

**Global trading and transfer pricing: Application of
the transfer pricing methods and OECD BEPS
Action Plan 9 to global trading of financial
instruments by MNE groups in the financial
services sector**

by

Arlene Joseph

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Supervisor: Associate Professor Craig West

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Abstract

This dissertation focuses on the Organisation for Economic Co-operation and Development ('OECD') transfer pricing methods and its application to Multinational Enterprise ('MNE') groups in the financial sector. This study examines whether the OECD's Base Erosion and Profit Shifting ('BEPS') Action Plan 9 is an appropriate framework for MNE groups in the banking sector or whether it creates further challenges.

Additionally, the dissertation scrutinises MNE groups in the financial sector that are involved in the business of global trading of financial instruments. It further explores the functions of a global trading entity, the arm's length principle and the OECD BEPS Action Plan 9.

This dissertation concludes that the global trading of financial instruments using the integrated trading model is challenged when the OECD traditional transfer pricing methods are applied. Multinational financial institution groups in the banking sector that are involved in the business of global trading of financial instruments are subject to rigid regulations. Furthermore, the report concludes that these rigid regulations mitigate some of the complications that arise when applying the OECD BEPS Action Plan 9.

Taxing authorities need to focus greater attention on the global trading of financial instruments by multinational financial institutions groups. As South Africa's financial institutions expand across borders, the concerns over transfer pricing and BEPS are likely to intensify. It is therefore imperative that the South African revenue authorities prioritise the recruitment of skilled personnel in order to address the complexities posed by the global trading of financial instruments by multinational financial institution groups.

Glossary of terms

Affiliated companies

Affiliated companies is a “general term used to describe the relationship between two or more companies linked by a common interest” (OECD, 2016c:1).

Associated enterprises

An associated enterprise is defined as an enterprise described in accordance with Article 9 of the OECD MTC. According to this article “two enterprises are associated if one of the enterprises participates directly or indirectly in the management, control, or capital of the other or if the same persons participate directly or indirectly in the management, control, or capital of both enterprises (i.e. if both enterprises are under common control)” (OECD, 2010c:23).

Controlled transactions

Controlled transactions in the context of this dissertation are “transactions between two enterprises that are associated enterprises with respect to each other” (OECD, 2010c:25).

Credit risk

Simply defined credit risk is the “risk that a bank will not receive the expected payments from the customer” hence the customer will default on payments due to a bank (OECD, 2010a:126).

Functional analysis

A functional analysis is “an analysis of the functions performed (taking into account assets used and risks assumed) by associated enterprises in controlled transactions and by independent enterprises in comparable uncontrolled transactions” (OECD, 2010c:26).

G20

The G20 function “is to coordinate policies at international level and to make globalisation...a sustainable process” (OECD, 2016d). The G20 countries are: Argentina, Australia, Brazil, Canada, China, France, the European Union, Germany, India, Indonesia, Italy, Japan, the Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, and the United States of America.

IASB

The International Accounting Standards Board (‘IASB’) is recognised as the independent standard-setting body of the International Financial Reporting Standards (‘IFRS’) Foundation (IFRS, 2016).

Independent enterprises

“Two enterprises are independent enterprises with respect to each other if they are not associated enterprises with respect to each other” (OECD, 2010c:26).

Market risk

“Market risk refers to the exposure to adverse changes in financial prices affecting the value of positions typically held for global trading purposes, for example as a result of fluctuations of foreign exchange rates, interest rates, equity prices or commodity prices” (OECD, 2010a:127).

Multinational enterprise group

The OECD transfer pricing guidelines defines a multinational enterprise group (‘MNE group’) as “a group of associated companies with business establishments in two or more countries” (OECD, 2010c:27).

OECD

The Organisation for Economic Co-operation and Development ('OECD') was established in 1961 and the headquarters is in Paris, France (OECD, 2016a).

“The OECD is a multilateral organisation comprising of 35 countries. The OECD provides a forum for representatives of countries to discuss and attempt to coordinate economic and social policies. It has an especially significant role in international tax matters” (OECD, 2016c:20).

OECD Model Tax Convention on Income and Capital

The OECD Model Tax Convention on Income and Capital ('OECD MTC') contains bilateral and multilateral treaties, the OECD MTC is applied by OECD member countries and non-member countries.

Permanent establishment

Section 1 of South African Income Tax Act defines a permanent establishment and refers to Article 5 of the OECD MTC. According to paragraph 1 of Article 5 in the OECD MTC the term “permanent establishment means a fixed place of business through which the business of an enterprise is wholly or partly carried on” (OECD, 2010b:24). This definition is further expanded in paragraphs 2 to 7 of Article 5 however an in depth examination of this definition is outside the scope of this dissertation. More recently there has been amendments to the permanent establishment definition in Article 5 of the OECD MTC as a result of the OECD BEPS Action Plan 7 on the prevention of the artificial avoidance of permanent establishment status.

Profit shifting

Profit shifting refers to the “allocation of income and expenses between related corporations or branches of the same legal entity (e.g. by using transfer pricing) in

order to reduce the overall tax liability of the group or corporation” (OECD, 2016c:23).

South African Income Tax Act

The South African Income Tax Act is the Income Tax 58 of 1962 (‘South African ITA’).

South African Reserve Bank

South African Reserve Bank (‘SARB’) is the central bank of South Africa. The SARB is the supervisory authority for the banking sector in South Africa

South African Revenue Service

The South African Revenue Service (‘SARS’) is South Africa’s taxing authority. SARS was established in terms of the South African Revenue Service Act 34 of 1997 as an autonomous agency, SARS are responsible for administering the South African tax system and customs service (SARS, 2016).

Trader or trading

Trader or trading in this dissertation refers to both the “initial assumption of risk (sometimes called dealing or market-making function) and the subsequent management of risk (hedging or risk management function)” (OECD, 2010a:118).

Transfer price

A transfer price is defined as the price “at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises” (OECD, 2010c:19).

Uncontrolled transactions

Uncontrolled transactions is defined as “transactions between enterprises that are independent enterprises with respect to each other” (OECD, 2010c:30).

Abbreviations

BCBS	Basel Committee on Banking Supervision
BEPS	Base Erosion and Profit Shifting
CbC	Country-by-Country
OECD CFM	OECD Committee on Financial Markets
OTC	Over-The-Counter
GSIBS	Global Systemically Important Banks
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
ISDA	International Swaps and Derivatives Association
ITA	Income Tax Act
KERTS	Key Entrepreneurial Risk Taking Functions
MNE	Multinational Enterprise
MNFIG	Multinational Financial Institution Group
NBFI	Non-Bank Financial Institution
OECD	Organisation for Economic Co-operation and Development
OECD MTC	OECD Model Tax Convention on Income and Capital
SARB	South African Reserve Bank
SARS	South African Revenue Service

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Chapter one

1.1 Introduction

1.1.1 Financial markets and the South African financial sector

According to Boule (2008:13) contemporary globalisation consists of the globalisation of trade and finance, the latter being more obscure but “far greater in extent”. Furthermore, “financial activities in the global economy” have a greater significance to “producing and trading in goods and services” (Boule, 2008:14). Global financial markets have experienced a revolutionary transformation over the last few decades and continue to transform (Thompson et al., 2014:11). The globalisation of financial markets has been encouraged by technological advancements, telecommunications, the free movement of capital and labour, cost shifting enablement, the relaxation of trade barriers and risk management processes (OECD, 2013:25). According to the Organisation for Economic Co-operation and Development (‘OECD’) OECD (2013:25), these factors have also transformed the management and structure of Multinational Enterprise Groups (‘MNE groups’). MNE groups responded to the globalisation of financial markets by expanding from localised to globalised operations by creating affiliates in various locations around the world (Oguttu, 2015b:537).

Globalisation has changed the business strategies of MNE groups to “maximising profits and minimising expenses and costs, including tax expenses” (OECD, 2013:27). The barriers preventing financial institutions entry into global markets have been removed as a result of globalisation, which has encouraged the creation of modern financial products (Boule, 2008:14). Financial innovation has modernised banks’ cross-border activities that moves beyond the traditional role of a loan provider and deposit taker (Brummer, 2012:16). The globalisation of financial markets has led to the development of hi-tech financial instruments. As a result, derivative financial products are being created by financial institutions to meet the global demand for innovative products. The increase in derivative activity

has been remarkable, in 1998, derivatives gross market value approximated eight percent of the world's gross domestic product ('GDP') which surged to almost 58% of GDP in 2007 (Blundell-Wignall et al., 2014:72).

South Africa's return to globalisation was following the first democratic elections in 1994 and the reformation of South Africa's international political and economic relations (Calitz, 2000:254 ; Committee, 2014:19). South Africa's return to international markets was marked by notable growth in international trade and commerce, carried out mainly by MNE groups (SARS, 1999:5 ; Committee, 2014:19). The OECD Committee on Financial Markets ('OECD CFM') acknowledged that non-member OECD countries, where South Africa is recognised as one of "five non-member key partner countries", have an important place in the global financial markets. The OECD CFM further stated that the securities markets and banks of non-OECD countries are recognised as "some of the largest by capitalization and assets in the world" (Thompson et al., 2014:54). The development of Africa's financial sector has been outstanding as the financial sector has shifted from an "unexplored and underinvested sector" to becoming one of Africa's stand out sectors (KPMG, 2013:4).

Banking has evolved over the last decade, making sub-Saharan Africa a significant player in the emerging markets arena. According to Gaibi et al. (2010:4), the sub-Saharan financial sector compares favourably with its counterparts such as Russia. In this era of rapid growth and expansion of Africa's financial sector, South Africa are the leaders of the banking sector (KPMG, 2013:8). South Africa's financial sector has an important role to play in the South African economy. According to Oguttu (2012:386), the financial sector is "at the heart of South Africa's economy" and that the use of derivatives has significantly increased over the last decade. The IMF (2014:10) describes South Africa's financial sector as "large and sophisticated". Within the South African economy, the MNE groups in the financial sector are dominated by the country's major banks, in this dissertation

referred to as the Multinational Financial Institution Groups ('MNFIG'), and Non-bank Financial Institutions ('NBF'), including pension funds, insurance institutions and collective investment schemes (IMF, 2014:10). The banking sector within Africa has been marked by growth and expansion across its borders (AfDB et al., 2016:86). According to AfDB et al. (2016:87), banks in Africa continue to be the major players in the financial sector. The IMF (2014:57) is of the view that South Africa's banking sector "has strong cross-border and cross-sectoral linkages". South African banks participate in global markets and have an expanding global presence, particularly across the African continent (IMF, 2014:10). South Africa also has branches of foreign banks that operate in the financial sector (IMF, 2014:57).

Moreover, South Africa has a "large OTC derivatives market with a notional value of US\$3 trillion which allows investors considerable scope to hedge positions with interest rate and foreign exchange derivatives" (IMF, 2014:12). According to the (IMF, 2014:10), the South African financial sector has a high degree of concentration and interconnectedness. As "the major banks are affiliated with insurance companies" and these "bank-affiliated insurers underwrite a substantial proportion of private pension assets, and some banks also own fund managers that offer unit trusts" (IMF, 2014:10). As a result, there are significant volumes of related party transactions; hence these financial groups have "significant pricing power and enables them to achieve returns on equity and assets higher than in more competitive economies" (IMF, 2014:10). The financial sector is an important sector of the South African economy. The expansion of banks into neighbouring African countries directly increases the number of cross-border transactions.

1.1.2 Global trading in the financial services sector

Global trading, in this context, is a financial institution's ability to execute customer orders of financial products on a global basis or on a 24-hour basis (OECD, 1998b:12). A financial product is described in section 1 of the Financial Advisory

and Intermediary Act as “securities and instruments ... including any securities as defined in section 1 of the Financial Markets Act.” The definition of securities in the Financial Markets Act is broad and includes “listed and unlisted securities ...”. Derivative financial instruments are one of the financial products traded in a global trading business. Financial intermediation by financial institutions has shifted to directly managing the risks of a portfolio that supports the dealing of derivatives. According to Boule (2008:14), derivative financial instruments are “significant features of the global economy and these derivatives create a virtual economy which is highly profitable but also unstable”.

The derivative market is a multi-trillion dollar market. However, the mid 1980's was characterised by major losses and bail outs. For example, the wipe out of the 200-year-old British bank Barings in 1995 due to the trading activities of one trader resulting in a loss of almost \$1 billion. Likewise, Allied Irish Bank lost close to \$700 million from speculation activities and similarly, Daiwa, where a trader for this Japanese bank lost more than \$1 billion. Thus, it is important that derivatives are monitored closely if used by enterprises (Hull, 2002:686,687). Hudson (2012:797,798) points out that derivatives and the financial services industry are being used for tax avoidance and that derivative markets have been extremely costly in relation to public bail outs of financial institutions. Furthermore, Hudson (2012:31) opines that derivatives markets have developed and grown over the years as multinational enterprises have sought to evade exchange controls, as such controls restricted the cross-border transfer of currency. According to Olivier and Honiball (2011:252), the value of derivatives has increased over the last twenty years to the extent where it is speculated that derivative markets have outgrown the worldwide securities market. Blundell-Wignall et al. (2011:37,38) support this view.

A derivative is a financial instrument that derives its value from the value of an underlying asset. There is a wide range of underlying assets, which can include “a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other

variable” (IFRS, 2014b:A1043). Furthermore, there is an array of derivative products that are created and traded by financial institutions. The most common derivative products include forwards and futures as well as swaps and options which are the starting point of complex derivatives products (Chisholm, 2004:1 ; Hudson, 2012:30 ; Thompson et al., 2014).

According to the OECD (1998b:16), global trading of financial instruments takes place in a variety of financial institutions, but banks are the market leaders in global trading activities. A global trading entity has a number of key people related functions, for example sales and marketing, trading and risk management, support and the role of capital and risk management (OECD, 1998b:21). Financial institution participation in the global financial markets requires that the institution has the ability to take on significant trading positions for a variety of financial instruments (Thompson et al., 2014:27). Therefore, such institutions should have a strong capital base in order to engage in global trading. This affirms the OECD’s report that banks dominate the global trading arena since they have the required capital base. The globalisation of financial markets and the similar expansion of MNE groups has facilitated global trading across various country borders. Such trading equally impacts the tax bases in the countries in which an MNE group operates. Rohatgi (2002:568) states that complex tax issues are created through global trading, the most significant of which are the taxation of permanent establishments and transfer pricing

1.1.3 Transfer pricing

Transfer pricing continues to be one of the most significant tax risks facing MNE groups around the world (SARS, 2013:42 ; Cooper et al., 2016:22). In the mid-1990s, taxing authorities transfer pricing concerns for banks increased (Borkowski, 2003:22). The increase in global trade by MNE groups may have a variety of business objectives such as the transfer of risks, reduction of taxation or other

internal group factors. Furthermore, transfer pricing is one of the key challenges facing banking executives due to the upward shift in globalisation and the ongoing pressure to increase profit margins (Irina et al., 2000:55).

