999).

Uncontrolled transaction

SARS' Practice Note No 7 para 1.2.2 defines an 'uncontrolled transaction' as a transaction which is concluded at arm's length between enterprises that are not connected persons in relation to each other. This could, for example, include transactions at arm's length between a member of a multinational and an unconnected person. Uncontrolled transactions form the benchmark against which a multinational's transfer pricing is appraised in determining whether its prices are arm's length.

2.3 THE ARM'S LENGTH PRINCIPLE

Transfer pricing can deprive governments of their fair share of taxes from global corporations and expose multinationals to possible double taxation. No country – poor, emerging or wealthy – wants its tax base to suffer because of transfer pricing. The arm's length principle can help.¹⁷

In order to avoid such problems as double taxation, South Africa has adopted the arm's length principle ("ALP") on which the current OECD international guidelines are based. More specifically, the ALP can be found in para 1 of Article 9 of the OECD Model Tax Convention Treaty used for bilateral treaties,¹⁸ which reads as follow:

[When] conditions are made or imposed between ...two [associated] enterprises in their commercial or financial relations which differ from those which would have been 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.¹⁹

¹⁷ John Neighbour 'Transfer pricing: Keeping it at arm's length.' Available at http://oecdobserver.org/news/fullstory.php/aid/670/Transfer_pricing:_Keeping_it_at_arms_length.html [Accessed 21 December 2006].

¹⁸ Ibid.

¹⁹ SARS' *Practice Note No 7* op cit note 16 para 7.2.

Even though South Africa is not a member of the OECD, the Practice Note is based on the OECD Transfer Pricing Guidelines²⁰ and these guidelines should be followed if no specific guidance is given in the Practice Note or s 31.²¹

The SARS' Practice Note No 7 para 7.3 states that:

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

The ALP provides MNEs and the relevant tax jurisdictions with a single international standard for transactions entered into between them that give the various tax jurisdictions a fair portion of the tax base of the MNEs.²² Using an internationally accepted method to split profits between connected enterprises is also beneficial when it comes to dealing with difficult countries that try to enforce their own transfer pricing rules.²³

Section 31(2) is the only section in the Act dealing with the definition of an arm's length price. It also does not provide any guidelines in terms of how to objectively determine an arm's length price. The SARS' Practice Note No 7 contains various different international methods for determining an arm's

²⁰ Organisation for Economic Cooperation and Development (OECD) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration* (1995).

²¹ SARS *Practice Note No 7* op cit note 16 para 3.2.2 and 3.2.3.

²² Neighbour op cit note 17.

²³ Olivier and Honiball op cit note 8 at 406.

length price, but because SARS' Practice Notes and Interpretation Notes do not normally constitute law (ITC 1675 62 SATC 219), the Commissioner will have to look at the facts of each case individually to determine whether an arm's length transfer price has been arrived at,²⁴ taking into consideration that, according to the Practice Note, an arm's length price does not necessarily constitute a single price, but a range of prices.

²⁴ Olivier and Honiball op cit note 8 at 407.

CHAPTER 3: TRANSFER PRICING METHODS

3.1 INTRODUCTION

Because the Act does not stipulate any methodology to be used in order to determine an arm's length price, SARS' Practice Note No 7 allows the taxpayer to use the standard transfer pricing methods accepted by the OECD Guidelines:

- the comparable uncontrolled price method (CUP method);
- the resale price method (RP method);
- the cost plus method (CP method);
- the transactional net margin method (TNMM); and
- the profit split method²⁵

The SARS' Practice Note No 7 states that in order to select the most suitable method, which should result in the maximum level of comparability and the least amount of adjustments, the facts of each case will need to be examined taking into account the availability of reliable data.²⁶ Although the Practice Note does not require a hierarchy of transfer pricing methods to be followed, it does mention that the traditional transaction methods are preferred.²⁷ The CUP method is then preferred over the other two traditional transaction methods, 'as it looks to the product or service transferred and is relatively insensitive to the specific functions which are performed by the entities being compared.'²⁸

3.2 INDEPENDENCE AND COMPARABILITY

In defining the ALP, the OECD Guidelines state the following:

²⁵ SARS' *Practice Note No 7* op cit note 16 para 9.1.1 and 9.2.2.

²⁶ SARS' *Practice Note No 7* op cit note 16 para 9.1.2 and 9.3.2.

²⁷ SARS' *Practice Note No 7* op cit note 16 para 9.3.1 and 9.3.4.

²⁸ SARS' *Practice Note No 7* op cit note 16 para 9.3.4; Olivier and Honiball op cit note 8 at 409.

Application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between "independent" enterprises. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently "comparable".²⁹

In order to apply the ALP, it is essential that the situations under review are comparable.³⁰ To meet the requirement of comparability, any differences that may arise between the situations being compared cannot be such that the circumstance being examined in the method is materially affected, and there is no possibility of a reliable adjustment being made.³¹ Adjustments to minor differences though should be avoided as applying arm's length methods always involve elements of judgement.³² There are many factors that can affect the assessment of comparability, such as the features of goods and services, the importance of functions performed, the economic circumstances, and the business strategies.³³

Companies are required to be independent as this ensures that transactions take place at arm's length. Transactions between related parties tend to deviate from market conditions by the imposition of conditions by one of the parties involved.³⁴

In certain situations it is not possible for both the requirements of independence and comparability to be applicable. It is then up to the tax authorities to decide which criteria to adhere to. In section 1.70 of the OECD

²⁹ OECD 'Transfer Pricing Guidelines' para 1.15 cited in Paul Balkus et al 'Using comparables with significant intercompany sales.' Available at [http://www.kpmgtaxwatch.com/pub/intl/TransferPricingGuide_2005_\(7thEdition\).pdf](http://www.kpmgtaxwatch.com/pub/intl/TransferPricingGuide_2005_(7thEdition).pdf) [Accessed 3 January 2007].

³⁰ SARS' *Practice Note No 7* op cit note 16 para 8.1.1.

³¹ SARS' *Practice Note No 7* op cit note 16 para 8.1.2.

³² SARS' *Practice Note No 7* op cit note 16 para 8.1.3.

³³ SARS' *Practice Note No 7* op cit note 16 para 8.1.6.

³⁴ Balkus op cit note 29.

Guidelines, it mentions that suitable comparables are not necessarily identical, yet it also mentions that information on controlled companies could be helpful 'in understanding the transaction under review or as a pointer to further investigation'.³⁵

3.3 ACCEPTABLE METHODS FOR DETERMINING AN ARM'S LENGTH PRICE

The OECD Guidelines classify the transfer pricing methods under two types of methods, namely:

- Traditional transaction methods, which are reliant on the information relating to the prices at which uncontrolled comparable transactions between unconnected parties would take place. Traditional transaction methods include the CUP, RP and CP methods.
- Transactional profit methods, which are reliant on the information relating to either the amount of profit generated by one party in comparison to an uncontrolled transaction, or to the division of the total profits brought in by both parties to the transaction. Transactional profit methods include the TNMM and the profit split method.³⁶

3.3.1 Traditional Transaction Methods

Comparable Uncontrolled Price method

The Comparable Uncontrolled Price (CUP) method is used to make a comparison between the prices charged for goods or services in a transaction that is controlled and the prices charged for comparable goods or services in a transaction that is uncontrolled, where the circumstances are

³⁵ Balkus op cit note 29.

³⁶ OECD *Transfer Pricing Guidelines* op cit note 20 II-2.

also comparable.³⁷ In practice, however, the comparability of goods or services is made difficult due to small changes in trading circumstances that can significantly impact the price.³⁸

Should differences exist between the two transactions, it may be possible to make adjustments to enable comparisons to be made.³⁹ Examples of adjustments that are often allowed include differences in the terms of a transaction (for example, credit terms, sell FOB to a connected person and at CIF to an independent party), differences in the volumes transferred and differences in the timing of the transaction.⁴⁰ However, if the following differences exist, it may not always be possible to make any adjustments: differences in the quality of the products, differences in the geographic markets, differences in the market levels and differences in the amount and type of intangible property involved.⁴¹

There are two types of comparable transactions, namely, external comparables and internal comparables. An external comparable transaction involves the transference of similar goods or services under similar circumstances between two unrelated enterprises. An internal comparable transaction, on the other hand, involves the transference of similar goods and services under similar circumstances with one of the parties involved being the taxpayer and the other an unrelated enterprise.⁴²

The Practice Note states that the CUP method should be used over other methods if comparable uncontrolled transactions can be obtained.⁴³ Although controlled and uncontrolled transactions are seldom ever truly

³⁷ SARS' *Practice Note No 7* op cit note 16 para 9.4.1.

³⁸ Wikipedia the free encyclopedia 'Transfer pricing.' Available at http://en.wikipedia.org/wiki/Transfer_pricing [Accessed 22 December 2006]; SARS' *Practice Note No 7* op cit note 16 para 9.4.3.

³⁹ SARS' *Practice Note No 7* op cit note 16 para 9.4.2.

⁴⁰ PricewaterhouseCoopers cited in Richardson op cit note 5; SARS' *Practice Note No 7* op cit note 16 para 9.4.2.

⁴¹ SARS' *Practice Note No 7* op cit note 16 para 9.4.2.

⁴² Ibid; Wikipedia op cit note 36.

