ARTICLE

Challenges of Applying the Comparability Analysis in Curtailing Transfer Pricing: Evaluating the Suitability of Some Alternative Approaches in Africa

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This article asserts that transfer pricing is perhaps the greatest profit shifting problem facing the international tax system. Thus, countries have historically been keen on preventing transfer pricing and on finding effective and efficient methods for allocating revenue that are administratively cost effective for both taxpayers and tax administrators. However, the problem as articulated in this article is that the comparability analysis that underpins the application of the arm's length principle (ALP) which is applied internationally to curb transfer pricing, continues to be a vexing problem for developing countries due to various conceptual, policy, legislative, administrative and capacity challenges in finding comparable data. Acknowledging these problems, various international bodies have recommended alternative approaches that are considered simpler and less administratively burdensome, that developing countries may adopt in certain cases so as not to carry out a fully fledged comparability analysis. This article explains the operation of some of these alternative approaches and it evaluates the advantages and drawbacks of each of them. The article provides examples of some African countries that have adopted the alternative approaches and the positions of others that have not adopted these approaches. Recommendations are then provided as regards the competing policy options that countries have to consider when adopting the alternative approaches. It is hoped that the article will be found useful by African tax administrations and policy makers when they consider whether to adopt the alternative approaches.

Keywords: Transfer pricing, comparability analysis, advance pricing agreements, safe harbours, arm's length principle, low value-adding intra-group services, sixth method, multinational companies

1 Introduction

Intra-group trade among multinational companies (MNCs) has been growing steadily since the mid twentieth century and arguably accounts for more than 30% of all international transactions.[1] The key feature of MNCs is that they are integrated (global) businesses with the ability to centralize control in one location.[2] However, this integration encourages 'transfer pricing' – a tax planning[3] scheme that entails setting prices at which connected entities sell, buy or share resources between each other[4] so that their profits appear lower in a country with higher tax rates and higher in a country with lower tax rates.[5] Since transfer prices are not negotiated in a free and open market, they may deviate from normal market prices (arm's length prices), agreed upon between unconnected parties where each party strives to get the utmost possible benefit from the transaction.[6] MNCs are able to set transfer prices because the network of internal payments for the goods and services they supply to each other allows some degree of substitution of costs which gives group members the freedom to establish conditions in their intra group trade, which are not available in uncontrolled trade between unconnected companies.[7] Transfer pricing is perhaps the greatest problem facing the international

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1 UN, *Practical Manual on Transfer Pricing for Developing Countries* (UN 2017), para. B.1.1.3.

2 *Ibid.*, para. A.2.8.

3 OECD, *Addressing Base Erosion and Profit Shifting* 36 (OECD Publishing 2013).

4 B. Arnold & M. J. Mclyntyre, *International Tax Primer* 53 (Kluwer Law International 2002); A. W. Oguttu, *Transfer Pricing and Tax Avoidance: Is the Arm's length Principle Still Relevant in the E-commerce Era?*, 18(2) SA Mercantile L.J. 139 (2006).

5 A. Ginsberg, *International Tax Havens* 20 (2nd ed., Butterworths 1997); A. Rappako, *Base Company Taxation* 16 (Kluwer Law and Taxation Publishers 1989).

6 Arnold & Mclyntyre, *supra* n. 4, at 55; D. Hay, F. Horner & J. Owens, *Past and Present Work in the OECD on Transfer Pricing and Selected Issues*, 22(10) Intertax 424 (1994); OECD, *Issues in International Taxation No 2 Thin Capitalisation: Taxation of Entertainers, Artists and Sportsmen* 17 (OECD Publishing 1987).

7 S. R. F. Plasschaert, *Transfer Pricing and Multinational Corporations: An Overview of Concepts, Mechanisms and Regulations* 4 (Saxon House 1979).

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tax system, particularly for MNCs[8] with subsidiaries resident in various jurisdictions with different tax laws and regulations.[9] Every country expects a fair share of taxes to be paid by companies operating in their territory for the exploitation of the resources made available to them. Thus, countries have historically been keen on preventing artificial transfer pricing and on finding effective and efficient methods for allocating revenue that are administratively cost effective for both taxpayers and tax administrators.