With the relaxation of exchange controls that previously regulated transfer pricing, in 1995, South Africa introduced a “tax payable in respect of international transactions to be based on the arm’s length principle”, namely section 31 of the South African ITA (‘South Africa ITA’) (SARS, 1999:6). South Africa is not a member of the OECD, however the SARS guidance makes reference to and acknowledges the then OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (‘OECD Guidelines’). Section 31 of the South Africa ITA was amended with effect for years commencing on or after 1 April 2012 and includes an amalgamation of the country’s thin capitalisation rules. SARS guidance on section 31 has not been updated and it appears that South Africa intends to continue to apply the OECD Guidelines.

The OECD issued specific guidelines for the global trading of financial instruments which are contained in the report titled “The Taxation of Global Trading of Financial Instruments”. This report was first issued in 1997 and later updated and reissued in 1998. The uniqueness of the banking industry and the need for special taxation rules for transfer pricing for this industry was identified in the 1984 OECD report titled “The Taxation of Multinational Banking Enterprises”. The OECD later published the “Report on the Attribution of Profits to Permanent Establishments”. This report focused on two main types of banking activities: (i) Part II (“Banks”) and (ii) Part III (“Global Trading”). Part II (“Banks”) relates to traditional banking activities and generally the traditional transfer pricing methods would apply. Part III (“Global Trading”) relates to worldwide and integrated transactions on financial instruments where the transactional profit methods are generally viewed as more suitable. The OECD CFM recognises that the “five non-member key partner countries”, being South Africa, Brazil, China, India and Indonesia, require a greater level of attention and focus as global financial markets become “more

interconnected and complex” (Thompson et al., 2014:7,8). The various reports issued by the OECD around transfer pricing with regard to banking institutions highlights the special nature of banking institutions. Therefore, special attention must be given to the various activities carried out by these entities.

Transfer pricing can be described as the determination of transfer prices for cross-border transactions between connected persons (OECD, 2010c:19 ; UN, 2013:2). According to Chip (2011:16-2), the United States of America and the OECD initially developed transfer pricing guidelines in the industrial context. However, some of the most significant cross-border controlled transactions take place within multinational banks, securities firms and insurance companies. It is noted that within these institutions, traditional transfer pricing rules do not easily apply in practice.

The arm’s length principle is the “international transfer pricing standard that OECD member countries have agreed should be used for tax purposes by MNE groups and tax administrations” (OECD, 2010c:31). The arm’s length principle is a principle where the parties involved in a transaction are placed on equal status and the varying taxation treatments created by economic distortions are removed. This encourages and supports the growth of international trade and investment (Oguttu, 2015a:215). According to Peng (2016:1), the United States of America and the OECD have both had a substantive impact on the progress of the arm’s length principle. Equally important, Peng (2016:1) states that over recent years the practical concerns on the market-based arm’s length principle have been put under the spotlight. This relates particularly to the applicability to pricing integrated intra-group transactions.

1.1.4 Problems of transfer pricing when applied to global trading

According to Miller and Oats (2012:21), tax systems were created in the early 20th century, when the rate of cross-border transactions were low and hence not very significant. The focus of tax systems at that time was on the domestic economy. Since then, MNE groups have globalised their businesses resulting in cross-border

transactions becoming significant due to globalisation, technology advances and the relaxation of trade barriers (Miller and Oats, 2012:251). The tax systems do not address this upward shift in cross-border trade, which requires further development in order to interact with other tax systems (Miller and Oats, 2012:21). Tax systems vary across countries, which creates tax benefit opportunities for taxpayers (Miller and Oats, 2012:21). Significant taxation issues arise when a MNE group engages in global trading across multiple jurisdictions. As a result, the most significant issue becomes the determination of transfer prices between the associated enterprises or the attribution of income and expenses in the case of a permanent establishment (OECD, 1998b:12 ; Rohatgi, 2002:568). Research by Rohatgi (2002:568) further provides that these tax issues, created by global trading, usually remain unresolved when using the traditional arm's length method. The difficulty in applying the arm's length principle to integrated operations led to the development of profit split methods (Peng, 2016:3). Globalisation and the increased integration of MNE's makes finding comparable information a challenge (Muyaa, 2014:352). Additionally, Muyaa (2014:352) states that comparability is a "comprehensive process requiring highly specialised information". Hence, performing a comparability analysis is not as straightforward since it requires that assumptions are made on the conditions of the uncontrolled transaction.

A global trading multinational financial institution has a dynamic business structure that spans the globe, potentially having a significant number of functions involved. A derivative transaction could involve a number of different risks that can be assumed or transferred and, therefore, the performance of functional analysis is crucial (OECD, 2010a:116). The performance of a functional analysis identifies the functions, assets and risks that are associated with the global trading operation to assist in the profit split across the business (Verdoner, 2005:284). According to Bilaney (2016:1), a function analysis is "one of the most important aspects in transfer pricing" and "necessary to accurately delineate the controlled transactions." Bilaney (2016:1) further states that the analysis of risk when performing a functional risk is a crucial aspect as this "influences price and other

terms and conditions in respect of the controlled transaction.” A key people function within a global trading business is the trading and risk management function (OECD, 2010a:118).

Cross-border transactions are generally governed by domestic tax rules and treaties, and within these rules are the core principles of “jurisdiction to tax, transfer pricing, leverage and anti-avoidance” (OECD, 2013:33). The South African Revenue Service’s Strategic Plan for 2014/15 to 2018/19 has once again listed transfer pricing as one of the strategic risks that is of concern (SARS, 2014:15). The aging international tax principles have created concerns for policy makers, one of which is base erosion and profit shifting (‘BEPS’). In 2013, the OECD developed and issued fifteen action plans (‘BEPS report’) to address the concerns relating to BEPS (OECD, 2016b:4). The BEPS report estimates the BEPS revenue losses to be around \$100 – 240 billion of global corporate income tax. The loss could be due to aggressive tax planning, the robustness of interaction of domestic tax rules between states, the lack of transparency and coordination between tax administrators, limited country enforcement resources and harmful tax practices (OECD, 2016b:4).

The BEPS project aims to address weaknesses in taxation systems that enable MNE groups to structure their businesses to artificially shift profits. These weaknesses result in a significant portion of the profits remaining untaxed or taxed at a low jurisdiction (OECD, 2013:5). A focus area of the BEPS project is transfer pricing as it relates to stated transactions that involve risk shifting within an MNE group to tax favourable locations (OECD, 2013:42). In the same way Verlinden et al. (2016:109) highlights that transfer pricing is a major area of the BEPS report. According to Verlinden et al. (2016:109) and Bilaney (2016:1), one of the goals of the BEPS report is to mitigate opportunistic group risk diversification in which a MNE may engage. Left unresolved, a section of the group “earns inappropriate returns solely because it has contractually assumed risk or has provided capital” i.e. artificially shift profits.

The concern around transfer pricing in the BEPS report has led to further evolution and refinement of the OECD Guidelines. BEPS Action Plan 8-10 contribute to the revisions of the OECD Guidelines, some of which include the replacement of section D of Chapter 1 of these Guidelines to support BEPS objectives. The objective of BEPS Action Plan 8-10 is to “create transfer pricing outcomes in line with value creation” (OECD, 2015a:13). Furthermore, Action Plan 8-10 can be divided into three parts: Action Plan 8 relating to intangibles, Action Plan 9 relating to risks and capital and Action Plan 10 relating to other high-risk transactions. One of the revisions in section D of Chapter 1 is the addition of a new six-step framework for the allocation of risks by MNE groups (OECD, 2015a:22). Subsequently, Verlinden et al. (2016:109) states that the OECD has addressed some of the concerns around Action Plan 9. Risk allocation and people functions were extensively covered in the OECD’s report on the Attribution on Profits to Permanent Establishments. The trading and risk management function is an important function of a global trading business. These recent developments warrant consideration by multinational financial institution groups.

The objective of Action Plan 9 of the report is to mitigate BEPS by “requiring that transactions be appropriately delineated so that the ultimate transfer pricing outcome aligns with each entity’s contribution to value creation” (Verlinden et al., 2016:110). According to Odintz et al. (2016:7), these new outcomes from the BEPS project will make it difficult for financial institutions to demonstrate the allocation of risks to taxing authorities. The BEPS final report on Action Plan 8-10, according to Collier (2014:252), will be relevant to derivatives, as these are risk shifters. Further work is being done to provide additional/revised guidance on the profit split methods. There is a lingering preference for traditional methods even though the hierarchy of these methods is no longer in the OECD Guidelines (Muyaa, 2014:353). Recently, the transactional profit split methods have received increased attention as evidenced in the BEPS report. Action Plan 13 of the report aims to re-examine the transfer pricing documentation requirements of MNE groups. Action Plan 13 imposes stricter requirements for MNE groups to provide

more comprehensive information to taxing authorities (OECD, 2016b:17). Greater transparency and understanding of MNEs groups is promoted by Action Plan 13 which will help combat the BEPS concerns (OECD, 2015b:9). However, Herrington and Lowell (2013:372) state that the implementation of the BEPS report action points “is reliant on each country’s initiative to implement the outcomes”. It is expected that with the continuous evolution of financial markets, transfer pricing complexities and challenges will continue to evolve and grow.

In summary, the globalisation of financial markets has led to the modernisation of MNE group structures. This has supported increased cross-border activity by MNE groups, such as the global trading of financial instruments by multinational financial institutions groups. Challenges, such as the difficulty in determining transfer prices between associated entities and BEP concerns, have therefore arisen. Multinational financial institution groups have an important role to play in the South African economy and are significant contributors to the financial sector. Global trading of financial instruments by these entities may have a significant impact on taxation implications for taxpayers and taxation revenues collected by the South African tax authorities if these issues are not addressed. The above forms the rationale for the study. The rationale is premised on the understanding that the global trading of financial instruments by multinational financial institution groups. This study seeks to examine the complexity of the transfer pricing challenges created by global trading of financial instruments and OECD BEPS Action Plan 9.

1.2 Research objective

The global trading of financial instruments is not a new issue and has been recognised by the OECD as an area of tax that requires special attention. As MNE groups continue to grow and the products they offer become more innovative due to changing needs of customers and business strategies. This area of tax is and will continue to be a significant area for taxing authorities and taxpayers. The South African financial sector continues to expand across borders. Cross border

transactions arising from their global trading businesses are likely to increase. This dissertation will investigate transfer pricing within the context of a global trading of financial instruments in the financial sector. Transfer pricing has been highlighted as a key focus area in the recent OECD project on base erosion and profit shifting. This dissertation will analyse the OECD Guidelines and examine the transfer pricing application issues in relation to global trading of financial instruments. This dissertation tests whether Action Plan 9 of the BEPS report will create further difficulties for MNE groups in the banking sector or whether the current framework is appropriate.

In order to achieve the research objective, the dissertation will examine the following:

- MNE groups that are involved in the business of global trading of financial instruments and the functions of such a business;
- OECD publications with regard to the arm's length principle and its' application to MNE groups that engage in global trading of financial instruments; and
- BEPS and specifically Action Plan 9 of the BEPS report and the concerns for a MNE groups in the banking sector that engage in global trading of financial instruments.

1.3 Research method

This study will use a legal doctrinal research methodology. According to Hutchinson and Duncan (2012:84), doctrine originates from the Latin noun *Doctrina*, which means "instruction, knowledge or learning." Furthermore, Hutchinson and Duncan (2012:85) state that the doctrinal research method is "at the basis of the common law and is the core legal research method." Doctrinal research is described as "research which provides a systematic exposition of the rules governing a particular legal category, analyses the relationship between rules, explains areas of difficulty and, perhaps, predicts future developments"

(Hutchinson and Duncan, 2012:101). This dissertation will apply a qualitative analysis of the literature on the global trading of financial instruments in order to identify and establish the general rules and principles.

1.4 *Dissertation structure*

The dissertation will be structured as follows:

Chapter two examines MNEs groups that engage in global trading of financial instruments. This chapter also analyses the functions of a global trading business and derivative financial instruments that are traded within such a business.

Chapter three will discuss the concept of transfer pricing in the context of the global trading of financial instruments. This chapter will analyse the arm's length principle that is advocated by the OECD Guidelines. This chapter examines the applicability of this principle to MNE groups that engage in global trading of financial instruments.

Chapter four will discuss Base Erosion and Profit shifting. This chapter also analyses OECD BEPS Action Plan 9 and the applicability to MNE groups in the financial sector.

Chapter five will conclude on this dissertation.

1.5 *Limitations of the scope of research*

- This dissertation will not examine South Africa's thin capitalisation rules which were merged with effect 1 April 2012 into section 31 of the South African Income Tax Act in order to be consistent with the OECD Guidelines.
- This dissertation will not address the issue of the source of derivative contracts and the possible imposition of withholding tax to derivative products.

Chapter two

2.1 Introduction

The OECD glossary of tax terms describes global trading as an activity that is executed by investment banks and securities dealers. This activity “involves financial instruments, financial services and financial goods” and the activity is performed continuously (24 hour trading) in global financial markets (OECD, 2016c:12).

This chapter will examine global trading and the entities who are involved in this activity. It will present an analysis of the functions of a global trading entity.

2.2 Global trading and global trading entities

Entities that conduct global trading of financial instruments may use a number of legal structures in order to carry out their business, such as through permanent establishments, separate legal entities or a combination of both (OECD, 2010a:113). While many types of financial institutions engage in global trading, multinational banking groups are seen as the leaders since they have the required trading expertise and capital base (OECD, 1998b:58 ; Irina et al., 2000:58 ; OECD, 2010a:111).

During 1964 to 1980, banking systems dominated financial markets and banking structures varied across countries. For example, Germany used universal banking where banks were allowed to perform all forms of financial intermediation, including being actively involved in the derivative market. The United States of America, in contrast, implemented stricter rules in order to separate the various forms of banking activities; traditional banking was detached from investment banking (Thompson et al., 2014:11). Over the last few decades globalisation has led to an evolvement of MNE groups and banking structures. The transformation

of banks has resulted in traditional core retail and commercial banking being combined with investment banking activities (Blundell-Wignall et al., 2011:10,35). The combination of these two banking types has led to a significant increase in securities activities (i.e. investment banking activities that encompass a significant derivative business) of a bank over traditional banking activities (Cranston, 2002:3,331). In 2009, after the 2008 financial crisis, in an attempt to mitigate the interconnectedness risks identified in banks, the OECD Secretariat proposed a separation of banks for the stability of the financial system. This proposal states that separation occurs at a specific threshold and is based on the securities businesses of a bank. When this threshold is breached by the securities businesses of the bank, it should be separated from the core bank. This is done so as to safeguard deposits and minimise government bail outs (Blundell-Wignall et al., 2014:77). There have also been other proposals calling for separation, such as the Volcker rule and the Liikanen proposal. The issue of bank separation will not be further examined in this study as this falls outside the scope of this dissertation.