⁴³ SARS' *Practice Note No 7* op cit note 16 para 9.4.2.

comparable, the guidelines advise that 'Every effort should be made to adjust the data so that it may be used appropriately in a CUP method'.⁴⁴

The Resale Price method

The Resale Price (RP) method involves working backwards with supply chain transactions.⁴⁵ The price at which the goods or services are sold to an unrelated third party, having originally been purchased from a connected enterprise, is reduced by an appropriate gross margin plus any adjustments for other related purchase costs (for example, customs duties), to arrive at the arm's length price. The gross margin covers the reseller's general, selling and administrative expenses and provides for a profit after taking into account functions performed, assets used and risks assumed by the reseller.⁴⁶

The RP method can diagrammatically be represented as follows:

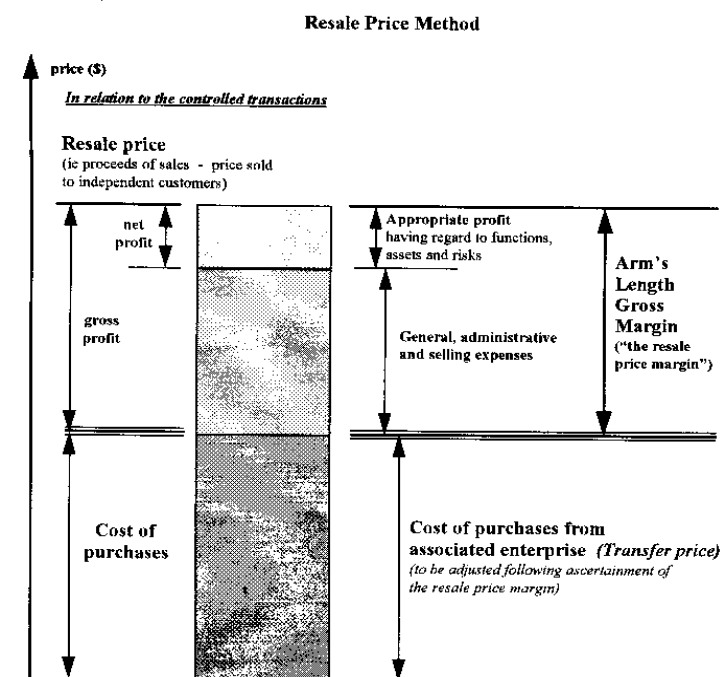


Figure 3.1
Diagrammatic illustration of the Resale Price method⁴⁷

⁴⁴ OECD *Transfer Pricing Guidelines* II-3 cited in Richardson op cit note 5 at 32.

⁴⁵ Wikipedia op cit note 38.

⁴⁶ SARS' *Practice Note No 7* op cit note 16 para 9.5.1.

⁴⁷ Taxation Ruling 97/20 *Income tax: arm's length transfer pricing methodologies for international dealings* (1997) para 3.2.2.

To determine the resale price margin in the controlled transaction, the resale price margin that the same reseller earns on goods or services purchased and sold in a comparable uncontrolled transaction may be referred to. The resale price margin can also be obtained by considering one used in a sale between two independent parties.⁴⁸

For the RP method the comparability of the functions performed by the connected and the independent entities is more important than that of the product comparability. The reason for this is that differences in products are more likely to have an affect on prices than on profit margins.⁴⁹ The RP method is therefore preferred to the CUP method in situations where controlled and uncontrolled transactions are comparable in all aspects other than the product itself.⁵⁰

The Cost Plus method

The Cost Plus (CP) method, which is mostly used for the trade of finished goods, is determined by adding an appropriate 'cost plus mark up' to the costs incurred by the supplier in manufacturing/purchasing the goods or services that are provided in a controlled transaction with an associated enterprise.⁵¹ The mark up includes an appropriate profit, taking into account the functions performed, assets used and risks assumed.⁵²

The CP method can diagrammatically be represented as follows:

⁴⁸ SARS' *Practice Note No 7* op cit note 16 para 9.5.2.

⁴⁹ Ibid.

⁵⁰ OECD *Transfer Pricing Guidelines* II-6 cited in Richardson op cit note 5 at 33.

⁵¹ SARS' *Practice Note No 7* op cit note 16 para 9.6.1; Wikipedia op cit note 38.

⁵² SARS' *Practice Note No 7* op cit note 16 para 9.6.1.

Cost Plus Method

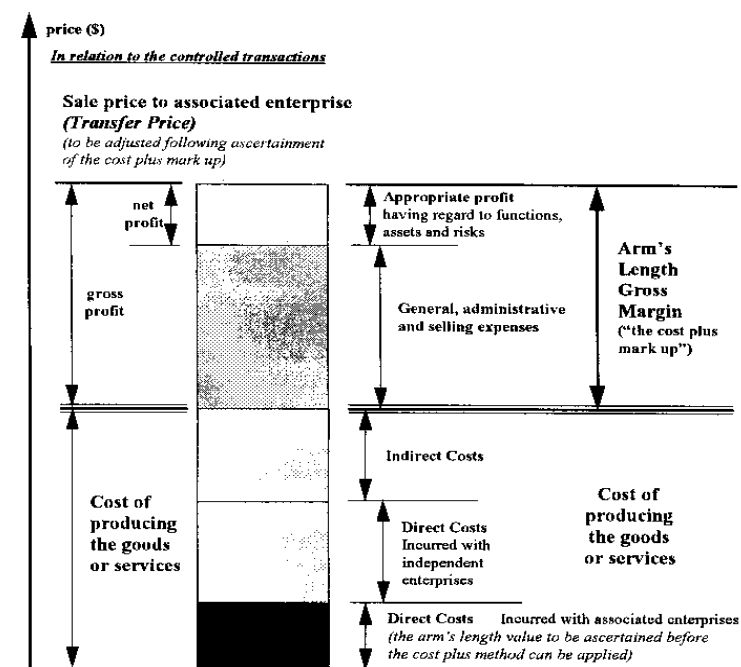


Figure 3.2
Diagrammatic illustration of the Cost Plus method⁵³

To determine the mark up, reference should be made to the mark up earned by the same enterprise in a comparable uncontrolled transaction, otherwise the mark up earned by an independent enterprise in a comparable uncontrolled transaction may be used. As under the RP method, functional comparability is more important than product comparability.⁵⁴

In practice, the application of this method causes certain problems to arise. Firstly, it is difficult to determine the costs to use as the effectiveness of companies varies, resulting in some incurring lower costs than others. Secondly, to stay in line with accounting policies the same type of costs need to be compared, and therefore appropriate adjustments may need to be made. Thirdly, segregated product data is often required which is not normally available in respect of the uncontrolled enterprises that are being used as comparisons.⁵⁵ Finally, there may be times when there is no link

⁵³ Taxation Ruling 97/20 op cit note 47 para 3.32.

⁵⁴ SARS' Practice Note No 7 op cit note 16 para 9.6.2.

⁵⁵ SARS' Practice Note No 7 op cit note 16 para 9.6.3.

between the cost and the sale price (for example, if competition forces the sale of goods that are approaching obsolescence at prices below cost). The facts of each case therefore need to be looked at to determine whether the CP method will be applicable.⁵⁶

3.3.2 Transactional Profit Methods

Transactional Net Margin method

The Transactional Net Margin method (TNMM) evaluates the taxpayer to establish the net profit margin realised from a controlled transaction, relative to an appropriate base, such as cost, sales or assets.⁵⁷ This ratio, referred to by SARS as a 'profit level indicator', is compared to 'profit level indicators' of the taxpayer's comparable uncontrolled dealings or an independent enterprise's uncontrolled dealings.⁵⁸

The following diagram illustrates the application of the TNMM on the 'net resale price' basis:

⁵⁶ OECD *Transfer Pricing Guidelines* II-12 cited in Richardson op cit note 5 at 35.

⁵⁷ SARS' *Practice Note No 7* op cit note 16 para 9.7.1.

⁵⁸ Ibid; OECD *Transfer Pricing Guidelines* op cit note 20 III-9.

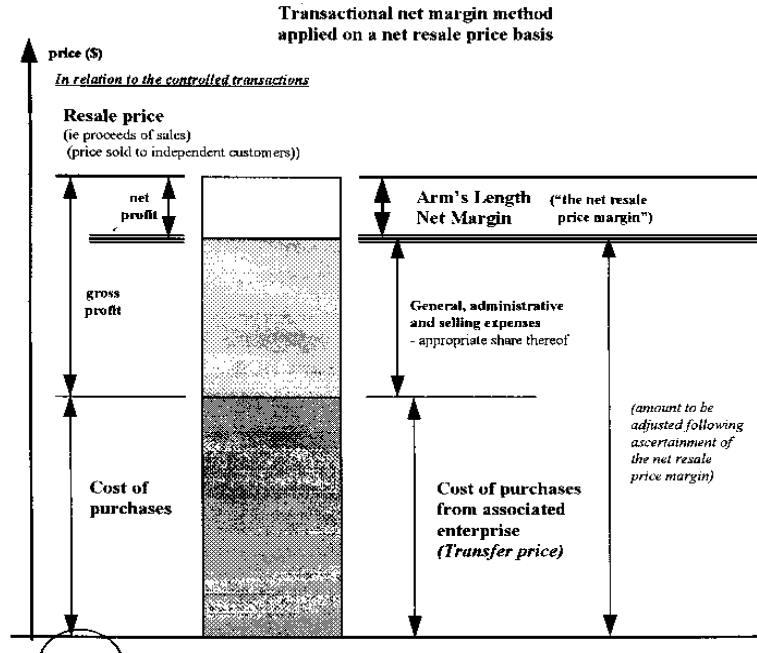


Figure 3.3
Diagrammatic illustration of the TNMM applied on a 'net resale price' basis⁵⁹

Similarly, the TNMM may be applied on a 'net cost plus' basis, diagrammatically illustrated as follows:

⁵⁹ Taxation Ruling 97/20 op cit note 47 para 3.75.