This article traces the historical development of the arm's length principle (ALP) in Article 9(1) of the Organisation for Economic Cooperation and Development (OECD) and United Nations' (UN) Model Tax Conventions (MTC);[10] which countries employ internationally to prevent transfer pricing; and how they adopted the transactional pricing methods for determining an arm's length price, which are set out in the OECD Transfer Pricing Guidelines.[11] However, the problem as articulated in this article is that the comparability analysis that underpins the application of the ALP and the transactional methods continue to be a vexing problem for developing countries due to various conceptual, policy, legislative, administrative and capacity challenges in finding comparable data. Acknowledging these problems, various international bodies such as the UN, OECD and the International Monetary Fund (IMF), have recommended alternative approaches that are considered simpler and less administratively burdensome, that developing countries may adopt in certain cases so as not to carry out a fully fledged comparability analysis. This article explains the operation of some of these alternative approaches and evaluates the advantages and drawbacks of each of them. The article provides examples of some African countries that have adopted the different approaches and the positions of others that have not adopted these approaches. Recommendations are then provided as regards the competing policy options that countries have to consider when adopting alternative approaches. It is hoped that the article will be found useful by African tax administrations and policy makers when they consider whether to adopt the alternative approaches.

2 Historical developments

The history of transfer pricing can be traced back to the onset of the industrial revolution in the nineteenth century and the rise in foreign investments by European country residents, spurred by the demand for raw materials and the search for guaranteed markets, which eventually lead to the scramble, partition and colonization of territories around the world.[12] E. G. Iweriebor, *The Colonisation of Africa*, Africana Age (NYPL: Schomburg Center for Research in Black Culture 2011), http://exhibitions.nypl.org/africanaage/essay-colonization-of-africa.html (accessed 23 June 2015); O. Adebayo, *Colonial Political Systems*, in Colonial Africa 1885–1939 vol. 3, 5 (T. Falola ed., Carolina Academic Pr 2002). These colonial power struggles sparked off World War 1 in 1914–1919 and eventually the allied victors formed the 'League of Nations' at the Paris Peace Conference on 10 January 1920.[13] The need for finances to rebuild economies after the War, compelled countries to introduce income and corporate taxes-[14] which in turn influenced companies involved in international trade to engage in tax planning to reduce their global tax exposure.[15] In response, countries started enacting tax rules to preserve their domestic tax bases.[16]

Transfer pricing rules were first introduced by the United Kingdom in 1915,[17] followed by the United States of America (USA) in 1917,[18] which developed the first comprehensive transfer pricing legislation under the War Revenue Act of 1917 to discourage companies from shifting profits to overseas associates by overpricing cross-border transactions.[19] Subsequent transfer pricing legislation was

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[8] UN, *Ad Hoc Group of Experts on International Cooperation in Tax Matters Tenth 'Transfer Pricing' ST/SG/AC.8/2001/CRP.6* (UN 2001).

[9] V. Tanzi, *Globalization, Tax Competition and the Future of Tax Systems* 6 (International Monetary Fund, Fiscal Affairs Dept 1996).

[10] OECD, Model Tax Convention *on Income and on Capital* (OECD Publishing 2017); United Nations, Model Double Taxation Convention *Between Developed and Developing Countries* (UN 2017).

[11] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* Ch. 2 (OECD Publishing 2017).

[12] E. G. Iweriebor, *The Colonisation of Africa*, Africana Age (NYPL: Schomburg Center for Research in Black Culture 2011), http://exhibitions.nypl.org/africanaage/essay-colonization-of-africa.html (accessed 23 June 2015); O. Adebayo, *Colonial Political Systems*, in Colonial Africa 1885–1939 vol. 3, 5 (T. Falola ed., Carolina Academic Pr 2002).

[13] M. Kelly, *5 Top Causes of World War 1* (updated 13 May 2019), http://americanhistory.about.com/od/worldwari/tp/causes-of-world-war-1.htm (accessed 26 Aug. 2019).

[14] R. S. Avi-Yohan, *Advanced Introduction to International Tax Law* 3 (Edward Edgar Publishing 2015).

[15] A. W. Oguttu, *A Critique of International Tax Measures and the OECD BEPS Project in Addressing Fair Treaty Allocation of Taxing Rights Between Residence and Source Countries: The Case of Tax Base Eroding Interest, Royalties and Service Fees from an African Perspective*, 29(2) Stellenbosch L.R. 318 (2018).

[16] League of Nations, *Economic and Financial Committee 'Report on Double Taxation'*, E.F.S.73.F.19 (5 Apr. 1923), http://adc.library.usyd.edu.au/view?docId=law/xml-main-texts/brulegi.xml&chunk.id=d640e396&toc.id=d640e396&database=&collection=&brand=ozfed (accessed 25 May 2018); J. A. Becerra, *Interpretation and Application of Tax Treaties in North America* Ch. 2 (2nd ed., IBFD 2013), para. 2.1.