A banking group generally establishes some group subsidiaries or branches across borders (Cranston, 2002:9). The establishment of these subsidiaries or branches in other jurisdictions was not always permitted as certain countries prevented the establishment of foreign entities. However, in 1980s, the OECD set up a project to promote the liberalisation of financial transactions or financial services to its members countries (Thompson et al., 2014:21,22). A banking group is described as having entities abroad and aligns to the definition of a multinational enterprise group which is in accordance with the OECD Guidelines. According to the OECD (2010c:27), a MNE Group is defined as “a group of associated companies with business establishments in two or more countries”. Similarly, Dunning and Lundan (2008:3) explain that an MNE is “an enterprise that engages in foreign direct investment and owns or, in some way, controls value added activities in more than one country.” The global structure of MNE groups in the financial sector supports the 24 hour global trading. MNE groups have to be

innovative in order to competitively participate in financial markets so as to achieve their business profit objectives. There are a broad range of financial products that are available and traded. According to the OECD (2010a:111), the “deepest worldwide markets are in certain currencies and derivative instruments”.

It is also important to consider the structure of the international transactions within this entity. Market forces and MNE group factors (focussing on the common interests of the group) may determine the structure of an international transaction (UN, 2013:12). International transactions based on internal group factors increase the importance of determining and ensuring that the transfer price of a cross-border international transaction is at an arm’s length (UN, 2013:12). Hence, the transfer price is an important element in a cross-border transaction between connected persons. This affects the taxable income, and consequently the taxation revenue of various countries taxing authorities involved in the transaction. The global trading of financial instruments requires that a comprehensive transfer pricing analysis is performed. The global trading of financial products in more than one jurisdiction as well as market making and taking of proprietary positions requires a transfer pricing analysis (Irina et al., 2000:70). According to Faiferlick et al. (2000:242), in a global trading entity the risk location, risk management, ownership of risk and the reward for putting capital risk are important considerations.

2.2.1 Trading models

According to the OECD (2010a:113), there are three types of trading models that a multinational financial institution group can employ to engage in the global trading of financial instruments. The trading models are comprised of the separate enterprise trading model, centralised product management model and the integrated trading model. These three trading models will be further examined in Chapter three.

2.2.2 Functions of global trading operations

A functional analysis of a global trading operation should consider the functions performed, assets used and the risks assumed in a global trading entity as the compensation is reflective of these aspects (OECD, 2010a:125). According to the OECD (2010a:125), the core of global trading lies in the “assumption and ongoing management of risk” which should be considered in a functional analysis. The functions of a global trading entity include sales and marketing, trading and risk management, treasury, support functions, capital and risk management. The functional analysis of a global trading entity is an important step towards a transfer pricing analysis. The functions within a global trading entity are usually spread across borders. A functional analysis may assist with identifying functions, locations, assets used, the risks in a global trading entity and its contribution to a global trading transaction.

2.2.2.1 Sales and marketing

Generally, the sales and marketing function is primarily responsible for the marketing of trades with customers and determines the price that a customer is willing to transact on that specific trade (OECD, 2010a:116).

It is important to consider the level of the sales function within a global trading entity (i.e. the basic sales function when compared to a more advanced sales function). Furthermore, making this distinction is a critical step as a basic function does not generally lead to the assumption of significant risk for the location that is carrying out the risk. On the other hand, an advanced sales function that is involved in structuring a product understands the mechanics of pricing and hedging and the work with traders, resulting in a significant cross functional integration (OECD, 2010a:117).

2.2.2.2 Trading and risk management

The trading and risk management function is considered to be one of the most important people function of a global trading operation. This function is associated with the assumption of risk and relies upon capital to manage the related risks (OECD, 2010a:118).

Global trading is described as “making a market and taking and managing proprietary positions” (OECD, 2010a:118). Traders provide marketers with prices at which transactions will be entered into with customers and they are responsible for the management of the associated market risk (OECD, 2010a:118). There are two types of trading relationships; the first type is where the clients enter into derivative trades with a bank and which includes entering into an International Swaps and Derivatives Association (‘ISDA’) master agreement. The second type is where a bank will have derivative trades with foreign branches, foreign subsidiaries or any other connected entity within the group. This trading relationship is of concern since it may include cross-border derivative transactions. These potential derivative transactions requires the determination of an appropriate transfer price in order to ensure it adheres to the arm’s length principle. Furthermore, the taxing authorities need to consider the pricing of the transaction or the attribution of profits and expenses in relation to a permanent establishment.

The trading and risk management function is complex when it is associated with derivative financial instruments as cash flows associated with the transaction are typically risky. Derivative transactions are usually analysed and the identified risks may be separated and assigned to the relevant trading books. An entity may have multiple books, for example rates derivatives or equity derivatives and the risks are managed accordingly (OECD, 2010a:119). In addition, the derivative transactions are usually managed and assigned by the derivatives trader and generally the underlying market risk of these transactions may be assigned to another entity within the group.

An example, provided by the OECD (2010a:119), of a derivative transaction that contains a number of the aforementioned risks assumes that a trader purchases a Euro-denominated note paying 5%. However, the principal amount of this note is linked to the German DAX. The Euro-denominated note has a “fixed-income risk (that Euro interest rates will go up, reducing the value of the note), equity risk (that the value of the DAX will decrease)” and a potential currency risk. This derivative transaction has now created a number of different risks that need to be analysed and managed. This usually requires the bank to enter into inter-desk/inter-branch (i.e. related parties within the group) transactions in order to allocate the risks to the relevant trading books. These related parties could be located across various jurisdictions of the group hence the need to perform a transfer pricing functional analysis.

The risk associated with derivative transactions is “unbundled” into the different risk types and assigned to the relevant trading book. Thus, one derivative transaction could be assigned to multiple trading books according to the risks (OECD, 2010a:119). A bank's internal market risk measurement system generally sets the bank's market risk factors, such as market rates and prices which will affect the bank's trading positions. The risks arising from a derivative transaction are managed by the trader who can attempt to make a profit for the financial institution. Moreover, the trader is restricted to the market risk limits of the financial institution (Chisholm, 2004:2 ; OECD, 2010a:119). The monitoring of market risk exposure is performed by a group that is independent from the trading units (Finance, 1990:81). Risk managers monitor the level of risk of a bank and mathematicians create the tools necessary to price new derivative products (Chisholm, 2004:2). Trading and risk management functions can either be performed by one trader (same person) or by different people who are based in different jurisdictions (OECD, 2010a:119).

2.2.2.3 Treasury function

The treasury function is performed by treasury book traders who are responsible for managing the funding needs of the financial institution. The funding needs of the financial institution are volatile and seen as dependent on the positions on exchange traded or over-the-counter ('OTC') contracts (OECD, 2010a:120). For example, the treasury book notionally earns inter-desk interest from its function as a clearing house by matching the cash requirement of one trading book with the surplus cash from another trading book (OECD, 2010a:120). The treasury book function also engages in internal hedging transactions. For example, if a German bank issues a term dollar denominated debt, a treasury book trader will usually enter into a currency swap with the bank's dollar book. This converts the risks into a floating rate Euro-denominated debt since the treasury function generally manages the short term risks of the financial institution's functional currency. These hedging activities are usually handled by the banks' other trading desks in order to maximise net hedging and lower hedging costs (OECD, 2010a:120).

2.2.2.4 Back office and other support functions

The people support functions include accounting, product control, system development, credit and intangibles. These are generally called the back office and provides support to the front office, also known as the marketers and traders (OECD, 2010a:121). Certain financial institutions have shifted some of the more important people support functions such as research, funding, accounting and product control and credit to the middle office (OECD, 2010a:121). Support functions are generally centralised in order to minimise costs (OECD, 1998b:24).

Habermacher and Sollberger (2013:2) state that "global trading and funding activities conducted by banks and securities firms can be managed and executed by employees in different countries around the world and involve significant cross-border transactions".

Furthermore, Chip (2011:16-4) provides that carrying out an evaluation of the various functions of a global trading operation contribution to profit or loss from a global trading customer transaction might be impractical. Evidence from the above analysis suggests that there are many functions to the global trading operation such as the complex trading and risk management function. The author concurs that attempting to analyse and separate each function will be challenging as the type of trading models that are used by the entity may influence the level of integration. The functional analysis is a step in the transfer pricing analysis that will determine the most appropriate pricing method to use.

2.2.2.5 Capital of financial institutions and risk assumption

According to the OECD (2010a:125), risk assumption and the ongoing management of risk is core to the global trading business. Banks are seen as leaders in global trading due to having the required capital and technical expertise. Financial institutions require capital to operate and this is usually invested in liquid assets (Chip, 2011:16-3). Having the necessary long term capital is crucial as this enables a bank to cover the different risks. The most common risk types are market risk and credit risk but operational risk is also significant (OECD, 2010a:126). A global trading entity requires capital to cover the various risks it may be exposed to from its activities. These entities may use a number of financial instruments to fund its trading positions. Information on the capital base of a financial institution is required by regulatory authorities and clients so as to provide evidence that the institution has a strong capital base to cover the risk exposure from global trading (OECD, 1998b:27). Credit risk is usually slightly lower in a global trading operation. In contrast, market risk is a significant concern for a global trading operation as the amounts payable under a derivative contract is affected by the market movements (OECD, 2010a:126). Market risk is described as the:

“exposure to adverse changes in financial prices affecting the value of positions typically held for global trading purposes, for example as a result of

fluctuations of foreign exchange rates, interest rates, equity prices or commodity prices (OECD, 2010a:127).”

Market risk of trading positions is managed daily, which can be done through hedging or trading on the market risk positions (OECD, 2010a:128).

Chip (2011:16-11), states that hedge funds are somewhat comparable to the “proprietary trading businesses of a global bank or securities firm.” Therefore, data from hedge funds can potentially be used to tackle the challenge of “allocating profits between entities that hold the capital at risk in global trading and permanent establishments or related entities”. These establishments or entities hire the traders and related staff to administer the capital at risk.

2.2.3 Global trading and product innovation

As affirmed by Rohatgi (2002:568), complex tax issues such as the taxation of permanent establishments and transfer pricing are created through global trading. Furthermore, Rohatgi (2002:568) states that the transfer pricing problems created from global trading operations is not typically resolved using the traditional arm’s length method. The profit split method or the formulary apportionment method would be more suited where an integrated trading model is utilised as the functions performed are of greater importance than the individual transaction. However, Thuronyi (2001:11) notes that it is challenging for financial institutions to allocate global profits to the various entities in different locations that are connected to a transaction. These entities use diverse accounting methods and, due to the integrated nature of global trading operation, this creates challenges. In the case of the global trading of financial instruments, there would be a high volume of foreign-related transactions. The functions would be spread across the group, and the parties of the group will work together; making it difficult to assess a party within the controlled transaction.

It is reported by Blundell-Wignall et al. (2011:10,11,35), “product innovation utilising derivatives and gambling in high risk trades has become a key driver of

profitability” within a bank. Financial intermediation of globalised banking groups has changed significantly. Cranston (2002:331) explains that the general tasks of investment banks include advising, underwriting, and distributing new issues of securities. Additionally, investments banks deal, on their own account, on securities and derivative markets as well as where these tasks generally involve an “integration of domestic and international markets.” Blundell-Wignall et al. (2011:36) further states that the derivatives market encompasses forwards and futures, options and swaps and other financial products. Derivative markets are concerned with the transfer of wealth between parties to either “hedge risks, or to seek arbitrage opportunities, or to gamble or to reduce tax, regulatory and agency costs.” According to Irina et al. (2000:58), the “most global products appear to be spot and forward contracts in heavily-traded foreign currencies”.

According to Thuronyi (2001:4) and Rohatgi (2002:561), derivatives fall into the category of new financial instruments as they differ from the simple debt or equity instruments. “A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity” (IFRS, 2014a:A839). Furthermore, Hudson (2012:831) asserts that derivatives and the financial services sector can offer investors tax efficiency as the products can be structured to change the appearance of cash flows. The IFRS (2014b:A1043) states that a derivative is a financial instrument that has the following characteristics: its value changes in response to some underlying asset, it requires little or no initial net investment, and it is settled at a future date. A key feature of a derivative financial instrument is that it derives its value from an underlying instrument or asset (Chisholm, 2004:1 ; Hull, 2002:1). The underlying asset has an extensive range that includes gold, silver, oil, gas, shares, bonds, currencies; and the link between the derivative and this underlying asset is the value (Chisholm, 2004:1 ; Hull, 2002:1).

The growth of derivative markets over the last few decades has been exceptional (Thompson et al., 2014:31). Derivative financial instruments can be traded either on an organised exchange or when agreed on directly between two parties in an

OTC market (Chisholm, 2004:1). Moreover, derivative exchanges have existed for a long time. Over recent years it has moved away from an open outcry system to electronic trading where parties trade standardised contracts as required by the exchange (Hull, 2002:2 ; Steinherr, 1998). South Africa has an Automated Trading System.

The derivatives OTC market has outgrown the derivative exchange market by a wide margin in terms of the volume of trades (Hull, 2002:2 ; Steinherr, 1998 ; Thompson et al., 2014:31). Furthermore, Blundell-Wignall et al. (2011:37) state that revenue and profit growth from OTC derivatives is strong, which is due to “bid ask spreads being wide or participants being able to reduce tax and regulatory costs”. Financial institutions often play the role of market maker for commonly traded instruments.

In Rohatgi (2002:566) opinion, the classification of financial instruments varies from country to country, where each country has its own set of rules, irrespective of whether the derivative financial instruments are issued by resident or non-resident entities. In addition, he states that some countries follow the legal or accounting treatment while other countries may look at economic substance. However, according to Hudson (2012:797), the tax treatment for derivative contracts follows the accounting treatment for taxpayers who deal in derivatives as part of their business. Hudson (2012:799) further explains that a derivative contract could have varying tax treatments and may be influenced by the taxpayer’s use of the derivative contract. Similarly, Hudson (2012:799) and Rohatgi (2002:565) cite the nature of a taxpayer and the intended use of the derivative as factors that affect the taxing of a derivative transaction. Essentially, the income or expenditure from a derivative contract can either be classified as revenue or capital. This depends on how the derivative user uses it in the business. Global trading activities by multinational financial institutions generates income that includes for example; interest and, dividends, trading gains, income from notional principle contracts and OTC derivatives, and fee income (OECD, 1998b:12). The OECD Guidelines

indicate that non-traditional financial instruments, that are derivative financial instruments, may be considered as “business income” under Article 7. Alternatively, these instruments may also be considered capital gains under Article 13 or as “other income” under Article 21 of the OECD Model Tax Convention on Income and Capital (‘OECD MTC’) (Oguttu, 2015a:372). The variation in the tax rules and practices across countries affects the derivative financial instrument. As a result, these instruments may create double taxation or double non-taxation on cross-border transactions (Rohatgi, 2002:567). The inadequacy of the international tax laws is echoed again by Olivier and Honiball (2011:257), and the failure to keep up with the development of increasingly complex and sophisticated financial instruments. Similarly, South Africa’s tax law also lags behind.