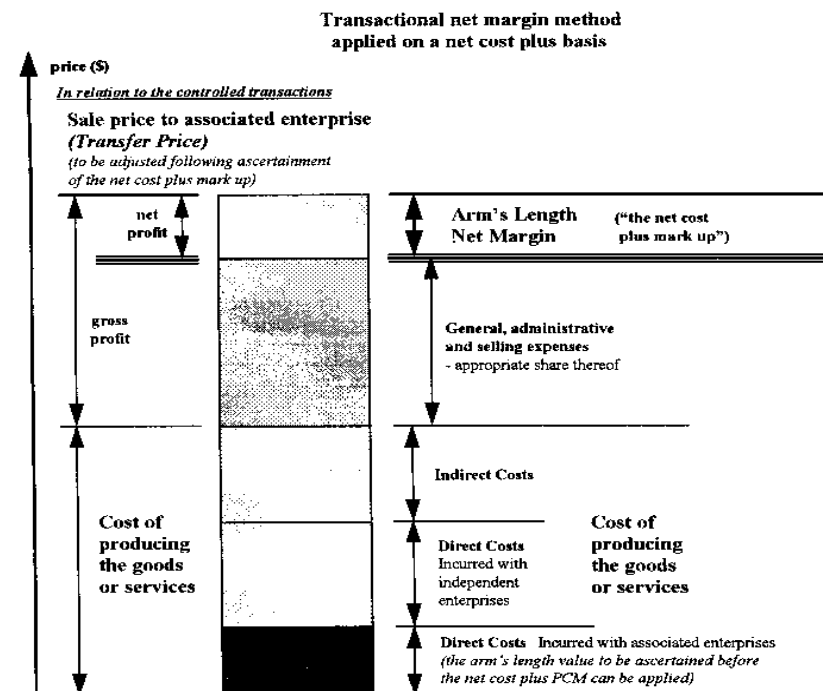


Figure 3.4
Diagrammatic illustration of the TNMM applied on a 'net cost plus' basis⁶⁰

TNMM is seen as a "unified version" of the RP and CP methods because it also makes use of comparable companies to determine an appropriate margin to apply.⁶¹ Another similarity with the RP and CP methods is that the TNMM concentrates on the functions performed by an enterprise, but comparing net profit as opposed to gross profit.⁶²

Traditional transaction methods are seen as more reliable than the TNMM due to the fact that the TNMM is sensitive to the differences in cost structures of comparable enterprises because of the inclusion of operating expenses, and the TNMM also requires structural similarity between the associated enterprise and the independent enterprise being compared, when in fact firms are structurally unique in practice.⁶³

⁶⁰ Ibid.

⁶¹ Wikipedia op cit note 38.

⁶² SARS' Practice Note No 7 op cit note 16 para 9.7.2.

⁶³ Ibid.

Practical problems surrounding the TNMM include the fact that net margins can be affected by certain factors that may not have an effect on price or gross margins, resulting in the possibility of an unreliable and inaccurate arm's length net margin.⁶⁴ Application of the TNMM may not be possible due to unavailability of information about the taxpayer when the arm's length price is required to be determined, as well as due to unavailability of information on the controlled transaction.⁶⁵ However, reliable information on gross margins may be impossible to get hold of and therefore in certain cases the TNMM may be the only practical method to apply.⁶⁶

The Profit Split method

This method involves taking the combined profit of the related enterprises in a controlled transaction and allocating the profit amongst the enterprises on a basis that is economically valid and that would have been used in an arm's length agreement.⁶⁷ The profit split method is mostly applicable to transactions that are so unified that it would be impossible to examine them independently.⁶⁸

There are two approaches to determining an arm's length transfer price under this method and they are as follows:

a). Residual Profit Split Analysis

This approach involves two stages. Firstly, each enterprise is allocated a basic return that is determined with reference to comparable transactions, in terms of functions and risks, of independent enterprises. The second stage involves the allocation of the remaining residual profit amongst the enterprises in a manner that would have been adopted by independent enterprises. Contributions by the enterprises to the residual profit are often subjectively

⁶⁴ SARS' *Practice Note No 7* op cit note 16 para 9.7.3; Richardson op cit note 5 at 42.

⁶⁵ SARS' *Practice Note No 7* op cit note 16 para 9.7.3.

⁶⁶ SARS' *Practice Note No 7* op cit note 16 para 9.7.2.

⁶⁷ SARS' *Practice Note No 7* op cit note 16 para 9.8.1.

⁶⁸ SARS' *Practice Note No 7* op cit note 16 para 9.8.2.

measured due to the lack of an external benchmark when the transactions entered into between the enterprises are unique.⁶⁹ This may cause the reliability of this method to determine an arm's length price to be questioned.⁷⁰

b). Contribution Analysis

This approach is useful when the transaction is between large integrated multinationals that operate under economies of scale. The reason being is that independent enterprises are not always able to save costs the way large integrated multinationals can and therefore it may be difficult for such multinationals to find an uncontrolled comparable transaction in order to determine a reliable arm's length transfer price.⁷¹

The combined operating profit of the two enterprises is divided amongst the enterprises with reference to the value of the functions each one has performed, taking into account assets used and risks assumed.⁷²

3.4 AUSTRALIA

The Australian Taxation Ruling 97/20 provides guidelines on the application of the ALP for cross-border transactions between independent parties with reference to division 13 of the Income Tax Act 1936. When determining a range of arm's length prices, the Australian Taxation Office (ATO) seems to favour the use of comparable uncontrolled transactions as para 2.84 of TR 97/20 states the following:

⁶⁹ Ibid.

⁷⁰ SARS' *Practice Note No 7* op cit note 16 para 9.8.3.

⁷¹ SARS' *Practice Note No 7* op cit note 16 para 9.8.2.

⁷² OECD *Transfer Pricing Guidelines* op cit note 20 III-6.

'The arm's-length range is constructed using only comparable uncontrolled dealings that have, or have been adjusted to, a high level of reliability in comparison with the controlled dealings'.⁷³

However, the ATO will allow controlled data to be used as corroborating evidence, based on para 2.90 of TR 97/20, which states 'In the absence of comparable uncontrolled dealings, it may be possible to infer from other industry available information whether dealings between the associated enterprises achieve an arm's length outcome. However, it should be noted that data that does not achieve a high level of reliability cannot be used in constructing an arm's-length range and, while it may be useful in terms of broad indications, cannot be given the same status in determining an arm's length outcome'. According to the ruling though, such information can still be useful in determining an arm's length range of prices when it is combined with other information.⁷⁴

The arm's length transfer pricing methods acknowledged by TR 97/20 are:

- the traditional transaction methods, namely the CUP method, RP method and CP method; and
- the transactional profit methods, namely the TNMM and Profit Split method

TR 97/20 does not provide an order of preference with regards to the selection of a method, as long as the method chosen results in the most reliable range of arm's length prices.⁷⁵

⁷³ Balkus op cit note 29.

⁷⁴ Ibid.

⁷⁵ OECD 'Transfer Pricing Country Profile: Australia.' Available at <http://www.oecd.org/taxation> [Accessed 20 December 2006].

3.5 UNITED KINGDOM

Schedule 28AA Income and Corporation Taxes Act 1988 contains the UK transfer pricing legislation which requires the application of the ALP for connected party transactions.⁷⁶ The UK tax legislation incorporates the OECD Transfer Pricing Guidelines and gives preference to traditional transaction methods rather than transactional profit methods.⁷⁷

The Inland Revenue emphasizes the importance of comparability when companies make use of benchmarking to determine an arm's length price, with the most important comparables being the functions performed and the size of the parties in relation to one another. In practice, the Inland Revenue will not accept companies that form part of a group as comparables, unless the group is wholly based in the UK and that any intra-group transactions, should they exist, can be eliminated.⁷⁸

In circumstances where it is not possible to determine a comparable uncontrolled price, the Inland Revenue will look to the 'cost-plus' or 'resale price' methods, depending on the facts of the case at hand. In situations where sufficient reliable information is absent, resulting in the standard OECD pricing methodologies not being applicable, the Inland Revenue is willing to make use of 'gross profit comparisons drawn from applicable industry-wide data' to establish an arm's length price.⁷⁹

The Inland Revenue has stated that their objective is '...to ensure that the UK taxpayer is paying the proper UK tax on its profits under the law'. To

⁷⁶ Balkus op cit note 29 at 33.

⁷⁷ Ernst & Young 'Global Transfer Pricing Reference Guide' at 69. Available at [http://www.ey.com/global/download.nsf/Austria/transfer_pricing_guide_06/\\$file/GlobalTPGuide_Feb06.pdf](http://www.ey.com/global/download.nsf/Austria/transfer_pricing_guide_06/$file/GlobalTPGuide_Feb06.pdf) [Accessed 22 December 2006].

⁷⁸ Balkus op cit note 29 at 33.

⁷⁹ Cridlan op cit note 4 at 31-32.

achieve this, they ‘...will in practice use any method which seems likely to produce a satisfactory result.’⁸⁰

3.6 CANADA

Transfer pricing is dealt with under section 247 of the Canadian Income Tax Act (“ITA”), which is administered by the Canada Revenue Agency (“CRA”).⁸¹ There are no rules and regulations in the ITA but administrative practices can be found in Information Circular 87-2R (September 27, 1999).⁸² ‘Reasonable efforts’ are required to be made by taxpayers in ensuring that non-arm’s length transactions with non-residents are concluded at arm’s length.⁸³

The CRA utilises the transfer pricing methods contained in the OECD Transfer Pricing Guidelines as no methods are prescribed in the ITA. The CRA believes that the methods have a ‘natural’ hierarchy, with the traditional transaction methods taking preference over the transactional profit methods.⁸⁴

In the CRA APA Program Report 2003-2004 statistics showed that more than 60% of the completed and in-progress APAs since the start of the program used the Profit Split and the TNMM transfer pricing methods, while only 17% made use of the CUP method. In addition, the CRA prefers the Profit Split method to the TNMM when there is a lack of reliable comparable transactions as it considers the arm’s length result of the Profit Split method to be more accurate.⁸⁵

⁸⁰ Cridlan op cit note 4 at 3.

⁸¹ Ernst & Young op cit note 77 at 13.

⁸² Ibid; Ernst & Young op cit note 1 at 21.

⁸³ Ernst & Young op cit note 1 at 21.

⁸⁴ Ibid; Ernst & Young op cit note 77 at 13.

⁸⁵ Thomas B Akin et al ‘Transfer Pricing Update Canada.’ Available at <http://library.findlaw.com/2006/May/10/245875.html> [Accessed 21 January 2007].

With regards to controversial transfer pricing practices, the approaches taken by the CRA include the use of:

- single year data;
- fewer comparables as opposed to more; and
- a point in a range instead of a whole range⁸⁶

3.7 CONCLUSION

All the countries under review have adopted the ALP and follow the transfer pricing methods contained in the OECD Transfer Pricing Guidelines. None of the countries examined are prescribed a hierarchy with regards to the selection of a suitable transfer pricing method, but preference in all the countries is given to traditional transaction methods, and more specifically the CUP method.