[17] The Finance Act 1915 of the United Kingdom provided transfer pricing rules focusing on a concept of control that originates from a close connection between two companies. *See* R. Dwarkasing, *Comments on the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles* (Maastricht University 2013), https://www.oecd.org/ctp/transfer-pricing/dwarkasing-maastricht-university.pdf (accessed 11 Dec. 2018).

[18] UN, *supra* n. 1, para. B 8.1.1.

[19] M. A. Heimert & M. Johnson, *Guide to International Transfer Pricing: Law, Tax Planning and Compliance Strategies* 5 (Kluwer Law International 2010); T. Althunayan, *Dealing with the Fragmented International Legal Environment: WTO, International Tax and Internal Tax Regulations* 116 (Springer 2010).

enacted by the USA in 1928 under Section 45 of the Internal Revenue Code (which latter become Section 482 of the Code), to provide that where two or more organizations were owned or controlled by the same interests, the Secretary of the Treasury had authority to distribute, apportion or allocate; gross income, deductions, credits or allowances between or among these organizations, so as to prevent tax evasion or to clearly reflect the income of such organizations.[20] The next country was France, which enacted transfer pricing provisions in Article 57 of its 1933 tax code, to enable the adjustment of accounts of entities under common control so as to restore profits which had been indirectly transferred. The next decade saw other countries introducing various provisions to prevent transfer pricing but the diverging provisions created a potential for double taxation. Some countries applied general anti-avoidance rules to prevent transfer pricing while others enacted broad powers for their tax authorities to adjust the accounts of related companies[21]; particularly when attributing profits to permanent establishments (PE)[22] and when allocating profits from transactions between enterprises under common control.[23]

International consensus on a uniform approach to deal with transfer pricing in cross-border trade only began in 1933 when the Fiscal Committee of the League of Nations[24] commissioned a study that was coordinated by Mitchell B Carroll, to investigate the various methods employed by countries in allocating taxable income.[25] The study showed that countries employed three different methods to evaluate whether the level of profit of a PE or an affiliate was appropriate.[26] The first method was the 'separate accounting method', in terms of which, local authorities assessed the local branch of its foreign enterprise on the basis of its separate accounts. The second method was the 'empirical method', whereby tax authorities compared the level of a company's profits with other companies engaged in similar business activities and then applied a standard profit margin as a percentage of turnover of the entity. The third method was 'fractional apportionment', whereby a PE was allocated a suitable proportion of the overall profits of the MNC.[27] To ensure uniformity of approach and to prevent double taxation of income, the League of Nations issued a report which proposed provisions to ensure an appropriate level of profits for a company in a given country, by authorizing adjustments to the profits with the aim of restoring the diversion of profits where due to close relations between entities under common control, conditions were created which were different from those which would have been made between independent enterprises.[28] The proposals were included in the League of Nation's 1945 draft MTC.[29] When the League of Nations was dissolved in 1945 at the end of World War II,[30] its work on developing a MTC was in 1948 passed on to the Organisation for European Economic Cooperation (OEEC),[31] which in 1961 became the OECD.[32] The proposals developed by the League of Nations were adopted by the OECD and included in Article 9 of its first Draft MTC of 1963[33] and subsequently in its 1979 final draft (which was revised in 1992, 1994, 1995, 1997, 2000, 2002, 2005, 2008, 2010, 2014 and 2017).[34] Article 9 of the OECD MTC, which has substantially remained the same over the years[35] provides that: 'when conditions are made or imposed between two associated enterprises in their commercial or financial relations which differ from those which would have been made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so

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[20] K. Vogel & P. Kirchhoff, *International and Comparative Taxation: Essays in Honour of Klaus Vogel* 51 (Kluwer Law International 2002).

[21] League of Nations, *Taxation of Foreign and National Enterprises: Methods of Allocating Taxable Income* vol. 4, Document No. C.425(a)M.217(a). 1933. II.A1933) (1933), http://setis.library.usyd.edu.au/pubotbin/toccer-new?id=cartaxa.sgml&tag=law&images=acdp/gifs&data=/usr/ot&part=0 (accessed 18 Dec. 2018).

[22] The general definition of a 'permanent establishment' in Art. 5 of the OECD MTC is that it is a physical place of business through which the business of an enterprise is carried on.

[23] Dwarkasing, *supra* n. 17.

[24] *Tax Treaty Case Law Around the Globe* 55 (E. C. C. M. Kemmeren et al. eds, IBFD 2014).

[25] League of Nations, *supra* n. 21.

[26] *Ibid.*

[27] League of Nations, *Taxation of Foreign and National Enterprises Studies of the Tax Systems and Methods of allocation of an Enterprise Operating in more than One Country* vol. III (1933), in the preface, https://archive.org/stream/taxationofforeig031922mbp/taxationofforeig031922mbp_djvu.txt (accessed 30 Aug. 2019).