Derivative financial instruments create transfer pricing issues when global trading is conducted by multinationals since functions and markets of a global trading operation are usually spread across more than one country (Rohatgi, 2002:566). Likewise, Thuronyi (2001:9) and Hudson (2012:831) state that derivative financial transactions may create transfer pricing issues. These authors provide the example of a “back to back transaction” where a transaction is arranged by the non-resident entity through a financial institution, in an attempt to disguise the fact that both parties are related and make it appear that the resident entity is transacting with an independent entity. The structured and complex nature of derivative financial instruments also creates challenges for taxing authorities since it may be difficult to determine if the price represents an arms-length price.

According to Irina et al. (2000:58,59), trying to identify the separate components of an integrated transaction is a difficult task for taxing authorities since the allocations of the income among the components may not be precise. The allocation of income and expenses is not a straightforward task and may not be allocated arbitrarily within an MNE group. The relevant intra-group transfers of income and expenses should be valued as “transfer prices within the group are unlikely to be the same prices that unrelated parties would negotiate” (UN, 2013:6).

2.3 Conclusion

This chapter examined the concepts of global trading, global trading entities and presented some of the key functions of a global trading operation. The chapter discussed product innovation leading to increased use of new financial instruments such as derivative financial instruments. The analysis presented in this chapter revealed that the business of global trading involves complex functions, significant volumes of transactions and is done on a continuous basis (24 hours) with operations established in multiple global locations.

Derivatives were described as financial instruments with a value that is dependent on the value of some other asset. Derivative financial instruments were described as sophisticated and complex instruments that have innovatively developed over time. These considerations are complex and contribute to the elaborate nature of transfer pricing issues that arise from the global trading of financial instruments.

Chapter three

3.1 *Introduction*

According to Miller and Oats (2012:418), transfer pricing traces back to 1928 when the United States of America's congress awarded the Internal Revenue Service ('IRS') the authority to adjust related party transactions. Miller and Oats (2012:418) highlight that:

“Subsidiary corporations, particularly foreign subsidiaries are employed to milk the parent corporation or otherwise improperly manipulated the financial accounts of the parent company.”

The quote above demonstrates the general perception that transfer pricing sometimes has and continues to have in the international environment. Transfer pricing continues to be a concern for MNE groups as taxing authorities perceive that the MNE groups' transfer pricing activity involves price manipulation. In addition, Dunning and Lundan (2008:621) describe transfer pricing manipulation as “transfer prices different to an independent transaction.” In 1935, the League of Nations included the arm's length principle in its model tax treaty (Miller and Oats, 2012:419). Later, in 1979, the OECD issued the OECD Guidelines. The OECD Guidelines advocated for the use of the arm's length principle to determine transfer prices.

Chapter three of this dissertation will examine transfer pricing and the arm's length principle as advocated by the OECD Guidelines. Secondly, the chapter will investigate the applicability of this principle to the global trading of financial instruments by a multinational financial institution group.

3.2 *Transfer pricing*

According to United Nations Practical Manual on Transfer Pricing for Developing Countries (UN, 2013:2):

“Transfer pricing is the general term for the pricing of cross-border, intra-firm transactions between related parties. Transfer pricing therefore refers to the setting of prices for transactions between associated enterprises involving the transfer of property or services.

These transactions are also referred to as controlled transactions, as distinct from uncontrolled transactions between companies that are not associated and can be assumed to operate independently ('on an arm's length basis') in setting terms for such transactions."

This definition of transfer pricing introduces the concepts of a transfer price, associated enterprises and the arm's length principle. The definition does not refer to taxation. According to Miller and Oats (2012:415), when transfer pricing is evaluated in an international tax context, it generally means "artificial manipulation of internal transfer prices within a multinational group with the intention of creating a tax advantage". Therefore, transfer pricing is a process of determining the transfer price of cross-border transactions between connected persons. This definition can be further expanded to include abusive transfer pricing which occurs "when income and expenses are improperly allocated for the purpose of reducing taxable income" (OECD, 2016c:31). In these situations, MNE groups may move profits from high tax jurisdictions to a country that has a lower tax rate. Conversely, expenses may be moved from low tax jurisdictions to a country that has a higher tax rate. Even though transfer pricing can be used for such activities, this may not always be the reason why MNE groups have transfer pricing policies. Transfer pricing has expanded over the last few decades to become a significant global taxation issue for both taxing authorities and taxpayers. Over recent years, there has been an increased focus on transfer pricing which is evidenced in the OECD BEPS project.

Global trading by MNE groups account for almost 30 percent of international transactions for developed countries (UN, 2013:1). More recently, according to Oguttu (2015a:214), 50 percent of the world trade is conducted by MNE groups and is expected to increase. This represents an increasing rate of global trading by MNE groups. It is further opined by Oguttu (2015a:215) that the increased global trading by MNE groups has propelled globalisation. MNE groups are dominant in the global trade arena due to having the required flexibility to engage in cross-border activities through the establishment of subsidiaries and branches in various jurisdictions around the world (UN, 2013:1 ; Rohatgi, 2002:412).

There is a growing perception that intergroup financial transactions lead to BEPS (Bakker and Łukosz, 2016:1). A country's tax base is directly influenced by transfer pricing as this affects the allocations of profits and losses to a specific country (Cooper et al., 2016:6). Intergroup financial transactions that involve financial instruments such as derivatives create transfer pricing complexities. For example, MNEs can design the transaction so that it does not appear to be related to a party, thereby making it challenging for a taxing authority to apply transfer pricing rules. Derivative financial instruments are inherently complex and require a detailed transfer pricing analysis to delineate the transaction. Comparable data is not always available, thereby creating complications when determining the transfer price. According to Irina et al. (2000:15), it is challenging for global trading businesses to identify the nature of the business in each jurisdiction as well as the income that is associated with the function. The quantification of the income associated with each function is complex.

According to Olivier and Honiball (2011:620), transfer prices enable multinational enterprises to shift profits from intra-group transactions to jurisdictions where taxation is low and move expenditures to high tax jurisdictions. This is supported by Oguttu (2015a:215) who states that tax savings is a driving force to establishing entities in multiple jurisdictions and, in particular, so-called tax-haven jurisdictions. Thus, in these instances, transfer pricing can be described as a mechanism for MNE groups to shift profits to various locations. These practices may be likened to the concept of abusive transfer pricing, but this may not always be the primary reason for such practices. MNE groups may engage in cross-border activities in order to manage the various group entities as well as monitor and manage the financial stability of these entities within the group. In such situations it would be inappropriate to label shifting of profits from one jurisdiction to the next as abusive transfer pricing. The action points contained in the BEPS report aims to address some of these transfer pricing concerns. According to Schön and Konrad (2012:3), transfer pricing is a mechanism for MNE groups to maximise the profit potential and minimise tax. Furthermore, Cooper et al. (2016:4) states that transfer prices

enable management to measure profitability and evaluate performance within a group. The related party transactions within a financial institution can include the “sale of tangible goods, the provision of services, or the transfer of intangible property between an organization’s business units”. The transfer price may take the form of commissions, service fees, royalties, premiums, specified unit costs, rent and interest payments (Irina et al., 2000:2).

South Africa’s return to the international markets was met with a notable increase in international trading activities, mainly among MNE groups. The globalisation phenomenon accelerated the tax authorities concern for the protection of South Africa’s tax base (SARS, 1999:5). The relaxation of exchange controls that previously regulated transfer pricing propelled South Africa’s tax authorities to introduce a ‘tax payable in respect of international transactions to be based on the arm’s length principle’ namely section 31. South Africa’s transfer pricing and thin capitalisation legislation came into effect in 1995, followed by Practice Note 2 in 1996 and subsequently Practice Note 7 in 1999. Developing countries such as South Africa are susceptible to transfer pricing abuse due to the lack of information (Cooper et al., 2016:xix). The previous section 31(3) and Practice Note 2 of the legislation deal with thin capitalisation provisions and guidance. However, these concepts fall outside the scope of this dissertation, and will not be discussed further.

More recently, the South African Revenue Service Strategic Plan for 2013/14 to 2017/18 (SARS, 2013:18) highlighted the concept of abuse within the global tax environment. Abuse occurs when multinationals use sophisticated schemes with the objective of manipulating loopholes in tax legislation within jurisdictions. The following risks were highlighted as significant (SARS, 2013:18):

- “Global economic uncertainty has resulted in multinational companies seeking innovative ways to protect profitability and their returns to shareholders by reducing their tax burden.
- The growing presence of multinational corporations in South Africa, which account for nearly 70% of worldwide trade, have the greatest ability to shift profits from high tax jurisdictions to low tax jurisdictions.

- Developing countries, such as South Africa, are likely to be the most impacted by transfer pricing manipulations as the current OECD and United Nations (UN) transfer pricing frameworks are seen to favour developed countries (e.g. due to the use of comparable data that is more relevant in developed countries). The relative shortage of transfer pricing skills and expertise in these jurisdictions is another likely factor.”

The three risks highlighted in the SARS Strategic Plan clearly echo their concerns about transfer pricing issues that are created by multinational groups and the need to protect South Africa’s tax base. Similarly, the 2014 SARS Strategic Plan recognised transfer pricing as one of the key risks it is concerned with (SARS, 2014:15). This ties with the OECD BEPS report that focus on addressing BEPS concerns resulting from transfer pricing. Moreover, transfer pricing continues to be one the most significant tax risks facing multinationals around the world (Olivier and Honiball, 2011:621 ; SARS, 2013 ; Oguttu, 2015a) and is elevated when MNE groups engage in multijurisdictional trading (Oguttu, 2015a:213). It is evident from the discussion above that transfer pricing continues to be a significant tax risk for South African taxpayers and tax authorities alike.

Cross-border transactions between MNE groups and their affiliated companies as well as the pricing of these related party transactions are a concern as it may be susceptible to manipulation. Transfer pricing manipulation does not generally benefit the countries that are involved (Dunning and Lundan, 2008:608). The arm’s length principle, as advocated by the OECD, is the mechanism that is used to protect the tax base of the various tax jurisdictions that the transaction affects. The purpose of the arm’s length principle is to determine an appropriate price for the transaction that is comparable to an uncontrolled transaction. According to Dunning and Lundan (2008:620), cross-border transfer pricing by MNE groups is a major concern for taxing authorities in developed and developing countries. The lack of clear transfer pricing legislation may also encourage transfer mispricing (Cooper et al., 2016:5). Furthermore, Cooper et al. (2016:6) states that transfer prices have a direct effect on a country’s tax base.

In 1994, the South African government had concerns around the protection of the country's tax base from abuse within the global tax environment. These concerns still prevail. Transfer pricing is a significant risk for South Africa, which is evident in the SARS current strategic plan. South Africa's transfer pricing legislation was first introduced in 1995 and is contained in section 31 of the South African ITA. Practice note 7, which is outdated, offers guidance on the application of the arm's length principle to tax authorities and taxpayers. Section 31 was amended in 2012 in order to modernise the South African transfer pricing provisions so as to better align with the OECD Guidelines. The complexities around transfer pricing are greater now than before. This dissertation asserts that SARS should have a greater level of acknowledgement of the uniqueness of the financial services sector and the activities carried out by these entities. The revenue service should closely monitor the global trading of financial instruments by multinational financial institution groups. Appropriate attention should be given to these entities since South African multinational financial institution groups are rapidly expanding their operations across the African continent and possibly across continents. Transfer pricing is a significant risk as it involves a substantial amount of tax and it is a complex issue that requires a high level of skills in order to fully understand the implications (OECD, 2012:9). As South Africa moves forward with modernising its transfer pricing rules, it is important that SARS builds a strong team with expert knowledge of this area of tax. A strong team of experts who have the necessary skills and experience will be able to robustly and effectively tackle these challenges. The protection of a country's tax base from transfer pricing requires comprehensive legislation and skilled staff (Cooper et al., 2016:7).

3.3 Allocation methods

MNE groups can allocate profits using one of two methods, either the separate accounting method or the formulary apportionment method. The OECD Guidelines recommend that the arm's length method (i.e. separate accounting method) should be used by MNE groups and taxing authorities to determine the transfer price of transactions between connected persons (OECD, 2010c:31,36 ; Olivier and

Honiball, 2011:627). Therefore, the OECD Guidelines can be seen as a manual designed to assist taxpayers and tax authorities with applying the arm's length principle. The arm's length principle is used in the OECD MTC and has been adopted in Article 7 and Article 9 of the OECD MTC.

The formulary appointment method allocates profits between the associated enterprises of a MNE group using a predetermined formula. The critics of the arm's length principle support the formulary apportionment method as they claim that this method is more aligned to economic reality and reduces the taxpayer's administrative burdens. The critics claim that the arm's length method is inappropriate for highly integrated MNE groups (OECD, 2010c:38). It was mentioned in Chapter 2 that Rohatgi (2002:566) suggests the use of the formulary apportionment method for highly integrated global trading operations. The OECD member countries do not concur with the advocates of the formulary appointment method. The member countries have raised major concerns that the formulary appointment method creates system implementation challenges against double taxation. In addition, they are of the view that using a predetermined formula is a random application; where no consideration is given to market conditions and the facts and circumstances of a specific transaction (OECD, 2010c:37,38).

3.4 Arm's length principle

The arm's length principle is the international standard on which transfer prices between associated enterprises are based and approved by the OECD. According to the OECD, the arm's length principle is the closest approximation to market situations as it reflects the "economic realities" of the related party transaction. Secondly, OECD member countries and certain non-member countries follow the arm's length principle to govern the evaluation of transfer prices among associated enterprises.

The OECD MTC contains bilateral and multilateral treaties and provides guidance on the application of the arm's length principle. The OECD MTC Article 9, which is the associated enterprise article, reads as follows:

“1. Where

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

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

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

The arm’s length principle detailed in Article 9 provides for a taxing authority to assess cross-border transactions between associated entities and adjust the transfer price if established that the cross-border transaction is not at arm’s length.