The most appropriate transfer pricing method to produce a reasonable estimate of an arm's length outcome will depend on the availability of reliable data and the extent of adjustments required to be made to ensure comparability.

In the Ernst and Young 2005-2006 Global Transfer Pricing Surveys,⁸⁷ the transfer pricing methods used by the respondents were found to be as follows:

⁸⁶ Ernst & Young op cit note 1 at 21.

⁸⁷ Ernst & Young '2005-2006 Global Transfer Pricing Surveys: Global Transfer Pricing Trends, Practices, and Analysis, November 2005' at 11. Available at [http://www.ey.com/global/download.nsf/International/Transfer_Pricing_Global_Surveys_Q4_2005/\\$file/GlobalTPSurvey_Q4_2005.pdf](http://www.ey.com/global/download.nsf/International/Transfer_Pricing_Global_Surveys_Q4_2005/$file/GlobalTPSurvey_Q4_2005.pdf) [Accessed 22 December 2006].

	Tangible goods	Intercompany services	Licensing agreements	Cost Sharing Agreements	Financing
CUP	30%	17%	33% internal 21% external	-	43% internal 14% external
Resale Price	17%	-	-	-	-
Cost	-	17%	-	31%	-
Cost Plus	26%	57%	-	50%	-
Profit Split	4%	-	8%	-	8%
Profits-Based	16%	-	12%	-	15%
Other/not stated	7%	8%	25%	19%	21%
Overall profits-based methods are increasingly used by tax authorities to test tangibles transactions whereas a minority of respondents use this approach.					

Table 3.1

Methods used by transaction type (Parents)

The survey indicates that the CUP method is the most commonly used method for transactions involving tangible goods, and is also the method that the OECD views as being the most direct way of determining an arm's length price.⁸⁸

In practice however, because South Africa's economy is relatively small, the application of traditional transaction methods may be difficult due to a lack of sufficient reliable comparables. Under such circumstances, the transactional profit methods may be the only option.⁸⁹

⁸⁸ Cridlan op cit note 4 at 49.

⁸⁹ Jozua Johannes Loots *Transfer pricing as strategic planning tool for multinational enterprises in a post isolation South Africa* (2001) 53.

CHAPTER 4: POLICY DOCUMENTATION AND PENALTIES

4.1 INTRODUCTION

The introduction by SARS, in 2004, of new transfer pricing policy disclosure requirements were much needed compliance guidelines for companies, who were in the dark regarding this issue since 1995, when transfer pricing legislation came into effect in South Africa.⁹⁰ Prior to the introduction of the new disclosure requirements, companies of all sizes, involved in cross-border intra-company transactions, could get away with ticking a box on their annual corporate tax returns to inform SARS that they have policy documentation.⁹¹

4.2 DOCUMENTATION REQUIREMENTS

With the new disclosure requirements it is compulsory for companies engaged in international activity with related companies to submit their transfer pricing policy documentation to SARS on completion of their annual corporate tax returns.⁹²

Practice Note No 7, issued by SARS in 1999, provides guidelines on the preparation of documentation, which is broadly based on Chapter 5 of the OECD Guidelines.⁹³ The Practice Note openly admits that 'there is no explicit statutory requirement to prepare and maintain transfer pricing documentation' but it goes on to express the importance of having sufficient documentation, which will be discussed further on.⁹⁴ Because section 31 of the Act does not

⁹⁰ M Honiball 'Transfer pricing: A criminal offence' 2004 *Finance Week* 41 at 41.

⁹¹ Kathy Thersby 'Transfer pricing case: no place to hide' (2005) 234 *Tax Breaks Newsletter* 7 at 7.

⁹² Honiball op cit note 90 at 41.

⁹³ SARS' *Practice Note No 7* op cit note 16 para 10.3.1; Ernest Mazansky 'Transfer pricing documentation requirements clarified' (2005) 238 *Tax Breaks Newsletter* 7 at 7.

⁹⁴ SARS' *Practice Note No 7* op cit note 16 para 10.2.1; Mazansky op cit note 93 at 8.

incorporate transfer pricing documentation, the only legislation giving SARS access to a company's transfer pricing information and documentation are sections 74, 74A, 74B, 74C, 74D and 75 of the Act, and section 69 of the Act may also be used to assist the Commissioner.⁹⁵

SARS issued an addendum to its practice note on 29 September 2005 to help clear the confusion amongst taxpayers regarding the need for companies to have a transfer pricing policy document or not. The addendum confirms that it is not a statutory requirement for taxpayers to prepare transfer pricing policy documentation, but that it is advisable for them to do so in order to minimise the risks associated with a lack of documentation.⁹⁶ Although taxpayers are not required by law to prepare policy documentation, they are under obligation to submit such documentation to SARS, with the annual tax return, should they indicate in the tax return that such documentation exists.⁹⁷ If SARS requests for information from a taxpayer, the request must be responded to within 30 days.⁹⁸

4.3 NON-COMPLIANCE PENALTIES

The information brochure that accompanies the IT14 tax return states the following:

It is incumbent upon the taxpayer that an accurate and full disclosure of all required and relevant information is made in the income tax return. In addition to possible prosecution and the imposition of penalties prescribed by the Income Tax Act for misrepresentation, neglect or omission to furnish or furnishing false information, additional

⁹⁵ SARS' *Practice Note No 7* op cit note 16 para 10.1.1.

⁹⁶ Mazansky op cit note 91 at 7; Billy Joubert 'Do you need a Transfer Pricing Policy Document?' Available at http://www.deloitte.com/dtt/press_release/0,1014,sid%253D23596%2526cid%253DI35642,00.htm [Accessed 29 November 2006].

⁹⁷ Joubert op cit note 96.

⁹⁸ Ernst & Young op cit note 77 at 58.

assessments (together with interest), may be raised after the expiry date of three years from the date of assessment.⁹⁹

In South Africa, a taxpayer could be penalised in terms of s 75 for failing to submit any documentation as required in terms of the Act or as requested by the Commissioner. Transfer pricing policy documentation would be included in 'any documentation'.¹⁰⁰

Section 76 involves the imposition of additional tax, equal to double the tax chargeable, in respect of the following situations:

- if a taxpayer fails to submit a tax return (s 76(1)(a)). This section could be applicable if a transfer pricing policy document is not furnished with the annual tax return rendering an incomplete submission of the tax return.
- if a taxpayer makes an incorrect statement in a tax return (s 76(1)(c)). Subsections (a) and (c) could be applicable if an incorrect statement is made relating to transfer pricing.

Section 76(1)(b) applies when a taxpayer omits income in his return that ought to have been included. However, s 31(2) does not prescribe that cross-border transactions between related parties must be concluded at arm's length. Therefore, a taxpayer can never be held to have omitted an amount 'which ought to have been included' in a tax return, as is stated in s 76(1)(b).¹⁰¹

In terms of proviso (i) to section 79(1) of the Act, the Commissioner can raise an additional assessment if the following requirements are met:

⁹⁹ Jacques Van Rhyen 'SARS looks at deals done ten years ago' (2006) 244 *Tax Breaks Newsletter* 6 at 6.

¹⁰⁰ Olivier and Honiball op cit note 8 at 421.

¹⁰¹ Ibid.

- (a) there had been a non-disclosure of material facts or fraud or misrepresentation by the taxpayer, and
- (b) the non-assessment of the amount in question was causally related to the non-disclosure of material facts or fraud or misrepresentation

The court in terms of the case of *SIR v Trow* held this.¹⁰² SARS can therefore charge companies additional tax at 29 per cent, STC at 12,5 per cent, interest and up to 200 per cent penalties on adjustments made to cross-border transactions as far back as the Nineties, resulting in massive financial implications for the companies concerned.¹⁰³

Under section 76(2)(a), however, the Commissioner has the discretion to remit the additional charge imposed under section 76(1), unless the taxpayer's intention was to evade tax.¹⁰⁴

4.4 THE NEED FOR DOCUMENTATION

The practice note provides a number of reasons on why it is advisable to prepare adequate transfer pricing documentation. The most obvious reason being that the Commissioner's attention is going to be drawn to a taxpayer's transfer pricing whose documentation is poorly prepared over a taxpayer's that has been adequately prepared. The Commissioner's investigation of a taxpayer's policy documentation could then lead to the taxpayer's arm's length amount being replaced by one that the Commissioner feels is more suitable, and the taxpayer will be in an unfavourable position to rebut the Commissioner's decision based on the fact that inadequate documentation was prepared.¹⁰⁵ As already stated above, taxpayers are required to furnish transfer pricing information with the annual

¹⁰² 1981 (4) SA 821 (A).

¹⁰³ Van Rhyn op cit note 99 at 6.

¹⁰⁴ Makola op cit note 3 at 39.

¹⁰⁵ SARS' *Practice Note No 7* op cit note 16 para 10.2.3.

tax return for companies (IT14), and if no documentation has been prepared and maintained, taxpayers will not be able to meet these requirements.¹⁰⁶

4.5 AUSTRALIA

4.5.1 Documentation Requirements

The contemporaneous documentation that is required to be maintained is detailed in Taxation Ruling TR 98/11. In order to prove that the ALP has been complied with, the documentation should show that the 4 step process, as provided by the ATO in TR 98/11, has been followed. This 4 step process, involving the setting and reviewing of transfer prices, is not compulsory but will be beneficial to the taxpayer. The 4 steps are as follows:

- Step 1: Accurately characterise the international dealings between the associated enterprises in the context of the taxpayer's business and document that characterisation;
- Step 2: Select the most appropriate transfer pricing methodology or methodologies and document the choice;
- Step 3: Apply the most appropriate method, determine the arm's length outcome and document the process; and
- Step 4: Implement support processes. Install review process to ensure adjustment for material changes and document these processes.¹⁰⁷

Even though there is no deadline for preparing transfer pricing documentation, it is expected to be prepared before submission of the annual tax return so that it can be noted on Schedule 25A that such documentation is available. The documentation is not submitted unless the ATO sends out a

¹⁰⁶ SARS' *Practice Note No 7* op cit note 16 para 10.2.4.

¹⁰⁷ Ernst & Young op cit note 87 at 7; OECD op cit note 75.

specific notification requesting it to be, and this should be done within the two weeks following the notification.¹⁰⁸

4.5.2 Penalties

Penalties relating to transfer pricing adjustments are covered in Section 225 of the Income Tax Act 1936 and Division 284 of the Tax Administration Act 1953, and they are as follows:

- Transfer pricing agreements entered into where sole or main purpose was to pay no or less tax → 50% of the tax avoided
If taxpayer has a reasonably arguable position → reduction to 25%
- Other transfer pricing agreements entered into where tax was avoided → 25% of tax avoided
If taxpayer has a reasonably arguable position → reduction to 10%

The Commissioner can however use his discretionary power to reduce the penalties to zero.¹⁰⁹

The relevant taxation rulings are TR 98/11 and TR 98/16 and they indicate that the above penalties can be avoided if taxpayers satisfactorily complete the 4 step process in setting and reviewing transfer prices and that they prepare contemporaneous documentation to substantiate the arm's length conditions arrived at.¹¹⁰ APAs also protect taxpayers from incurring penalties, unless the transactions or agreements entered into do not satisfy the terms and conditions of the APA.¹¹¹

¹⁰⁸ Ernst & Young op cit note 87 at 7.

¹⁰⁹ OECD op cit note 75.

¹¹⁰ Ibid.

¹¹¹ Ernst & Young op cit note 87 at 7.

4.6 UNITED KINGDOM

4.6.1 Documentation Requirements

The taxpayer is required to have prepared transfer pricing documentation by the time the annual tax return must be filed. It is not compulsory though to submit the documentation together with the annual tax return, but rather when the UK Tax Authorities ask to see it.¹¹²

The Inland Revenue, with regards to the availability of transfer pricing records, has provided the following guidance:

- transactions should be accounted for as they take place
- records of tax adjustments and transactions with connected parties need only be performed on filing of the tax return
- proof to show that an arm's length price has been arrived at need not be prepared unless requested by the Tax Authorities¹¹³

However, such guidance may not be useful in practice due to the following reasons:

- Transfer pricing adjustments to ensure the price is at arm's length should be done before a company's books are closed for the year as adjustments to a tax return, in some countries, do not allow for alterations to both sides of a transaction when the transfer pricing adjustment is downwards, resulting in double taxation.
- Transfer pricing adjustments done in a tax return are more likely to result in an audit.¹¹⁴

¹¹² BKR International 'BKR Transfer Pricing Survey: Transfer Pricing and Documentation' at 16. Available at <http://www.lohncaulder.com/docs/library/154.pdf> [Accessed 3 January 2007].

¹¹³ Sean Foley and Andrew Hickman 'Meeting the "contemporaneous" requirement' at 17. Available at [http://www.kpmgtaxwatch.com/pub/intl/TransferPricingGuide_2005_\(7thEdition\).pdf](http://www.kpmgtaxwatch.com/pub/intl/TransferPricingGuide_2005_(7thEdition).pdf) [Accessed 3 January 2007].

4.6.2 Penalties

Should documentation not be available when requested by the Tax Authorities, paragraph 23 of schedule 18 of the Finance Act 1998 imposes a fixed penalty not exceeding £3000.¹¹⁵ Where the transfer pricing has to be adjusted, as the result of a fraudulent or negligent tax return being submitted, additional penalties of up to 100% of the tax lost will also be imposed on the taxpayer under Section 95/96 of Taxes Management Act of 1970 and Paragraph 20 Schedule 18 Finance Act of 1988.¹¹⁶ Interest will also be levied on the additional tax payable by the taxpayer due to the transfer pricing adjustment.¹¹⁷

Documenting transfer pricing policies may protect taxpayers from neglect penalties, as the documentation will serve as proof of the application of the ALP. Any reduction in penalties will be made after taking into account size, gravity, disclosure and co-operation.¹¹⁸

4.7 CANADA

4.7.1 Documentation Requirements

Regulations issued by the CRA state that the deadline for the preparation of contemporaneous documentation is by the filing date of annual tax returns, which is six months after year-end. Any documentation submitted after year-end will not be seen as contemporaneous and will be subject to transfer pricing penalties.¹¹⁹

¹¹⁴ Foley and Hickman op cit note 113 at 17.

¹¹⁵ Foley and Hickman op cit note 113 at 16.

¹¹⁶ Foley and Hickman op cit note 113 at 17; Ernst & Young op cit note 77 at 69.

¹¹⁷ BKR International op cit note 112 at 16.

¹¹⁸ Ernst & Young op cit note 77 at 69.

¹¹⁹ Foley and Hickman op cit note 113 at 14.

To avoid the imposition of penalties, taxpayers need to show that they have made concerted efforts to arrive at an arm's length transfer price. According to section 247(4) of the Canada ITA, this can be achieved by preparing contemporaneous documentation that includes a description of the following:

- (1) the actual transaction,
- (2) the terms and the conditions of the transaction and its related transactions,
- (3) the participants involved and how they are related to each other,
- (4) the information available and transfer pricing methods looked at to arrive at the arm's length transfer price used
- (5) the business reasons for the transfer price chosen¹²⁰

4.7.2 Penalties

In terms of subsection 247(3) of the ITA, a transfer pricing adjustment is subject to a penalty of 10%, provided the adjustment is positive. In other words, a penalty may only be imposed on a taxpayer where the transfer pricing adjustment has resulted in an increase in the taxpayer's income or a decrease in the taxpayer's loss.¹²¹ Before a penalty is imposed the Transfer Pricing Review Committee reviews it, and up to March 2006 the Committee has suggested penalties for about half the cases that it has reviewed.¹²²

The following situations can lead to the elimination of transfer pricing penalties:

- The net transfer pricing adjustments do not exceed the lesser of: 10% of the taxpayer's gross revenue or C\$ 5 million, or

¹²⁰ Jamie M Wilks and McShane D Jones *Customs Valuation and Transfer Pricing in Canada* (2002) 52.

¹²¹ Akin et al op cit note 85.

¹²² Ernst & Young op cit note 77 at 13.

- The taxpayer made “reasonable efforts” to conclude an arm’s length result by preparing contemporaneous documentation, either within six months following its taxation year end, or within three months of the CRA’s request.¹²³

4.8 SURVEY ON TRANSFER PRICING DOCUMENTATION PRACTICES

In Ernst & Young’s 2005-2006 Transfer Pricing Surveys, compliance demands was highlighted as one of the major driving forces behind the increase in the importance of transfer pricing.¹²⁴

Even though transfer pricing documentation serves as a guard against a transfer pricing audit, many of the 348 parent companies interviewed did not approach transfer pricing documentation seriously. Numerous countries require transfer pricing documentation to be prepared by the filing date of the annual return, yet less than fifty percent of the companies interviewed stated that they do so. Almost one third of the respondents mentioned that they only prepare documentation on a country-by-country basis when the need to do so arises, resulting in some of these respondents only preparing documentation when they have been selected for an audit. The risk of these countries incurring transfer pricing penalties due to transfer pricing adjustments is large.¹²⁵

¹²³ Ibid; Ernst & Young op cit note 1 at 21.

¹²⁴ Ernst & Young op cit note 87 at 4.

¹²⁵ Ernst & Young op cit note 87 at 10.

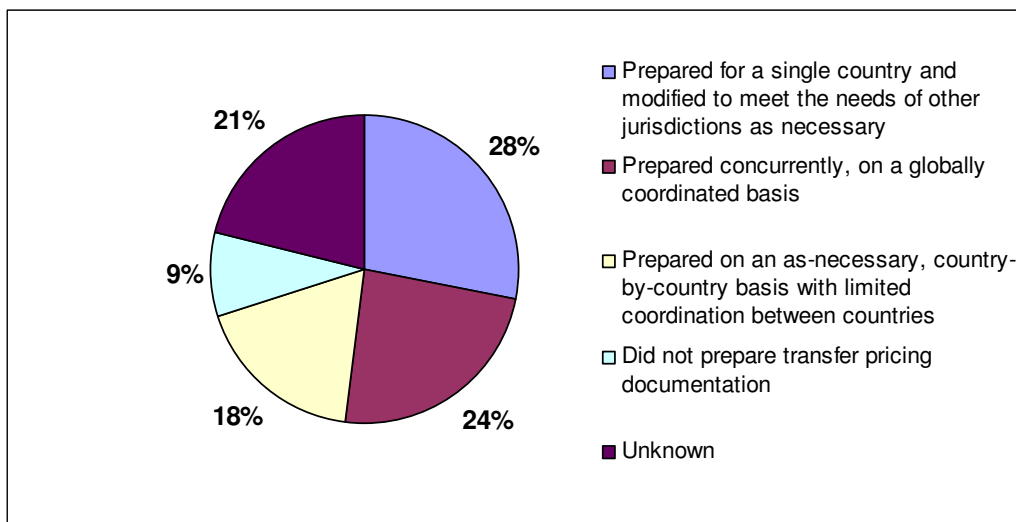


Table 4.1
Approach to Transfer Pricing Documentation (Parent Companies)

When asked the reasons for preparing transfer pricing documentation, 18% of the parent company respondents indicate that it is to defend themselves in an audit and 24% use it to reduce risk. Only 9% see preparing documentation as an opportunity to plan their taxes.¹²⁶

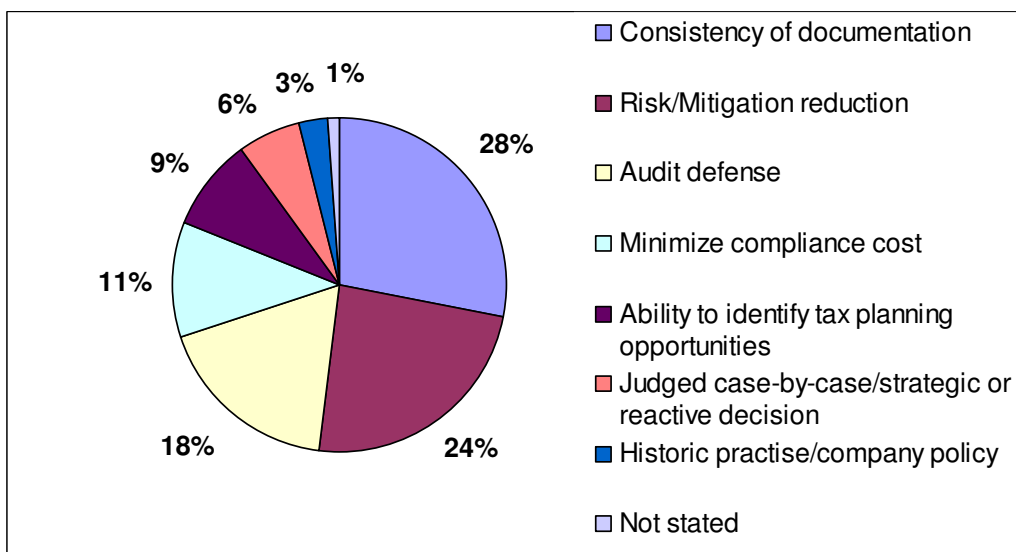


Table 4.2
Why MNEs Prepare TP Documentation

¹²⁶ Ibid.