According to the OECD (2010c:19):

“two enterprises are associated if one of the enterprises participates directly or indirectly in the management, control, or capital of the other or if the same persons participate directly or indirectly in the management, control, or capital of both enterprises.”

The term “associated enterprises” in Article 9 refers to the conditions and prices under which transactions may be undertaken between associated enterprises and an independent party. These conditions may not be solely driven by market forces, but may be driven by internal group factors. As in the case of independent parties, the conditions of the transaction will be generally driven by market forces. Furthermore, Article 9(2) provides for the corresponding adjustment so as to avoid possible double taxation.

The arm’s length principle is also contained in Article 7, which relates to the business profit of the OECD MTC. It is relevant in situations where global trading is conducted through branches, head office and a permanent establishment, whereas Article 9 is relevant to global trading through subsidiaries (OECD,

2010a:130). Hence, Article 7 and Article 9 of the OECD MTC are relevant for global trading operations.

The arm's length principle involves the comparison of a controlled transaction to an uncontrolled transaction. Comparability is core to the application of the arm's length principle (Cooper et al., 2016:80, 129). A comparable transaction need not be identical but it must not be significantly different from the transaction. It is challenging to delineate a global trading transaction, since the transaction is usually split across jurisdictions and functions. As a result, the countries that are involved in such transactions, have a risk not receiving the correct share of profit or loss (Irina et al., 2000:5).

3.5 Traditional transaction methods

There are three types of traditional transaction methods, namely the cost plus method, the comparable uncontrolled price method and the resale price method. These methods are used to determine whether the transfer price is at arm's length. These methods compare the controlled transaction of the entity to an uncontrolled transaction between independent parties.

3.5.1 Cost plus method

The glossary of the OECD (2010c:26) describes the cost plus method as:

“A transfer pricing method using costs incurred by the supplier of property (or services) in a controlled transaction. An appropriate cost plus mark is added to this cost, to make an appropriate profit in light of the functions performed (taking into account assets used as risks assumed) and the market conditions. What is arrived at after adding the cost plus mark to the above costs may be regarded as an arm's length price of the original controlled transaction.”

The cost plus method is best suited for application by MNE Groups “where services are provided, semi finishes goods sold between connected parties and connected persons have concluded joint facility agreements or long term buy and supply arrangements” (SARS, 1999:17). However, one of the practical problems with the cost plus method is that different entities cost management strategies are more effective. Furthermore, like the resale method, different entities may use various

accounting policies to determine the cost, hence the gross margins of these entities could differ based on the cost accounting method used (SARS, 1999:17).

3.5.2 Comparable uncontrolled price method

The glossary of the OECD (2010c:24) describes the comparable uncontrolled price method as:

“A transfer pricing method that compares the price for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrollable transaction.”

The Comparable Uncontrolled Price Method (‘CUP method’) is viewed as the primary and most preferred method since it is the closest direct way of applying the arm’s length principle (SARS, 1999:14 ; Oguttu, 2015a:216 ; Croome et al., 2013:544). This method is dependent on seeking a transaction between independent enterprises, which is similar to the controlled transaction (Oguttu, 2015a:216). Therefore, a difference in the price of controlled transactions to the price of uncontrolled transactions may indicate that the price is non-arm’s length, which may require an adjustment. Consequently, if a similar independent transaction cannot be identified, this method would be difficult and impractical to apply. The OECD acknowledges that the comparability of transactions may not be practical in every case as price is not always available.

3.5.3 Resale price method

The OECD (2010c:28) glossary describes the resale price method as:

“A transfer pricing method based on the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. The resale price is reduced by the resale price margin. What is left after subtracting the resale priced margin can be regarded after.”

Functional comparability is important since the functions that are performed by the MNE Group should be comparable to the functions that are performed by the independent entity. If not, it becomes difficult to perform an adjustment for the differences (SARS, 1999:15). In the absence of a similar independent transaction, this method can be applied as it is based on the price at which the product was

acquired from a related party and is resold to an independent enterprise. This method is suitable for use when a reseller does not uplift the value of the product when resold to an independent party (Oguttu, 2015a:216 ; SARS, 1999).

This method has a few practical problems as it may require segregated product data which may not be available for the independent enterprises. Furthermore, independent entities may apply different accounting policies in order to calculate costs. Often, this makes it difficult to identify an independent entity that has a similar transaction that has a minimal effect on the margin (SARS, 1999:16).

3.6 Transactional profit methods

There are two types of transactional profit methods, namely the transactional net margin method and the profit split method. Transaction profit methods are preferred when the traditional transaction methods cannot be practically applied to integrated transactions which occur in a global trading operation. According to Peng (2016:3), transaction profit methods were developed due to the challenges created by integrated operations when applying the arm's length principle. Similarly, Croome et al. (2013:546) explains that the profit split method is generally "applied where transactions are so interrelated that they cannot be evaluated separately".

3.6.1 Transaction net margin method

The OECD (2010c:30) Guidelines describes the transaction net margin method as:

"A transactional profit method that examines the net profit margin relative to an appropriate base that a taxpayer realises from a controlled transaction."

The comparison of net profit under the transaction net margin method model makes it a very volatile method as the operating expenses, which may vary significantly, are included here (SARS, 1999:18). A gross margin comparison is thus more reliable than a net profit margin, hence making the net margin method a last resort option (SARS, 1999:18).

3.6.2 *Profit split method*

The OECD (2010c:28) glossary describes the profit split method as:

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

This method splits the combined profit from a controlled transaction using the economic method as the split of the profit should indicate the associated enterprise’s contribution to the transaction. The split should reflect the arm’s length principle. When a transaction is highly interrelated and cannot be evaluated separately, the profit split method is usually used (SARS, 1999:19). The OECD Guidelines provides two alternative approaches to the profit split method, namely the residual profit split analysis method and the contribution analysis method, which are not exhaustive or mutually exclusive (SARS, 1999:20).

3.6.2.1 *Residual profit split analysis*

The residual profit split analysis is a method that involves two steps, firstly, to allocate a basic return to the connected persons of the transaction. This is determined by using what an independent firm would receive for performing a similar function and undertaking similar risks. The second step splits the residual profit to the connected persons which requires judgement on each connected persons relative contribution to the residual profit (SARS, 1999:20).

3.6.2.2 *Contribution analysis*

The contribution analysis method splits the combined profit of the connected persons to the transactions using each person’s relative contribution to the combined profit (SARS, 1999:21).

The profit split method creates certain practical problems as it relies on worldwide group data that typically has limited availability and the allocation of profits is subjective. These practical problems can include the calculation of the combined

profit, deciding on the revenues to be included in profit, using the gross or net profits for the profit split. These could be due to the involvement of various locations in a single transaction, hence different locations may follow diverse principles (OECD, 2010a:142).

The OECD Guidelines recommend that the expected profits rather than actual profits be used for the split. The arm's length principle requires that MNE groups' compare their profit split facts and circumstances with independent parties. However, this is problematic as this information is sensitive to MNEs and therefore rarely disclosed. As a result, this method focuses on identifying the unique and valuable contribution of each entity to the transaction and determining a profit split. This can become challenging if the functions of a specific transaction is split across borders. The availability of internal comparable information is rare in highly integrated MNE groups (Cooper et al., 2016:141).

3.7 Application of arm's length principle to global trading of financial instruments

It is stated by Croome et al. (2013:546) that in order to determine the pricing strategies of an MNE group, a benchmarking exercise is performed against the "pricing strategies of independent entities in uncontrolled transactions." The choice of the transfer pricing method is decided on by the availability of reliable data for the given transaction. Applying the arm's length price to a global trading operation requires that a functional analysis is performed and requires the evaluation of capital and risk assumption. Upon completing a functional analysis, the next step is to identify the relevant transactions and subsequently determine the transfer price in accordance with the OECD Guidelines (OECD, 2010a:131).

The OECD Guidelines state that the arm's length principle should be followed for the global trading of financial instruments. The performance of the functional analysis is important as it identifies the contributions made by each function and rewards the various functions of a global trading operation (OECD, 1998b:31). According to Cooper et al. (2016:133), the remuneration/profit of a related party

from a transaction “will generally be correlated with the functions it performs, the risks it bears, and the assets that it employs”.

The OECD prefers that a comparability analysis is done on a separate basis for each transaction. Furthermore, the OECD points out that an analysis will not meet the reliability requirements of the OECD Guidelines if it has not been done on a separate basis for certain derivative trading activities (OECD, 1998b:32). According to the OECD (1998b:33), it is generally the case that independent data sourced relates to the “routine or non-discretionary activities”. The OECD provides for a flexible application in the search for comparable data. In case of searching for comparable data for MNE groups involved in the business of global trading of financial instruments the search is not limited to only the derivative market as third party data may be used, provided that a reasonably accurate adjustment is made to the data

3.7.1 Sales and marketing

The sales and marketing function of a global trading entity should be evaluated on the basis of the services provided, the type of product and actual functional involvement in a global trading transaction. This evaluation facilitates the classification into a basic or more advanced function. This classification affects the reward that the function receives. A sales function that is classified as basic may be rewarded with a simple fee or commission (OECD, 1998b:36). In such a situation, the traditional transaction method such as the CUP method may be used. An advanced sales function will generally work closely with the trading and risk management function to develop tailor-made derivative financial instruments. In such an instance, evaluating each functions contribution to the global trading transaction is not easy. In these cases, the CUP method may not be practical. The cost plus method will encounter similar issues to the CUP method. The resale price method may be used to evaluate the sales function, but this method has its own set of problems. There may be a few practical problems as this method requires segregated product data, and such data may not be available for the

independent enterprises which may be structured differently. Global trading profits that arise from global trading transactions should be allocated to the functions that are contributors to the profits. The residual profit method generally rewards the simpler functions such as support functions and is determined by using the traditional arm's length service fee. The integrated functions portion would be the balance of the total profit less this fee. Under this method, the residual profit is allocated using a factor formula.

The OECD speaks about the flexibility to make "reasonably accurate adjustments" in relation to the differences between controlled and uncontrolled transactions (OECD, 1998b:36). Certain countries are of the view that, in certain circumstances, the profit methods are the go-to methods for certain transactions. Comparability can be seen as being an issue for a global trading business that is highly integrated and has complex functions. Sourcing comparable and independent data might be possible for basic functions and simple transactions. However judgement is required and adjustments are needed to be made for complex functions. These requirements tend to drive the use of the profit based methods.

3.7.2 Trading and risk management function

According to the OECD (2010a:144), the trading and risk management function is an "important people function in a global trading operation" and the share of profits will be allocated using the profit split method. Thus, this function will be analysed using the three trading models. Applying the separate enterprise trading model for various locations means that the model operates as if the trading and risk management function was a separate profit centre. Therefore, following different trading strategies (OECD, 2010a:115). Thus, the various locations could have opposing positions to common entities in the group and the banks may match these positions with entities within the group. Generally, forward transactions and transactions of traded currencies are managed under the separate enterprise trading model (OECD, 2010a:115).

Under the separate enterprise model each location carries out its trading activities, resulting in limited or no integration of the locations and functions. Therefore, trading and risk management that occurs under the separate enterprise trading model; generally comparable transactions can be sourced and thus using the traditional methods is applicable. The related party transactions generally take place under the arm's length conditions. Moreover, the CUP method may be used when comparable data is generally available. Under this model, each location is considered as a "separate legal entity" and rewarded the appropriate share of the trading profit and losses from the global trading transaction (OECD, 1998b:38). Within the centralised product management model, market risks are centralised and managed in one location that could "be where the natural home or primary is located" of the entity (OECD, 2010a:114). Usually, physical securities are traded under the centralised product management model, however derivatives may also be traded under this model (OECD, 2010a:114). For global trading operations that use the centralised product management model, the trading location is centralised and assumes the ultimate responsibility for trading and hedging (OECD, 1998b:38).

Sourcing comparable information is possible since most transactions are done with independent uncontrolled transactions. Therefore, other functions that are performed by support, middle office or back office (so called simpler functions) allow for the easy sourcing of comparable data. The traditional transaction methods are best suited for transfer pricing transactions. When complex trading functions are performed outside the central location, the model appears to shift toward an integrated model. This shift creates problems with regard to the use of the traditional transfer pricing methods.

The OECD (2010a:113) describes the integrated trading model, where traders particularly trading centres, "set prices and trade off a portfolio of positions called a book while a market is open in that location." When the market closes in that location, the trading of the book shifts to the next trading location where the market is open (this process is described as "book passing"). When global trading is done

between associated enterprises, the legal ownership of the book does not change when the trading location changes (OECD, 2010a:113). Trading operations under the integrated trading model is independent, but the overall trading limits may be centrally managed by a financial institution

Under the integrated trading model, the trading and risk management functions are globally dispersed across the various locations of the MNE group. According to the OECD (1998b:39), sourcing comparable information for a “trading or risk management in an integrated form is unlikely to be found between independents.” Therefore, it may not be possible to make “reasonably accurate adjustments” in order to make the data comparable. The functions that operate under an integrated trading model are significantly integrated making the transactions highly interrelated. Consequently, an evaluation of the comparability analysis on a separate basis may not be possible. In such a situation, the use of traditional methods may not be possible since the availability of the comparable independent transactions may not be available. According to Peng (2016:3), the profit split method offers a more fluid option as compared to independent transactions as it considers the facts and circumstances of the particular related party transaction and does not result in a radical split of profits.

The transaction net margin method is unlikely to be used by the front office of a global trading operation because sourcing comparable net margins is a challenge. It is for this reason that the profit split method is more appropriate. The profit split method identifies the combined profit, the relevant functions of the entity and determines the contributions of the functions. Thereafter, an allocation of the profit is performed (OECD, 2010a:144). The two profit split methods are residual profit split analysis or the contribution analysis; however, these methods are neither exhaustive nor mutually exclusive.

A financial institution may use a combination of the three trading models. For example, a bank that is trading in foreign currency options may choose to follow an integrated trading model approach. Alternatively, another bank that is trading in

spot and forward transactions may apply the separate enterprise model approach (OECD, 2010a:115). The OECD report (OECD, 2010a:115) explains that the trading activities of an enterprise may not fall into any of these models. For instance, the trading authority may neither be completely transferred to one particular location nor located in only one jurisdiction. Global trading operations are highly interrelated and could be split into various functions and locations; therefore a combination of the separate enterprise trading model, centralised product management trading model or integrated trading model may be used.

The complex functions of a global trading business that does not follow centralised product management model or separate trading models, leads one to consider whether some functions can be rewarded using either traditional or profit split methods.

3.7.3 Back office and other support functions

The support functions of a global trading operation can usually be evaluated using traditional methods. Comparable uncontrolled market prices are often available for selected back office functions and may be sourced from investment funds (OECD, 1998b:39). As a result, the cost plus method and the CUP method may be used to apply the arm's length price to such situations. Using traditional transaction methods may be problematic when the back office is integrated into other functions, making it difficult to evaluate this function (OECD, 1998b:40).