4.9 CONCLUSION

With the increasing interest in transfer pricing in South Africa, it is advisable for companies engaged in cross-border transactions to start preparing contemporaneous documentation now, especially because of the backdating that may take place should the Commissioner find that the taxpayer is guilty of non-disclosure of material facts, fraud or misrepresentation. In a jurisdiction where the onus is on the taxpayer, preparing adequate documentation may serve as a vital defence against transfer pricing investigations by SARS in illustrating compliance with the ALP. As will be discussed further on, the other countries under review may make use of APAs to protect themselves from incurring transfer pricing penalties. However, this option is not yet available to South Africa, making the preparation of contemporaneous documentation even more important to South Africa than the other countries.

Because it is not a statutory requirement to prepare documentation, it is difficult for taxpayers to be certain that they are meeting statutory requirements with regards to preventing the incurrance of penalties as a result of non-compliance with the ALP. Following the guidelines contained in SARS' Practice Note No 7 may not always serve as a preventative measure against non-compliance penalties if the taxpayer has construed the guidelines to mean something different to that of SARS.

South Africa is the only country under review that does not have specific provisions relating to transfer pricing penalties, but rather general penalty rules applicable in terms of the Act. However, these general penalty rules provide the same purpose and the Commissioner has the discretion to remit penalties imposed in the same way the other countries can use specific transfer pricing provisions.

The disadvantages to preparing transfer pricing documentation include the fact that it is time consuming and costly, but with SARS seeing transfer pricing as a potentially 'lucrative area',¹²⁷ the tax risk of not preparing such documentation could be even higher.

¹²⁷ Joubert op cit note 96.

CHAPTER 5: ADVANCE PRICING AGREEMENTS

5.1 INTRODUCTION

The OECD defines an APA as follows:

An advance pricing agreement ('APA') is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, and critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An APA is formally initiated by a taxpayer and requires negotiations between the taxpayer, one or more associated enterprises, and one or more tax administrations.¹²⁸

APAs between two countries (bilateral) or between multiple countries (multilateral) are preferable as they aid in the prevention of double taxation, a primary risk associated with transfer pricing.¹²⁹

Unfortunately, South Africa has not been granted the option of agreeing in advance to an acceptable range of pricing with the revenue authorities.¹³⁰ This is made clear in para 16.2 of the SARS' Practice Note No 7, which states that 'the APA process will not in the foreseeable future be made available to South African taxpayers'. SARS does not give the reasons why.

5.2 CERTAINTY IN LAW

'...the subjects of every state ought to contribute towards the support of the government in proportion to the revenue which they respectively enjoy under the protection of the state.' In order for this to be achieved, taxpayers need to know with certainty the time, manner and amount to be contributed. This

¹²⁸ OECD 'Transfer Pricing Guidelines' para 4.124 cited in Eduardo A Baistrocchi 'Transfer Pricing in the 21st Century: A Proposal for both Developed and Developing Countries' at 11. Available at <http://repositories.cdlib.org/bple/alacde/20> [Accessed 5 December 2006].

¹²⁹ Rolf & Casley cited in Olivier and Honiball op cit note 8 at 415.

¹³⁰ Cridlan op cit note 4 at 46.

allows taxpayers to predict the tax consequences of transactions in advance, resulting in effective tax planning and budgeting. Certainty can be achieved through the implementation of legal rules. Transfer pricing in South Africa is lacking in certainty, as the application of the Practice Note issued by SARS, providing the working of available transfer pricing methods, does not always result in an arm's length condition being achieved by the taxpayer. To ensure certainty of arriving at an arm's length price, other countries have adopted the use of APAs.¹³¹

In the case of *R v Jopp*,¹³² the court held that the person bound by the by-law or regulation must know with reasonable certainty what act is permitted, or what act is enjoined or prohibited so that the person may conduct his affairs accordingly. If certainty exists, the by-law or regulation is valid. If there is uncertainty, the by-law or regulation is invalid.¹³³

In *R v Rousseau*,¹³⁴ the principle from *R v Jopp*¹³⁵ was applied. The court held that the by-law or regulation affecting the person must provide guidance such that the person is able to avoid contravening it.¹³⁶

5.3 ADVANTAGES OF USING APAs

The upholding of the principle of tax certainty is necessary so that taxpayers can know in advance the tax consequences of any given transaction. One of the means of ensuring transfer pricing certainty, and preventing the incurrance of penalties for non-compliance with the requirements of the relevant tax authority, is the use of APAs.¹³⁷

¹³¹ Annet Wanyana Oguttu 'Resolving Transfer-pricing Disputes: Are "Advance Pricing Agreements" the Way Forward for South Africa?' (2006) 18 *SA Merc LJ* 392 at 392-393.

¹³² 1949(4) SA 11 (N).

¹³³ Yvonne Burns 'Administrative Law' (2003) 1 2ed *LAWSA*; Makola op cit note 3 at 51.

¹³⁴ 1956(1) SA 783 (C).

¹³⁵ *Supra* note 130.

¹³⁶ Makola op cit note 3 at 51.

¹³⁷ Oguttu op cit note 131 at 401.

Besides bringing certainty, APAs can help to avoid the extensive audits, queries and controversies resulting in costly transfer pricing disputes, by arriving at arm's length prices before the conclusion of any transactions.¹³⁸

As mentioned above, the use of an APA eliminates the need to conduct a long, drawn out audit. This has resulted in an increase in the number of countries choosing in favour of offering APAs as tax authorities can then devote more time and utilise scarce resources in other tax administrative areas.¹³⁹

Other advantages of using APAs include the reduction or elimination of double taxation, providing an alternative solution to allocating profits to the correct tax jurisdictions without being taxed twice, and minimising the volume of record keeping as APAs will allow you to know in advance what substantiating records are required to be kept.¹⁴⁰

5.4 CRITICISMS AGAINST THE USE OF APAs

If the issues involved are difficult and the interests of the participants vary, the APA negotiations may lead to quarrelsome situations. APAs have also not been regarded as being helpful in resolving difficult issues, such as those involving high value intangibles, but should rather be used for more straightforward issues, such as those involving tangible property, services and routine intangibles.¹⁴¹

Because APAs are not statutory in nature, they cannot be legally objected to. When APAs are negotiated in private it may result in subsequent parties being negatively affected due to the fact that they had no

¹³⁸ *Federal Tax Conference Discussion Paper* cited in Oguttu op cit note 131 at 401.

¹³⁹ Campos cited in Oguttu op cit note 131 at 402.

¹⁴⁰ Australian Taxation Office 'International Transfer Pricing: Advance Pricing Arrangements' 2005 at 3.

¹⁴¹ *Federal Tax Conference Paper* cited in Oguttu op cit note 131 at 402.

say in the agreements concluded. The agreements concluded may also be more influenced by tax considerations than business reasons if getting an APA results in a greater advantage overall.¹⁴²

Another criticism against APAs is that the period they are entered into is fixed, and if this period is too long the taxpayer's flexibility in making sound business decisions may be negatively affected.¹⁴³ The adoption of APAs is also not being done at a rapid pace due to the requirement of the employment of specialised professionals that are costly and difficult to retain, creating an additional disincentive to the APA process.¹⁴⁴

For companies with "skeletons in the cupboard", the use of APAs may not necessarily be beneficial. Because of the extensive amount of information required to be included in an APA, it may result in transfer pricing information being uncovered that would not have been picked up in an audit. This information can also be used for auditing/litigation purposes in prior years not covered by the APA.¹⁴⁵

There is also the possibility of an APA application being refused by the tax authorities, or they may, at any time, withdraw from the process due to a number of reasons. This means that taxpayers may incur APA application preparation expenses with no guarantee of securing an APA.¹⁴⁶

¹⁴² Lodin cited in Oguttu op cit note 131 at 402.

¹⁴³ Vogel cited in Oguttu op cit note 131 at 403.

¹⁴⁴ *Federal Tax Conference Paper*, Hadari and Campos cited in Oguttu op cit note 131 at 403.

¹⁴⁵ Bulbul Sen 'Advance Pricing Mechanisms in Transfer Pricing: World Experience & Lessons for India.' Available at [http://www.assochem.org/events/recent/event_36/Bulbul_Sen_APA.ppt#256,1,Advance Pricing Mechanisms in Transfer Pricing: World Experience & Lessons for India](http://www.assochem.org/events/recent/event_36/Bulbul_Sen_APA.ppt#256,1,Advance_Pricing_Mechanisms_in_Transfer_Pricing:_World_Experience_&_Lessons_for_India) [Accessed 17 January 2007].

¹⁴⁶ Ibid.