MNEs manage a number of costs such as technology, operations, research, accounting, compliance and legal on a centralised basis (Irina et al., 2000:57). An arm's length price can be determined using traditional methods for these functions (OECD, 1998b:40). Independent parties are most likely to manage these functions in a similar way thereby making comparable data available (OECD, 1998b:40). When evaluating such services, there are two important considerations. Firstly, determine whether a service was provided and secondly, in accordance with the arm's length principle calculate the charge for the centralised service (Irina et al., 2000:58). The OECD Guidelines suggest that Chapter 7 should be applied to such

services. Independent parties will most likely manage these functions in a similar way, making comparable data available (OECD, 1998b:40).

3.7.4 *Capital and Risk Assumption*

Capital is important in a global trading operation. Capital is evaluated in terms of its influence on the functional analysis and its role as a capital provider (OECD, 1998b).

When the capital provider is centralised in the location where the trading, dealing and risk management functions are situated, there is no need for a separate evaluation. This is due to the capital requirements of other functions being insignificant to the trading, dealing and risk management functions. A capital function that is separate to the trading and risk management function or spread requires a separate evaluation to determine an arm's length price reward for its contribution (OECD, 1998b:40). The OECD (1998b:41) reports that risk assumption is commonplace in financial markets, hence capital comparable data is generally available. It is important that a functional analysis and analysis of facts and circumstances of the capital provider is performed. The role of the capital provider of a simple versus complex product also needs to be considered. Capital is directly related to risk, the higher the risk the greater the amount of capital is required to cover that risk. If a more complex product is involved in the transactions, the capital provider will play a larger role and a greater amount of capital is required. Reliable, accurate adjustments can be made to achieve a profit split (OECD, 1998b:41).

Rohatgi (2002:419) states that when multiples operations are conducted through more than one permanent establishment, the transfer pricing issues are not typically resolved using the traditional arm's length method. He explains that the profit method is the best-fit for multinationals that have the integrated trading model. Moreover, Rohatgi (2002:419) substantiates this view by explaining that

an integrated trading model results in individual transactions losing importance resulting in the entities relying on other operations to manage the transaction risks. Global trading operations of a business entail a multitude of functions that are performed by a variety of people who may be based around the world. Furthermore, these trading operations use the profit split method since it is the most appropriate for this scenario.

The global trading of derivative financial instruments by multinationals creates challenges when applying the arm's length principle as the operations are highly interrelated (Thuronyi, 2001:10). Additionally, Thuronyi (2001:11) opines that the highly integrated nature of global trading operations is difficult to separate and allocate to various operations due to the underlying complexities. Operations that take place in different countries may follow market to market accounting while other countries may follow an accrual basis accounting. The global trading of financial instruments is multifaceted, requiring highly skilled individuals to perform effective audits on the global trading operations (Thuronyi, 2001:10).

A MNE group engaging in the global trading of derivative financial instruments, as part of its' trading and risk management function, needs to consider the market and credit risks. Derivatives are described as tools used to shift risks and used by MNE groups for hedging strategies. An associated enterprise bears a significant market risk as it can choose to hedge the exposure to this risk or have another associated enterprise hedge the risk. However, the former case may reflect that the entity has indeed assumed the risk. Hedging or non-hedging of risks are important considerations when the allocation of profits are made to the different locations within the MNE groups (OECD, 2010c:47). Derivative risk management is challenging as cash flows in the derivative instrument could have multiple risks, resulting in the transaction being "unbundled into separate risk components so that they can be assigned to the appropriate trading books" (OECD, 1998b:23). According to the OECD (1998b:40), global trading business capital considerations

occurs during a functional analysis and an evaluation of the capital provider enterprise is generally centralised in one enterprise.

The transfer pricing method is influenced by high levels of integration within a global trading business, making it difficult to source uncontrolled comparable data for controlled transactions. This tends to sway taxpayers towards using the transactional profit methods to determine the arm's length price of a global trading transaction. The OECD (2010a:96) states that it may be difficult to find comparable data for an exotic financial instrument and financial instruments used for internal hedging arrangements.

3.8 Proposed revised guidance on the profit split methods

As part of the BEPS project, the OECD is revising the guidance on transactional profit splits. This revision will replace part iii of section c of Chapter ii of the OECD Guidelines. In September 2016, the OECD issued a draft with an intention of finalising the report in 2017. In the draft report, the OECD gave consideration to the OECD 2010 Profit Attribution Report on Permanent Establishments. The profit split method has become the primary option for global trading operations that follow an integrated trading model.

3.9 Conclusion

Chapter three examined the arm's length principle which is the OECD and member countries global standard for determining transfer prices of cross-border transactions with related parties. While the OECD and member countries view the arm's length principle as the global standard, there are critics who support the global formulary apportionment method. The OECD Guidelines recommends five transfer pricing methods when determining a transfer price. These methods can be split into two groups, namely the traditional transaction methods which include the cost plus method, the comparable uncontrolled price method and the resale price method. The second group, known as the transaction profit methods comprises of the profit split method and transaction net margin method.

Examination of the various methods revealed that it may be difficult to apply the preferred traditional transaction methods when determining transfer prices of global trading transactions. The challenges could be attributed to the highly integrated nature of global trading operations and the difficulty sourcing comparable transactions. Recently, as part of the BEPS project, the OECD Guidelines were amended as result of OECD BEPS Action Plan 8-10. OECD BEPS Action Plan 9 is of particular interest for the financial sector as it relates to the allocation of risk and capital. This aspect will be covered in the next chapter.

Chapter four

4.1 Introduction

According to the OECD (1998a:13), tax policies were originally created for “domestic and social concerns”. This was prior to the globalisation phenomenon of national economies and markets. During that era, tax authorities were only concerned with their domestic tax systems. The globalisation of national economies and markets has led to countries “modernising their tax systems” (OECD, 1998a:14). MNE groups and their affiliates operate as a “single integrated enterprise” that pursues the groups’ business strategy (OECD, 2013:25). MNE groups engaging in global trading have their functions globally dispersed and operate across borders. The business strategies of MNE groups have changed to global business strategies focused on increasing the group’s profit potential (OECD, 2013:27). Having robust tax strategies that reduce the tax obligations of the group is one way to increase the profit of the group. The globalised world has created base erosion and profit shifting concerns. The OECD has put in place the BEPS project to address the BEPS concerns by refining tax rules that tackle issues such as transfer pricing, harmful tax regimes, tax treaty abuse and hybrid mismatches (Valderrama, 2016:3).

Chapter four will examine BEPS and Action Plan 9 of the BEPS project. An analysis of the transfer pricing concerns noted in OECD BEPS Action Plan 9 and its applicability to global trading of financial instruments will be presented. This chapter will briefly analyse tax transparency and Action Plan 13 of the BEPS project.

4.2 Base erosion and profit shifting

Base erosion and profit shifting (‘BEPS’) is defined as a practice that “focuses on moving profits to where they are subject to lower tax rates and expenses to where

they are relieved at higher tax rates” (OECD, 2013:39). Therefore, BEPS can be described as a mechanism for a MNE group to reduce the tax obligations of the group through profit shifting.

The OECD identifies the following contributors to BEPS: firstly, “domestic laws and rules that are not co-ordinated across borders”; secondly, “international tax standards have not kept pace with the global business environment” and, thirdly “lack of information at level of the taxing authorities and policy makers” (OECD, 2016b:4). It is the OECD’s view that the international rules relating to the taxing of cross-border transactions are worn-out. Most tax systems were developed in the 20th century when cross-border activity was low (Miller and Oats, 2012:21). Present tax systems are not equipped to address the current era of significant cross-border activity and innovative financial products. MNE groups worldwide are seen to be avoiding taxes by shifting profits to more tax favourable locations resulting in loss of taxation revenue for developing countries (OECD, 2013:13).

The OECD, following the political mandate of the G20 leaders in 2013, initiated a project to address base erosion and profit shifting. This is the BEPS project which includes fifteen action plans. To identify and monitor BEPS, taxing authorities require the co-operation and information from various jurisdictions. Transfer pricing creates opportunities for BEPS as MNE groups can manipulate transfer prices to reduce the overall group tax obligation. This activity may result in the base erosion of the tax bases across the various jurisdictions that the group operates in. According to Bakker and Łukosz (2016:1), “Intra-group financial transactions attract the attention of tax administrations, as they are increasingly perceived to lead to base erosion and profit shifting”.

The OECD (2016b:4) explains that BEPS has a greater impact for developing countries due to the significant reliance on corporate income tax. South Africa, as a developing country, is more susceptible to transfer pricing abuse. Moreover, South Africa lacks skills and resources to tackle such concerns. Exchange controls that previously offered a certain level of protection to the country’s tax base have

been relaxed in order to encourage foreign investment into the South African economy. Thus, with the relaxation of the exchange controls, BEPS is of a greater concern for South Africa.

4.3 Taxing of cross-border activities

The OECD (OECD, 1998a:34) reports that the jurisdiction to tax, transfer pricing, leverage and anti-avoidance are core principles of taxing cross-border activities.

4.3.1 Jurisdiction to tax

MNE groups engaging in global trading of financial instruments that have entities across the world are exposed different tax systems with varying tax rates. The differences in tax systems may result in double taxation or double non-taxation (OECD, 2013:39). MNE groups may exploit these differences when evaluating the group's tax policies. The variation of tax rates create an incentive to shift profits. The business strategies of MNE groups are profit driven through reducing expenses, including tax expenses. Tax expense may be reduced by:

- Shifting the profit to a low or no taxation jurisdiction of the group,
- Using hybrid entities, setting up a foreign branch in a low tax jurisdiction,
- Using hybrid financial instruments and other financial transactions and,
- Using conduit companies and derivatives.

4.3.2 Transfer pricing

Transfer pricing is used to allocate profits and losses between jurisdictions. The decision to shift functions/assets/risks to a tax favourable location is motivated by the level of the functions/assets/risks as the level of functions/assets/risks is correlated to the expected reward (OECD, 2013:42). The greater the level of functions/assets/risks the higher the reward. The OECD acknowledges that functions are not easily transferable, stating that risks and ownerships of assets are indeed transferable. Tax policies that are designed to engage in such practices

may result in BEPS. The transfer of risk by MNEs creates a number of transfer pricing concerns (OECD, 2013:42):

- “how risk is actually distributed among the members of a MNE group,
- whether transfer pricing rules should easily accept contractual allocations of risk,
- level of economic substance required to respect contractual allocations of risk,
- managerial capacity to control risks and the financial capacity to bear risks; and
- whether any indemnification payment should be made when risk is shifted between group members.”

These concerns led to BEPS Action Plan 8-10 and the revision of Section D of Chapter 1 of the OECD Guidelines.

4.3.3 Leverage

The different treatment of debt versus equity across jurisdictions creates a bias for debt financing. A reduction in the tax expense can be easily achieved by leveraging high tax group companies with intra-group debt (OECD, 2013:43).

4.3.4 Anti-avoidance

There are differences in the anti-avoidance rules across jurisdictions. Taxation policies are designed to avoid the provisions of anti-avoidance rules.

In each of the four core principles, namely jurisdiction to tax, transfer pricing, leverage and anti-avoidance, the prevalent theme is that taxpayers have the primary objective to maximise business profits. Reducing their tax obligations is one way to achieving a higher profit. MNEs may design tax policies with the intention to circumvent the taxation laws so as to minimise their tax obligations.

4.4 Revisions to transfer pricing

The arm’s length principle states that an MNE group’s associated enterprises are treated as separate entities. This shifts the focus to the related party transaction

and evaluates if the conditions of the related party transaction would differ from a comparable independent transaction (OECD, 2010c:33). This shift in focus towards the related party transaction is known as the comparability analysis and “is at the heart of the application of the arm’s length principle” (OECD, 2010c:33 ; OECD, 2015a:15). The availability of comparable information influences the selected transfer pricing method for a global trading transaction.

A comparability analysis compares transactions between connected persons of a controlled transaction with the conditions of transactions between independent enterprises, (i.e. the uncontrolled transaction) to calculate an arm’s length transfer price (OECD, 2010a:131). The purpose of the comparability analysis is to find a suitable uncontrolled transaction of an independent party. As part of this analysis, an assessment of differences between the transactions and the price is also performed. A variation in the price between the controlled transaction and uncontrolled transaction is a possible indication that the controlled transaction may not be undertaken at an arm’s length, hence requiring an adjustment. Globalisation and the increased integration of MNEs has made finding comparable information challenging (Muyaa, 2014:352). Muyaa (2014:352, 353) cites the lack of expertise and practical experience; and difficulties to obtain information in smaller markets as challenges when performing a comparability analysis.

4.5 Objective of OECD BEPS Action Plan 9

The objective of the OECD BEPS Action Plan 8-10 report is to create “transfer pricing rules which creates transfer pricing outcomes in line with value creation” (OECD, 2015a:13). The OECD BEPS action plan on the arm’s length principle recognises that “the arm’s length principle can be misapplied to separate income from the economic activities that produce it and to shift the income into low-tax environments”(Law, 2014:42). Furthermore, Law (2014:42) states that part of the work of the arm’s length principle focused on the “contractual allocations of risk to low tax environments”.

According to Action Plan 9 (OECD, 2015a:13) of the BEPS report, the objective is to create:

“rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital.”

The BEPS report has led to the revision of the guidance for applying the arm’s length principle contained in section D of Chapter 1 of the OECD Guidelines. Section D of Chapter 1, relating to comparability of the OECD Guidelines has been deleted and replaced with the revisions from the OECD BEPS Action Plan 8-10 report. The revised guidance on the arm’s length principle provides clarity to taxpayers and taxing authorities on applying the arm’s length principle as well as to reinforce the principle. The comparability analysis and risk aspects in the OECD Guidelines have been expanded. Consequently, the revised section D.1 of Chapter 1 of the OECD Guidelines introduces a two-step process when performing a comparability analysis:

“first aspect is to identify the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations in order that the controlled transaction is accurately delineated; the second aspect is to compare the conditions and the economically relevant circumstances of the controlled transaction as accurately delineated with the conditions and the economically relevant circumstances of comparable transactions between independent enterprises” (OECD, 2015a:15).

The revised section D of Chapter 1 of the OECD Guidelines states that certain aspects when identifying the commercial or financial relations include: obtaining an understanding of the industry sector, factors affecting the MNE performance, strategies, products, key functions performed and assets and risks assumed. It is important to determine each entity’s role within the MNE group and to identify “its commercial or financial relations with associated enterprises” in relation to the related party transactions within the group” (OECD, 2015a:15).