5.5 THE APA PROGRAM IN AUSTRALIA

The ATO encourages taxpayers to use APAs and more specifically bilateral APAs. Guidance on APAs and the process surrounding them can be found in the Taxation Ruling TR 95/23 and the ATO has also written a guide on Australia's APA program.¹⁴⁷

In Australia APAs are available to any enterprise engaged in cross-border connected party transactions and agreements as long as such transactions or agreements covered by the APA are not immaterial, hypothetical or involving unacceptable transfer pricing methods that do not result in an arm's length price range being achieved.¹⁴⁸

There is no set layout for an APA application; however the application must contain stipulations for the use of the transfer pricing methodology. The APAs are generally negotiated in such a manner that besides providing certainty for the taxpayer, they also provide results that are realistic, avoiding the possibility of unpleasant audit situations.¹⁴⁹

Advantages to having an APA in Australia include providing assurance to the taxpayer against an adjustment to the transfer pricing methodology selected, assisting in resolving issues that may have arisen in previous periods and the option of renewal before expiration of the initial term. Disadvantages, on the other hand, include the considerable cost of collecting information and the lengthy process of twelve months before the approval/refusal of an application.¹⁵⁰

¹⁴⁷ OECD op cit note 75; Ernst & Young op cit note 87 at 7.

¹⁴⁸ OECD op cit note 75.

¹⁴⁹ OECD op cit note 75; Ernst & Young op cit note 87 at 7.

¹⁵⁰ Sen op cit note 145.

5.6 THE APA PROGRAM IN THE UNITED KINGDOM

Legislation on APAs was introduced in the UK in 1999 in section 85-87 of the Finance Act, and guidelines on the application of these sections are contained in a Statement of Practice released in September 1999. In order for an application for an APA to be granted, it needs to be established that the transfer pricing issues to be dealt with in the APA are so complex that it will impact compliance with the ALP.¹⁵¹

Applications for both unilateral and bilateral APAs will be considered, however bilateral APAs are encouraged over unilateral APAs. This is due to the fact that bilateral APAs result in tax administrations of both countries agreeing to the method selected for dealing with the transfer pricing issues covered in the APA.¹⁵² An APA will last a minimum period of 3 years and a maximum period of five years and will normally apply prospectively. In certain circumstances though, where the facts surrounding prior periods are considerably similar, special provisions can be made to roll back the APA methodology.¹⁵³ There are also provisions in place for an APA to be renewed, unless the issues stay the same, which in that case the APA can just be amended and extended. A disincentive to the APA process is the time factor, with the UK taking 18 – 21 months from the receipt of an application.¹⁵⁴

Should a taxpayer, at any time, be guilty of misrepresentation or omission of facts resulting in the APA reflecting non-arm's length conditions, or there has been a lack of compliance by the taxpayer with a provision contained in the agreement, the tax authorities may revoke the APA. Furthermore, a taxpayer cannot appeal against a revocation but can only

¹⁵¹ Ernst & Young op cit note 77 at 69.

¹⁵² Makola op cit note 3 at 43; John Hobster and Les Secular 'UK: Advance pricing agreements' 1999 *International Tax Review*. Available at <http://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=12646&SID=468151&TYPE=20> [Accessed 17 January 2007].

¹⁵³ Hobster and Secular op cit note 152.

¹⁵⁴ Sen op cit note 145.

appeal against the assessments issued subsequent to the revocation. APAs do not provide protection against transfer pricing penalties for tax evasion in a tax return as a result of fraudulence, misrepresentation or non-disclosure of material facts. False or misleading information in an APA application will also attract penalties.¹⁵⁵

5.7 THE APA PROGRAM IN CANADA

The Canadian APA program has been in operation since 1993 with APAs being available under Information Circular 94-4R (March 2001).¹⁵⁶ There is no statutory provision relating to APAs, however, the Competent Authority Services Division (CASD), which is responsible for the Canadian APA program, considers APAs to be its 'preferred transfer pricing dispute resolution program'.¹⁵⁷ The CRA's purpose for the APA program is to:

- eliminate the possibility of double taxation;
- allow taxpayers to determine acceptable transfer pricing methodologies for non-arm's length transactions with non-residents for purposes of the ITA; and
- assist in the resolution of transfer pricing disputes.¹⁵⁸

Although unilateral, bilateral and multilateral APAs are available to taxpayers, the CRA prefers bilateral and multilateral APAs as unilateral APAs cannot prevent double taxation.¹⁵⁹ Bilateral and multilateral APAs also provide the benefit of certainty with regards to the treatment of the transfer pricing issues in all the countries concerned.¹⁶⁰

¹⁵⁵ Hobster and Secular op cit note 152.

¹⁵⁶ Makola op cit note 3 at 44.

¹⁵⁷ Ernst & Young op cit note 1 at 22.

¹⁵⁸ transferpricing.ca 'The Transfer Pricing Regulatory Environment in Canada.' Available at <http://www.transferpricing.ca/legal.htm> [Accessed 21 December 2006].

¹⁵⁹ Makola op cit note 3 at 45.

¹⁶⁰ transferpricing.ca op cit note 158.

The CASD does not levy a fee for APAs, but should an APA application be accepted or an APA renewed, a non-refundable fee is charged for 'out-of-pocket' costs, which could include, for example, the cost of travelling and accommodation of the team conducting the application process.¹⁶¹

The APA program, however, also includes many unappealing aspects, such as the following:

- the approval process is lengthy and expensive;
- the cost of providing detailed information to the fiscal authorities can outweigh the benefits that result. The costs include 'sensitive commercial pricing and strategic information' being disclosed by the fiscal authorities through industry databases, and the use of APA information in subsequent audits.
- There is no guarantee that the Canadian government will accept a bilateral or multilateral APA and therefore double taxation may still occur.¹⁶²

5.8 CONCLUSION

All three countries reviewed above follow an APA program with the United Kingdom being the only country with APA statutory provisions though. Preference lies with bilateral and multilateral APAs, which assist in the avoidance of potential double taxation and provide certainty with regards to the agreement of transfer pricing methods to be used by the countries involved in the cross-border transactions.

Although the APA application process is time-consuming and costly, the benefit of tax certainty, which assists in the prevention of non-compliance penalties and costly transfer pricing disputes, outweighs the cost advantage. South Africa should therefore consider allowing taxpayers to apply for APAs

¹⁶¹ Makola op cit note 3 at 45; Ernst & Young op cit note 1 at 22.

¹⁶² Makola op cit note 3 at 46-47; transferpricing.ca op cit note 158.

in respect of transfer pricing as an alternative to contemporaneous documentation that may not assist in a transfer pricing dispute anyway.

As mentioned above, there are also many downsides to APAs. For this reason, South Africa should modify/simplify aspects of the APA programs followed in other countries when deciding on a suitable program. The following changes could be implemented:

- The APA period could be shorter than the minimum period of three years as per other countries to allow for flexibility in the making of business decisions
- The expense involved in the application process should be reduced for small to medium sized multinationals so that they are not disadvantaged
- Guidelines should be issued by authorities that help minimise the possibility of a refusal of an APA so that unnecessary preparation expenditure is not incurred¹⁶³
- The APAs should initially be limited to resolving straightforward issues to avoid unpleasant negotiation situations

The advantage to South Africa of introducing an APA program after other countries is that South Africa can learn from their experiences without having to incur the same costs and time. An APA program in South Africa would also encourage foreign investment and promote economic growth, as foreigners, with subsidiaries or branches in South Africa, would be more attracted to invest in a country where they know transfer pricing disputes will be resolved easily.¹⁶⁴

The lack of specialised professionals and the cost of retaining them may pose a problem to South Africa. However, with transfer pricing being the dominant tax issue facing MNEs, according to Ernst & Young's 2005-2006

¹⁶³ Sen op cit note 145.

¹⁶⁴ Oguttu op cit note 131 at 404-405.

Global Transfer Pricing Surveys, the cost of employing specialised professionals in APAs may be less than those incurred resolving transfer pricing disputes as a result of no APA program being available to taxpayers in South Africa.

CHAPTER 6: E-COMMERCE

6.1 INTRODUCTION

Everything that was comfortable and familiar about business is changing. We're at the beginning of an age that will complete the relentless act of connecting everything to everything else. This networked economy – decentralised and anti-hierarchical – will be the most important force shaping the next decade, and will change the world's societies, culture, and politics. But first it will radically transform business, altering the way they reach their customers, advertise their wares, distribute their products, create new businesses, and communicate with one another and their staffs.¹⁶⁵

Because of the increased use of the Internet and electronic commerce ("e-commerce") as a way of doing business, tax authorities will have to review their present legislation and practices to protect their respective tax basis.¹⁶⁶ One of the crucial challenges that e-commerce has created is that of being able to apply the ALP to transfer pricing when trade takes place between multinational corporations in different tax jurisdictions.¹⁶⁷ In the discussion paper, prepared by the Fiscal Affairs Committee, for the OECD Ottawa Conference on electronic commerce, it was mentioned that e-commerce has not resulted in the introduction of new problems for transfer pricing, but instead has made them more common. The lack of physical boundaries makes it extremely difficult to identify, trace, quantify and verify cross-border transactions.¹⁶⁸

¹⁶⁵ J Daly cited in Richardson op cit note 5.

¹⁶⁶ Bernard du Plessis and Michelle Viljoen 'Taxation of e-commerce: income tax.' Available at <http://www.buys.co.za/publications/cyberlaw/cybertext/chapter8.htm> [Accessed 21 December 2006].

¹⁶⁷ Annet Wanyana Oguttu 'Transfer Pricing and Tax Avoidance: Is the Arm's length Principle Still Relevant in the e-Commerce Era?' (2006) 18 *SA Merc LJ* 138 at 138-139.

¹⁶⁸ Jonathan S Schwarz 'Transfer Pricing and Electronic Commerce.' Available at <http://www.jschwarz.demon.co.uk/jstransferpricing03.html> [Accessed 18 January 2007].