The OECD Guidelines states that it is crucial to identify “economically relevant characteristics of the commercial or financial relations” of related party transaction (OECD, 2015a:15). This step should be performed prior to the application of the arm’s length principle. An analysis of the economic relevant characteristics of the transaction should be performed to accurately delineate related party transactions. According to the OECD (2015a:16), the “economically relevant characteristics or comparability factors” that should be “identified in commercial or financial relations” between related parties to ensure that the transaction is accurately delineated are: the characteristics of the property or services, a functional analysis, the contractual terms of the transaction, economic circumstances and the business strategies of the MNE group. These characteristics are used to accurately delineate a controlled transaction and comparison of the controlled transaction to an independent transaction to determine the arm’s length price (OECD (2015a:16).

4.6 Economically relevant characteristics

4.6.1 Factor 1: The contractual terms of the transaction

The guidelines state that the contractual terms of the transaction should be considered when performing a transfer pricing analysis. These terms can be formalised through written contracts, however the guidance advises in addition to evaluating the written contracts, consideration should be given to the actual conduct of the parties to the transaction (OECD, 2015a:17, 18).

4.6.2 Factor 2: Functional analysis

According to the OECD (2015a:20), the objective of the functional analysis is to “identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed”. This analysis determines the functions of the relevant parties to the transaction and their contribution to the transaction.

Risk and reward usually has a direct correlation. The OECD BEPS project identifies this relationship. Action Plan 9 of the BEPS report aims to prevent MNEs

to manipulate related party transactions associated with allocation of risk. OECD BEPS Action Plan 9's objective is to ensure that allocations of risk to an associated enterprise within the group aligns to the underlying economic activity by that enterprise.

4.6.2.1 Six step risk framework

The revised guidance on the performance of a functional analysis introduces a new six-step framework of risk. Furthermore, the revised guidance speaks of "economically significant risks", a term that is referred to in the OECD Guidelines in Chapter IX: Business Restructurings. It is stated that economically significant risks have a "significant profit potential" and that risks may be reallocated due to the "significant profit potential" (OECD, 2010c:249). The "significance of risk" depends on the "size, likelihood of realisation, predictability and the possibility to mitigate it" (OECD, 2010c:249).

Carrying out a functional analysis is significant when performing a transfer pricing analysis. The functions and assets of a controlled transactions can be identified, however the identification of risk poses a challenge. The evaluation of risk is an important step in the OECD Guidelines which is highlighted again in the BEPS Action Plan 9. Risk is defined within a "transfer pricing context" where "it is appropriate to consider risk as the effect of uncertainty on the objectives of the business" hence risks will be assumed for the existing uncertainty (OECD, 2015a:25).

Risk management in OECD BEPS Action Plan 9 refers to the "function of assessing and responding to risk associated with commercial activity" (OECD, 2015a:22). Whereas risk assumption is described in OECD BEPS Action Plan 9 as "taking on the upside and downside consequences of the risk with the result that the party assuming a risk will also bear the financial and other consequences if the risk materialises" (OECD, 2015a:23). Therefore the risk management function does not assume the risk but performs risk mitigation functions under the direction of the party assuming the risk (OECD, 2015a:23). According to OECD

BEPS Action Plan 9, a party has the financial capacity to assume risk if it has appropriate funding to “take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if the risk materialises” (OECD, 2015a:23). A party has control over risk if it has the capability to make decisions on risks associated with opportunities and the performance of that function (OECD, 2015a:24).

The new six-step risk framework provides guidance on identifying and analysing risk to enable controlled transactions to be delineated to appropriately determine the arm’s length price. The revised OECD Guidelines stresses “that contractual allocation of risks is accepted only when it corresponds to actual control and capacity to bear the formally allocated risk” (Cooper et al., 2016:137). The six-steps of the new risk framework is as follows:

Step 1: Identify economically significant risks with specificity

Step 1 identifies the economically significant risks for transfer pricing. Action 9 of the BEPS report states that “the significance of a risk depends on the likelihood and size of the potential profits or losses arising from the risk” (OECD, 2015a:26). It is inherent that enterprises will assume risks that it can be rewarded for in return for the risk assumption. This is similar to the descriptions provided in Chapter IX of the OECD Guidelines.

A non-exhaustive list of risks provided by the OECD considers the internal and external risks which include:

- Strategic risks or market place risks
- Infrastructure or operational risks
- Financial risks
- Transaction risks
- Hazard risks

“Control over a specific risk in a transaction focusses on the decision-making of the parties to the transaction in relation to the specific risk arising from the transaction” (OECD, 2015a:27).

Step 2: Contractual assumption of risk

Step 2 identifies the party that assumes the risk in a controlled transaction. Risks can be stipulated in written contracts or be implicitly assumed. Action Plan 9 of the BEPS report states that the contractual assumption of risk is an ex ante agreement. Determining the risk assumption by the associated enterprises occurred ex ante is an important aspect of the transfer pricing analysis when the outcomes are certain (OECD, 2015a:28). The guidance further notes that ex post reallocations of the risk, when risk outcomes are certain, are inappropriate. Risk assumption by MNE is effected by the MNE’s capability to manage and control risks. The determining of the arm’s length price between the associated enterprises is strongly affected by the enterprises risk assumption to the transaction, but the enterprises stipulated in the written contracts may not necessarily identify who assumes the risk (OECD, 2015a:29).

Step 3: Functional analysis in relation to risk

Step 3 performs a functional analysis of the associated enterprises in relation to the risk. This analysis focuses on each associated enterprises role in the transactions, including the economically significant risks are assumed and managed, who controls the risk management functions and which enterprises have the financial capacity to the assume the risk.

Step 4: Interpreting steps 1-3

Step 4 evaluates steps 1,2 and 3 to determine if the “contractual assumption of the risk is consistent with the conduct of the parties and other facts of the case” (OECD, 2015a:31). The OECD recognises that taxing authorities may experience challenges in determining whether the associated entity assuming the risks also controls the risk. Therefore, a test can be applied by using comparable risk

assumptions identified in a comparable independent transaction (OECD, 2015a:33).

The difficulty finding comparable information is a challenge for multinational financial institution groups that engage in global trading of financial instruments. Therefore, step 4 could be a challenge for such entities.

Step 5: Allocation of risk

Step 5 allocates the risk to the associated enterprise controlling the risk that has the financial capacity to assume the risk. In situations where multiple entities have control and the financial capacity to assume the risk, the risk can then be allocated to the enterprise having the “most control” (OECD, 2015a:33).

Step 6: Pricing of the transaction, taking account of the consequences of risk allocation

The OECD BEPS Action Plan 8-10 report states that the delineated transaction pricing is in accordance with the OECD Guidelines. The financial and other consequences of the assumption of risk is taken into account as well as the risk management remuneration (OECD, 2015a:34).

The revisions to the OECD Guidelines from the BEPS project applies to all entities in all industries as stated in the OECD Guidelines (OECD, 2015a:185):

“The guidance in this chapter, and in this section on risk in particular, is not specific to any particular industry sector. While the basic concept that a party bearing risks must have the ability to effectively deal with those risks applies to insurance, banking, and other financial services businesses, these regulated sectors are required to follow rules prescribing arrangements for risks, and how risks are recognised, measured, and disclosed. The regulatory approach to risk allocation for regulated entities should be taken into account and reference made as appropriate to the transfer pricing guidance specific to financial services businesses in the Report on the Attribution of Profits to Permanent Establishments (OECD, 2010).”

4.6.2.2 New risk framework and global trading entities in the banking sector

According to Odintz et al. (2016:7), the OECDs' BEPS new risk framework will make it difficult for the financial sector to show that the "risk was allocated to a counterparty and that the compensation for such allocation was appropriate". Global trading entities in the financial sector have to manage their contractual allocations of risks closely as risk assumption should align to underlying economic activity by an entity. This is to ensure that the appropriate entity in the related party transaction is appropriately rewarded. A concern over the inappropriate risk transfers was noted in the OECD Guidelines. In the OECD 2010 Report on Profit attribution of Permanent Establishments, the OECD addressed concerns of risk and internal transfers of risk within a global trading operation in the financial services sector. The revision to the OECD Guidelines creates the need for taxing authorities and taxpayers to focus more attention on risk analysis. These revisions do provide further requirements and guidance to support the techniques used by these businesses. It will also create new challenges for the increased focus of risk analysis as this is an important function of a global trading operation business.

Chapter two examined the people functions of a global trading operation. The chapter revealed that the trading and risk management function of a global trading operation is an "economically significant activity" and most of the functions are people functions. According to the OECD (2010c:46), the consideration of risk assumption and the allocation of risk, is an important aspect of a functional analysis. An idea of the arm's length principle is that the "more extensive the functions/assets/risks of one party to the transaction, the greater its expected remuneration will be and vice versa" (OECD, 2013:42). BEPS has a growing concern due to the potential for BEPS occurring as a result of transfer pricing arising from inappropriate risk and capital as detailed in Action Plan 9 of the BEPS report.

Multinational financial institution groups that engage in the global trading of financial instruments are exposed to financial risks such as market risk, credit risk

and operational risk. Risk identification is an important aspect of a functional analysis and there is a correlation between risk and reward; the higher the assumed risk the higher the expected return (UN, 2013:192). The importance of risk in a transfer pricing analysis has been reiterated by the OECD in a number of its transfer pricing publications. Capital and profit allocations are affected by risk assumption where capital is allocated to the functions that support the risks and similarly for the profit allocation (OECD, 2010a:17).

The OECD 2010 Report on Profit Attribution to Permanent Establishments speaks of terms such as “economically owned” and that the purpose of the functional analysis is to establish where the risks are “economically owned” (OECD, 2010a:94). The concept of economic ownership is also considered and financial assets and risks are only economically owned, “where they are booked if the key entrepreneurial risk-taking functions related to their creation have been performed there” (OECD, 2010a:94). According to OECD (2010a:94), this concept applies to dealings that intend to transfer the ownership of financial assets within an MNE group. The key entrepreneurial risk-taking functions (‘KERTS’) have to also transfer in order for it be recognised as a transfer of economic ownership.

Within a global trading entity, the significant people functions assumption of risk and economic ownership of assets are interrelated. A separation of the two can be difficult, hence the OECD uses KERTS for this sector (OECD, 2010a:15). KERTS are described as:

“Those which require active decision-making with regard to the acceptance and/or management (subsequent to the transfer) of individual risks and portfolios of risks. For a bank, the creation of a financial asset and its subsequent management are likely to be the key entrepreneurial risk-taking functions and,... economic ownership of the financial asset (and the income and expense associated with holding that asset, lending it out, or selling it to third parties) is generally attributed to the location performing those functions” (OECD, 2010a:66).

An important step is the identification of the KERTS so as to identify where the people performing the function are located (OECD, 2010a:150). A problem arises when the functions are split across different locations, such as a global trading entity that follows the integrated trading model. A global trading entity's trading and risk management function could be split between the trading locations. In such a situation, the functional analysis should determine "the true nature of the functions performed" to determine the "true risk taker" for situations where the KERTS are split across locations (OECD, 2010a:150). A functional analysis determines which enterprise is performing the various KERTS in order to attribute the financial instrument and the risk. The measurement of risks will follow a regulatory approach for entities that conduct global trading through a multinational bank. Capital allocations within a permanent establishment follows the risks created by KERTS whereas for a subsidiary, the capital can be located in a different entity to where the risk is assumed (OECD, 2010a:160).

Market and credit risks may be shifted between the different entities of a global trading operation. Market risk is an important function in a global trading operation. A common example of the internal shifting of market risks between MNE groups is by means of a swap. This is where one entity can swap a fixed rate instrument for a floating rate instrument or vice versa. The mirror swap needs to be evaluated to determine whether the contract "that purports to transfer market risk should be recognised as a dealing to be taken into account when attributing profits." For this to be the case, there has to be "a real and identifiable event (i.e. a genuine change in the part of the enterprise that is managing the market risks assumed as a result of the customer transaction)" (OECD, 2010a:163). It is important that the transfer of the market risk management function includes the "assumption of the market risk and the appropriate portion of the dealer spread and the trading profit potential of the financial instrument relating to the customer transaction"(OECD, 2010a:163).

The OECD (2010a:18) acknowledges that the financial sector places importance on risk as it affects the capital, income and expenses of institutions within this sector. The OECD notes that institutions within the financial sector have advanced tools to measure risk. Furthermore, regulators within the financial sector also require banking institutions to have specific levels of capital to cover the various risk exposures. Central banks are generally the regulatory and supervisory authority for the banking sector. The Basel Committee on Banking Supervision ('BCBS') sets the international standard for prudential regulation and supervision of the banking sector. Similarly, the insurance sector and investment management sectors also regulates risks and capital. The first issue of the BCBS rules was in 1988 and focussed on the capital requirements for credit risk, in 1996 the rules were extended to included capital requirements in relation to market risk (Scott, 2005:3). According to Scott (2005:3) over 100 countries have in one way or another implemented the rules of the BCBS. The objective of the BCBS "is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability" (Basel, 2016a:1). The main goals of the BCBS according to Basel (2010) and Basel (2016b:1) are to:

- "Improve the banking sector's ability to absorb shocks arising from financial and economic stress
- Improve risk management and governance
- Strengthen banks' transparency and disclosures".

The BCBS robustly supervises the capital and risk management processes of the banking sector. The financial crisis elicited by the non-disclosures of key "on and off balance sheet risks and derivative exposures" propelled the BCBS to further strengthen the risk coverage of the capital framework and liquidity rules (Basel, 2010:3). The capital requirements of the trading book and complex securities have increased. More recently, the BCBS has developed a set of principles for the total loss absorbing capacity ('TLAC') for global systemically important banks ('GSIBS'). This is intended to reduce the risk of contagion and the BCBS will provide a prudential treatment for non-GSIBS (Basel, 2016c:1). This is further evidence of

the BCBS' commitment to strengthen its supervision of the banking sector and also highlights the importance the BCBS places on the capital and risk management functions in the banking sector.

Therefore, the banking sector is a highly regulated sector with little room to act outside these various regulations imposed by the BCBS. The BCBS also has a standard for prudential regulation and supervision on banks called the 'Core Principles for Effective Banking Supervision'. This standard enables bank supervisors to revoke a bank's banking licence or recommend the revocation of a bank's licence should the assessment raise dire concerns that are not aligned to the core principles (Basel, 2012:37). Therefore, banks are under extreme supervision and the improper allocation of risk and capital allocation are unlikely to occur.

According to Brummer (2012:88), the International Swaps and Derivatives Association ('ISDA') "is a trade association of firms and professional service providers in the over-the-counter derivatives industry." The ISDA master agreement is the "authoritative contractual framework used in derivative transactions to memorialise contractual obligations between parties" (Brummer, 2012:88). The ISDA has implemented good governance principles for the derivatives industry. The ISDA's mission is "promoting practices conducive to the efficient conduct of the business, promoting the development of sound risk management practices, and fostering high standards of commercial conduct" (Brummer, 2012:89).