6.2 POTENTIAL DIFFICULTIES AND EFFECTS OF E-COMMERCE

6.2.1 Goods and Services

In traditional commerce, the open market value of goods and services is generally determined with reference to the various characteristics displayed. With respect to goods, this could include quality and reliability, while services could include the nature and extent of the services. Goods and services offered electronically, however, have been de-materialised as a result of being supplied in a digital form, thus causing the comparability of transactions to be affected. One such comparable factor is that of durability. Music on a CD for example can be played many times, but if that music is digitised it can only be played subject to management by the supplier. Comparability with respect to prices is also impacted as digitised products may be easily copied.¹⁶⁹

Before the Commissioner can adjust a transfer price to reflect an arm's length price, the provision in s 31(2) has to be met in that the goods or services must have been sold at a non-arm's-length price. In traditional commerce, transactions are generally easy to uncover by the trail of paper they leave behind, while prices charged for goods or services sold electronically are difficult to determine due to payment being made with electronic money or digital cash. These forms of payment make it relatively easy for multinational corporations to carry out transfer pricing transactions.¹⁷⁰

The functions performed by each company must be compared before the prices of controlled and uncontrolled transactions can be compared.¹⁷¹ This comparison must be determined with reference to the important

¹⁶⁹ Oguttu op cit note 167 at 146; Schwarz op cit note 166.

¹⁷⁰ Oguttu op cit note 167 at 154.

¹⁷¹ Schwarz op cit note 168.

activities and responsibilities undertaken or to be undertaken.¹⁷² To perform a functional analysis, a close understanding of the business functions is required to determine the relative contributions made. In e-commerce transactions this is difficult to measure. For example, when an intangible is delivered on a web page the functions being performed could be any of the following: an advertisement, subject to a copyright, or a provision of services.¹⁷³

Physical services such as consulting are also available electronically through video conferencing and electronic messaging for example. Because physical consultants are generally very expensive, multinational corporations are more likely going to seek on-line services at lower costs from distant locations than expensive services offered locally.¹⁷⁴

6.2.2 Identification of Connected Parties

In terms of s 31(2) of the Act, the price that goods or services are sold can only be said to be non-arm's length if the two parties concerned are 'connected'.

At present it is difficult to determine who the physical parties are behind Internet transactions as the only information that can be gathered from an Internet address is who is responsible for the upkeep of that name. It does not give you the users of that address or the location of the computer. Owners of web sites can also not be detected as usage of Internet sites does not leave a trail, owners can conceal the existence or location of their websites by using intricate networks or false names, they can use offshore servers to prevent monitoring of their sites and where monitoring is not

¹⁷² OECD *Transfer Pricing Guidelines* para 1.20 cited in Schwarz op cit note 168.

¹⁷³ Oguttu op cit note 167 at 155; Schwarz op cit note 166.

¹⁷⁴ Oguttu op cit note 167 at 147.

avoidable, encryption may be used to prevent the nature and value of their Internet transactions from being revealed.¹⁷⁵

The following views were expressed by the ATO regarding this issue:

A key issue will be the extent to which the Internet will allow business activities to be undetectable or anonymous, so that the key taxing and auditing requirements of the existence and identity of persons or transactions cannot be determined. A high level of non-detection could lead to tax evasion in a highly competitive global business environment where businesses may be forced to adopt non-compliance facilities to compete with other businesses, thus exacerbating non-compliance. The migration of businesses to the Internet may be partially driven by the tax avoidance and evasion opportunities it presents.¹⁷⁶

6.2.3 Methods Used to Arrive at an Arm's Length Price

Following the Transfer Pricing Guidelines of the OECD, there must be a comparable uncontrolled transaction to be able to apply the traditional transaction methods so as to arrive at an arm's length price.¹⁷⁷ In traditional commerce, finding comparable uncontrolled transactions is often difficult as multinational enterprises are frequently integrated to attain economies of scale, and they trade in highly specialised goods and services. Independent transactions carried out by two non-integrated enterprises trading in the same or similar goods or services are therefore not comparable to the measures achieved through integration.¹⁷⁸

¹⁷⁵ Du Plessis and Viljoen op cit note 166.

¹⁷⁶ Australian Taxation Office (1997) 49 cited in du Plessis and Viljoen op cit note 166.

¹⁷⁷ OECD *Transfer Pricing Guidelines* at 325 para 34 cited in Oguttu op cit note 167 at 155.

¹⁷⁸ Oguttu op cit note 167 at 155.

Finding comparable uncontrolled e-commerce transactions is even more difficult as it is hard to determine exactly what the transactions involve due to their uniqueness. Separate transactions can also be so closely linked that it becomes impossible to evaluate them individually. The traditional approach is also negatively impacted by the use of Intranets within multinational enterprises, as an analysis with independent transactions cannot be done.¹⁷⁹

Traditional transaction methods are usually given preference in determining an arm's length price. However, at the OECD Ottawa Conference on e-commerce in 1998, it was proposed that in certain situations the application of transaction profit methods, more specifically the Profit Split method, would be more suitable. This is because in e-commerce the traditional transaction methods are unreliable due to a lack of comparable uncontrolled transactions or highly integrated business transactions.¹⁸⁰

6.3 CONCLUSION

South Africa, along with many other countries, has adopted the ALP on a basis consistent with the OECD Guidelines, as this principle produces the most reliable outcome. However, where transactions are not restricted to the geographical boundaries of a country, goods and services can be transferred between countries at a non-arm's length price, in an effort to evade tax, without being detected.

As mentioned by the ATO earlier in this chapter, if businesses succeed in evading tax through the use of e-commerce, it puts them at a competitive advantage, and other businesses will therefore need to follow suit in order to stay in business. To protect South Africa's tax base,

¹⁷⁹ Oguttu op cit note 167 at 155-156.

¹⁸⁰ OECD *Electronic Commerce Discussion Paper* cited in Oguttu op cit note 167 at 148-149.

taxpayers need to be provided with guidelines with regards to conducting trade electronically, and certainty as to the consequences of their actions.

One of the reasons making it difficult to determine an arm's length price is the inability to evaluate a comparable transaction when it is so closely linked to another transaction. It may be useful for South Africa to consider the way in which the United Kingdom has defined a transaction in its transfer pricing legislation to include "a series of transactions" where separating transactions may not enable the assessment of the arm's length conditions.¹⁸¹

Because it has to first be established that goods or services were sold at a non-arm's length price and between connected parties, before the Commissioner can adjust a transfer price to reflect an arm's length price, it may be necessary to modify or add to the current s 31(2), to enable it to also apply to e-commerce transactions. Section 31(2) could incorporate the provisions of the Electronic Communications and Transactions Act No. 25 of 2002, which would enable information pertaining to the cross-border supply of electronic goods and services to be ascertained.¹⁸²

¹⁸¹ Schwarz op cit note 168.

¹⁸² Oguttu op cit note 167 at 158.

CHAPTER 7: CONCLUSION

This study has addressed a number of important issues in respect of transfer pricing in South Africa, a topic that has come under the spotlight in recent years, as a result of globalisation leading to an increase in international trade. A comparative examination was made between the approaches to transfer pricing adopted by South Africa to those adopted by Australia, the United Kingdom and Canada.

The results of the research indicate that all the countries under review have accepted the ALP, endorsed and adopted by the OECD. This principle is achieved through the use of the transfer pricing methods contained in the OECD Transfer Pricing Guidelines, of which preference is given to the traditional transaction methods. Although the ALP produces a sound outcome, South Africa's lack of comparable uncontrolled transactions makes it difficult to apply, encouraging the use of foreign comparables, which leads to further complications such as the ability to make adjustments to enhance comparability.¹⁸³ Comparable uncontrolled transactions are also difficult to find when trade is conducted electronically, and therefore in certain situations transaction profit methods will be more suitable.

Findings with regards to documentation include the need for legal requirements that would provide taxpayers with certainty as to what would constitute adequate documentation for SARS, avoiding unnecessary time and money being spent. The need for documentation is highlighted by the Ernst & Young 2005-2006 Global Transfer Pricing Surveys in which it states that: '...many countries plan to focus their attacks on transaction flows with lower tax jurisdictions.'¹⁸⁴

¹⁸³ Loots op cit note 89 at 108.

¹⁸⁴ Ernst & Young op cit note 1 at 8.

Although South Africa is the only country under review without specific transfer pricing penalties, the general penalty provisions of the Act are effective in punishing taxpayers for not complying with the ALP, and are also discretionary as with specific transfer pricing penalties in other countries. According to Jacques van Rhyn, tax director of PricewaterhouseCooper, the transfer pricing area of taxation has globally become a major source of income for tax authorities and the accompanying penalties and interest are onerous.¹⁸⁵ Taxpayers should prevent themselves from incurring interest, penalties and double taxation, as a result of transfer pricing adjustments to cross-border transactions entered into from July 1995, by retroactively applying the guidance issued by SARS in Practice Note No 7. SARS will not accept ignorance as an excuse.¹⁸⁶

An additional finding of the research is that South Africa, unlike the other three countries reviewed, has not yet implemented an APA program, putting it at a great disadvantage with regards to legal certainty. APAs would also provide certainty that foreign investors are looking for, which would in turn benefit South Africa's economy. South Africa falls into the category of countries referred to by the Ernst & Young 2005-2006 Global Transfer Pricing Surveys when it mentions that: 'Hard hitting documentation and penalty regimes precede APA availability by some years.'¹⁸⁷ Until an APA program is introduced in South Africa, preparing documentation is the best line of defense when it comes to transfer pricing investigations.

The following findings from Ernst & Young's investigation of various tax authorities sum up the key messages with regards to transfer pricing:

... tax authorities are better prepared than ever before; they are better informed; and they are under more pressure to deliver revenue "gains" from anti-avoidance work. Transfer pricing adjustments are going to become more contested and more frequent. The environment will also become far more litigious. Companies will need not just tax

¹⁸⁵ Kathy Thersby 'Transfer pricing attack: motor industry under spotlight' (2006) 251 *Tax Breaks Newsletter* 2 at 2.

¹⁸⁶ Richardson op cit note 5 at 135.

¹⁸⁷ Ernst & Young op cit note 1 at 8.

technical expertise to counter these trends, they will also need to carefully align their transfer pricing structures with the commercial and operational imperatives of their business. And they will need to think globally in terms of policy, and locally in terms of documentation and defense. Nothing less will do.¹⁸⁸

¹⁸⁸ Ernst & Young op cit note 1 at 12.

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