Risk and the allocation of capital within the OECD BEPS Action Plan 9 may be of little concern to a global trading entity operating in the banking sector since there is minimal room for improper actions. A bank found guilty of such conduct could have its banking licence revoked. The OECD discussion draft on BEPS Action Plan 8-10 received a number of comments. The comments from financial institutions were of a particular interest for this dissertation. Certain institutions noted that the risks and capital were adequately addressed in the OECD 2010 Report on the Attribution of Profits to Permanent Establishment (2015:41, 103). Risks also affect

the capital structure of the business, therefore shifting capital around businesses is complicated, plus the use of capital is not always flexible. According to Oguttu and Schulze (2011:6), the developments from the BCBS aims “to ensure that the risks inherent in the bank’s portfolios relating to trading activities, securitisation and exposure to off-balance sheet vehicles are better reflected in minimum capital requirements, risk management practices and accompanying disclosures to the public.” This dissertation supports the comments that multinational financial institution groups are a highly regulated industry. Thus, multinational financial institution groups with global trading of financial instruments as part of their business will also be subjected to this high level of regulation. Additionally, these institutions use KERTS to evaluate risks, as stated in the OECD 2010 Profit Attributed report. KERTS is well established for use by financial sector institutions such as banking groups, insurance companies and asset managers. The highly regulated nature of multinational financial institution groups and the regulations around risk and capital allocations imposed by the BCBS mitigates some of the concerns around base erosion and profit shifting.

The development of BEPS offers South Africa an opportunity to evaluate the branches of foreign banks operational in the country if the arm’s length principle is aligned to value creation. According to Law (2014:46), developing countries can “argue that the arm’s length principle ought to recognise the values created by market factors and remunerate them adequately”. Law (2014:42) further indicates that China and India have led the efforts to “incorporate market facing factors for the allocation of income of multinationals”.

South Africa tax authorities need to consider the revisions to the existing OECD Guidelines and how these will be implemented and interpreted for multinational financial institution groups engaging in the global trading of financial instruments. South Africa’s banking sector regulatory and supervisory authority is the South African Reserve Bank (‘SARB’) while the non-banking financial services industry’s authority is the Financial Services Board (‘FSB’). South African banking institutions

adhere to the Basel principles and are highly regulated entities. As indicated above, BCBS sets the international standard for prudential regulation and supervision of the banking sector. South Africa has implemented Basel II and the implementation of Basel III began in 2013 and runs over a six year period (SARB, 2016b:1,2). Consideration needs to be given to the branches of foreign banks that operate in South Africa. South Africa adheres to these international standards imposed by the BCBS with regards to banking regulation and supervision. In 2015, the IMF published its assessment of South Africa's adherence to the Basel core principles and found that South Africa has a "high level of compliance with the core principles" (SARB, 2016a:2). On the basis of this evidence, it is fair to suggest that South Africa's financial sector is highly regulated and has strong measures in place to mitigate base erosion and profit shifting concerns stemming from Action Plan 9 of the BEPS report. Entities involved in the business of global trading of financial instruments within the banking sector are also highly regulated and subject to these regulations.

4.6.3 Factor 3: Characteristics of property or services

Property or services characteristics are important considerations for controlled and uncontrolled transactions since it could influence price variance. This factor is more important for the traditional transfer pricing methods rather than the transactional profit split methods (OECD, 2015a:35, 36).

4.6.4 Factor 4: Economic circumstances

Variations in economic circumstances may impact on the arm's length prices. Therefore, it is important to consider the location, size, level of competition, substitute goods and services, supply and demand and government regulation of markets (OECD, 2015a:36).

4.6.5 Factor 5: Business strategies

The OECD Guidelines state that it is important to examine a selection of business strategies that directs daily operations. These include new product development,

diversification levels, appetite for risk, duration of arrangements and other factors (OECD, 2015a:37).

4.7 Transparency

According to Bianchi and Peters (2013:19):

“Our inner secret desire for transparency is part and parcel of our perennial quest for truth, the quest for the Holy Grail of good governance and democratic rule, legitimacy and accountability, justice and fairness to all.”

Transparency has become important in the current era. Tax transparency of MNEs has increased (Owens, 2014:512). The transparency of information leads to accountability (Turina, 2016:384).

The United Nations describes transparency as:

“Transparency means (...) that information is freely available and directly accessible to those who will be affected by such decisions and their enforcement. It also means that enough information is provided and that it is provided in easily understandable forms and media” (Turina, 2016:383).

Tax transparency is seen as an instrument to assist taxing authorities to combat certain taxation risks such as BEPS. Having greater tax transparency for MNE groups enables tax authorities to better understand their economic activities. According to Turina (2016:395), transparency and information exchange gained prominence with the OECD when the lack of information was seen to be contributing to harmful tax competition. However, Bianchi and Peters (2013:10) importantly point out that having access to information does not always mean it's useful. Consideration should be given to information overload, the level of information and the possibility of manipulated information. The usefulness will depend on the context that the information is provided (Bianchi and Peters, 2013:10).

The lack of available information to taxing authorities is cited as a significant contributor to the difficulties experienced when performing the transfer pricing analysis of MNE groups.

4.8 Country-by-Country reporting

Globalisation has influenced the tax bases of countries. The desire of MNEs to reduce their taxation obligations has led to them having “aggressive tax positions” (Valderrama, 2016:1). The OECD has adhered to the political mandate of the G20 and developed instruments to exchange information, to deal with tax fraud, tax evasion and BEPS (Valderrama, 2016:3). Similarly, the OECD has developed the global standard for the automatic exchange of information and the BEPS report.

The paucity of transparency in financial reporting supports profit shifting (Evers et al., 2014:295). Chapter V of the OECD Guidelines, as it relates to transfer pricing documentation, has been refined as a result of the BEPS project.

Action Plan 13 of the BEPS project requires the development of:

“rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNEs provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template” (OECD, 2015b:9).

The objective of Action Plan 13 of the BEPS project is to enforce a more comprehensive level of disclosure for MNEs. The revised OECD Guidelines includes a template for Country-by-Country (‘CbC’) reporting. The revised Chapter V of the OECD Guidelines contains a three-tiered standardised approach to transfer pricing documentation. The first tier requires that MNEs provide a master file that contains standardised information about all entities within the group. The second tier requires that a local file is maintained that contains transfer pricing documentation for material transactions in a specific location. The third tier requires MNE groups to produce an annual CbC report of economic activities for each location that it operates and which details the group’s allocation of income and taxes paid. The CbC report requires information on revenues, profits and taxes. Additionally, the report also requires MNEs to disclose the number of

employees, stated capital, retained earnings and tangible assets in each tax jurisdiction. MNEs are further required to “identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities each entity engages in” (OECD, 2015b:9).

This heightened focus on increasing transparency through CbC reporting may result in greater levels of available information on cross-border transactions of MNE groups. According to the OECD (2015b:9), CbC will enable taxing authorities to better assess whether the transfer pricing practices have a BEPS effect. Additionally, Owens (2014:512) states that the new CbC reporting requirements originating from the BEPS project will be used as a “high level risk assessment tool.” The CbC report cannot be a substitute for the transfer pricing analysis of cross-border transactions as it does not provide conclusive evidence on transfer prices (OECD, 2015b:16). Turina (2016:406) states that the CbC report of the BEPS drives the accountability of MNE groups. According to Evers et al. (2014:296), the supporters of CbC reporting view CbC reporting as a tool for encouraging MNE groups to align their taxes paid to the economic activities in the various jurisdictions they operate in.

The three-tiered standardised approach to transfer pricing documentation may provide taxing authorities with better insights into the operations of MNE groups since they are required to report on activities, profits and tax for each of the locations it operates in. This will also assist taxing authorities in the evaluation of cross-border transactions and with any related transfer pricing concerns. The new CbC reporting requirements are implemented for years beginning on or after 1 January 2016 and applies to MNE groups with an annual consolidated group revenue greater than or equal to EUR 750 million (OECD, 2015b:10).

The CbC reports will provide taxing authorities the needed transparency on MNE groups operations and taxes paid. CbC reports may be exchanged among taxing authorities across the various jurisdictions that the MNE groups operates in. CbC reports can also assist in understanding the transfer pricing practices of the MNE

groups. However, the CbC report does not provide “conclusive evidence” on “transfer pricing practices” (OECD, 2015b:16).

Bianchi and Peters (2013:110) state that “financial markets are global and therefore global and transparent international financial institutions should govern them.” The desire for transparency will further develop as globalisation progresses. The CbC report is a step towards obtaining information and making MNEs more transparent. However, the information disclosed in the CbC report may not include all the relevant details required to evaluate an MNE’s transfer pricing activities. Hence, the problems related to the sourcing of comparable information will continue and be of concern. According to Bakker and Łukosz (2016:4), material intergroup derivatives should be disclosed in the master and local file respectively.

It is recommended that MNEs maintain a comprehensive tax policy that includes the new innovative instruments that are globally traded as part of their businesses. While the developments promote greater levels of transparency of MNEs, Valderrama (2016:14) states that should also “enhance transparency of the tax administration and the protection of taxpayers’ rights”. Action Plan 13 supports the OECD project on tackling BEPS issues and it will encourage MNEs to provide information on the group’s profits, taxes and economic activity.

Chapter five

5.1 Conclusion

Globalisation has led to the changing structure of MNE groups and how the various functions within the group are performed. Global trading businesses have become highly integrated business operations. Cross-border transactions between MNE groups have significantly increased. The prominence of transfer pricing continues to grow across the international community. The significant growth in global trading has raised concerns for taxing authorities worldwide to protect the country's tax bases.

Multinational financial institution groups that engage in global trading of financial instruments create significant transfer pricing concerns. Cross-border transactions that occur in these institutions are highly interrelated, especially for institutions that follow an integrated trading model. Performing a functional analysis and attempting to separate the various functions is no longer a simple task. Hence, applying the arm's length principle using the traditional transfer pricing methods to such situations is not always easy. Additionally the lack of comparable information increases the complications. Global trading operations that follow the integrated trading model generally use the profit split methods.

Derivative financial instruments also pose another challenge since these can be structured specifically for the global trading transaction, making it difficult to find comparable instruments. Therefore, the use of traditional transfer pricing methods, in which comparability plays an important role, is not always practical. Global trading operations that follow the integrated trading model experience application issues when using the traditional methods due to the lack of comparable information. Comparable information is not always available due to the variations in the level of integration between MNE groups and the sensitivity of the information which prevents disclosures. Action Plan 13 of the BEPS report requires greater levels of transparency from MNEs regarding transfer pricing documentation and may subsequently encourage MNEs to disclose more

comprehensive information. This could assist taxing authorities to better understand the profits, taxes and economic activities of MNE groups. OECD BEPS Action Plan 13 CbC reporting requirements does not however provide conclusive evidence on transfer prices.

The BEPS project has led to the revision of the OECD Guidelines. OECD BEPS Action Plan 8-10 report seeks to align transfer pricing outcomes with value creation contributed to some of the revisions. Action Plan 9 of the BEPS report relating to the allocation of risk and capital has attracted attention to the financial sector since these are important areas of MNE groups in the financial sector. OECD BEPS Action Plan 9 identifies inappropriate risk allocation between MNE groups as a BEPS concern. The risk and capital function of multinational financial institution groups is highly monitored and regulated. Therefore, multinational financial institution groups in the banking sector that conduct global trading of financial instruments as part of business will also be subject to a high level of regulation. The highly regulated nature of multinational financial institution groups such as the regulations imposed by the BCBS mitigates some of the concerns around BEPS. The likelihood of inappropriate risk and capital allocation occurring in such businesses is remote. The consequences are dire for MNEs in the financial sector that fails to adhere to the regulations within the industry. The 2010 Report on the Attribution of Profits to Permanent Establishments has comprehensive detail on the risk and capital allocations for the banking sector. The OECD should consider developing a better link between the 2010 Report on the Attribution of Profits to Permanent Establishments and the OECD Guidelines. The BCBS, as the international supervisory authority for prudential regulation and supervision of the banking sector, has put significant efforts to strengthen the regulation of the banking sector.

This dissertation argues that not enough attention is given to complex areas like transfer pricing issues that arise from the global trading of financial instruments by multinational financial institution groups. Therefore, it is recommended that taxing

authorities should place more focus on this area of concern. The SARS compliance audit reveals that focus was placed on mining sectors; however, while these are important sectors, the financial sector plays a critical role in the South African economy. The taxing authorities need to better understand transfer pricing transactions that occur in MNE banking groups. It is promising to note that the SARS Compliance Programme 2012/12- 2016/17 seeks to examine financial sectors. The lack of focus on the financial sector by developing countries with regard to transfer pricing was also highlighted by the OECD, stating developing countries choose to focus more on the mineral wealth and natural resources sector (OECD, 2012:68).

As globalisation mechanisms advances further, the revolution of financial markets will continue. The transfer pricing challenges that are created from the global trading of financial instruments by multinational financial institution groups will become more challenging. The tasks to address these concerns for both taxing authorities and taxpayers will also become more challenging. The traditional transaction transfer pricing methods may lose complete relevance as these groups become even more integrated and create greater distinctive, innovative and complex financial products.

Most of the OECD BEPS reports on the fifteen action plans have been issued; it is now for the countries to implement these recommendations into law. This presents new hurdles for South African taxing authorities. The efficient and effective implementation of the relevant BEPS action points for South Africa rests on its own shoulders. South African taxing authorities should assess these actions points and categorise these in order of relevance and importance in relation to the South African tax environment. This dissertation provides sufficient evidence to call for the South African tax authorities to evaluate the revisions to the OECD Guidelines and its applicability to the financial sector. This is necessary to ensure that the transfer pricing outcomes of the multinational financial institution groups are in line with value creation. South African financial institutions are in an expansion phase

across borders. As the expansion intensifies, South African transfer pricing concerns arising from global trading of financial instruments will become more significant. The recent changes to the OECD Guidelines places additional pressure on the South African tax authorities and taxpayers.

Comprehensive and effective transfer pricing legislation offers protection of a countries tax base, addresses double taxation issues and facilitates cross-border trade (UN, 2013:6). It has been noted in the most recent reports that SARS has resource constraints to deal with transfer pricing issues (Step, 2015:1). Miller and Joubert (2015) note that although SARS has recruited staff from the “big four firms” resource pressures continue. SARS should therefore consider other ways to increase its resource base so that it can appropriately and effectively tackle the complex issues of transfer pricing. A critical issue being the global trading of financial instruments by multinational financial institution groups should be on the top of its agenda.

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