[28] *Ibid.*, above in the preface.

[29] League of Nations, *Report on the Work of the Tenth Session, Held in London from March 20th to 26th, 1946* (C.37.M37.1946.II.A), 8 (1946).

[30] G. George, The League of Nations: From 1929 to 1946 25 (Avery Publishing Group 1996).

[31] The OEEC was formed in 1948 to administer American and Canadian aid under the Marshall Plan for the reconstruction of Europe after World War II.

[32] OECD, *History (OECD 2019),* https://www.oecd.org/about/history/ (accessed 30 Aug. 2019).

[33] OECD, *Draft Double Taxation Convention on Income and on Capital: Report of the OECD Fiscal Committee* (OECD Publishing 1963).

[34] OECD, *supra* n. 10, para. 11.2 of the Introduction: Historical Background.

[35] B. Lepard, *Customary International Law: A New Theory with Practical Applications* 292 (Cambridge University Press 2010); J. Wittendorf, *Transfer Pricing and the Arm's Length Principle in International Tax Law* 147 (Kluwer Law International 2010); K. Dziurdz & C. Marchgraber, *Non-Discrimination in European and Tax Treaty Law: Open Issues and Recent Challenges* 522 (Linde, 2015).

accrued, may be included in the profits of that enterprise and taxed accordingly'. Article 9 embodies the so-called ALP which in effect, requires that the pricing of intra-group transactions should be comparable to prices that unrelated parties would charge. The rationale is to ensure neutrality between MNCs and independent enterprises so that they are on an equal footing for tax purposes. This eliminates any economic distortions that differential tax treatment may create,[36] thereby promoting the growth of international trade and investment. The ALP allows national tax authorities to make an adjustment to the profits of one enterprise where the terms of transactions between associated enterprises differ from terms that would be agreed between unrelated enterprises in similar circumstances.[37] When the UN issued its first MTC in 1980[38] (which was revised in 2001, 2014 and 2017), it also adopted adopted the ALP.[39]

It should however be noted that when the ALP was first adopted in the 1961 draft OECD MTC, there were no guidelines as how an arm's length price was to be determined. By then, countries were not overly concerned about such guidelines, as there was no significant international trade by MNCs during that time.[40] Countries were content on relying on the powers of adjustment in their national legislation that focused on restoring the proper level of profits for the MNC. However, the period after the 1960s witnessed a substantial growth in the business of MNCs, with many engaging in transfer pricing schemes to shift profits out of the countries in which they operated. This forced countries to begin seeking clearer measures of how to determine an arm's length price. The USA was the first country to develop such measures. In 1968, it issued regulations that provided procedural rules for applying the ALP by coming up with specific transactional pricing methods (set out below) for determining the arm's length price of a transaction. There regulations (now embodied in Section 482 of the 1986 Internal Revenue Code and Treasury Regulation Section 1.482–1) showed a clear shift by the USA from the previous approach, which placed focus on ensuring the appropriate level of profits; and the adjustment of the profits was just the means to that end.[41] The transaction-based methods developed by the USA are: the 'comparable uncontrolled price' (CUP) method[42]; the 'resale price method' (RPM)[43]; and the 'cost plus method' (CPM).[44] However, the USA itself experienced challenges in the application of these transactional pricing methods, as in practice, the methods often fell short of government expectations due to the unavailability of comparable data and the taxpayers' advantage of having access to more information than the government.[45] Thus, the USA developed two transactional 'profit-based' methods that are presumed not to be as influenced by characteristics of a particular transaction.[46] These are: the 'comparable profits method' (CPM)[47] and the 'profit split method' (PSM).[48]

The USA's shift towards focusing on transaction pricing methods to determine an arm's length price was initially rejected by OECD countries. In its 1967 report

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[36] OECD, *supra* n. 11, at 324.

[37] UN, *supra* n. 1, para. A.4.6.

[38] UN, *supra* n. 10, para. 18 of the Introduction.

[39] Wittendorf, *supra* n. 35, at 252; A. Amatucci, *International Tax Law* 152 (Wolters Kluwer Law & Business 2006); A. Lymer & J. Hasseldine, *The International Taxation System* 56 (Kluwer Academic Publishers 2002).

[40] UN, *supra* n. 1, para. A.2.12.

[41] L. Eden, *Taxing Multinationals: Transfer Pricing and Corporate Income Taxation in North America* 51 (University of Toronto Press 1998); Arnold & McIntyre, *supra* n. 4, at 58; PWC, *International Transfer Pricing: United States* 8161 (PWC 2013/2014), https://www.pwc.com/internationaltp (accessed 26 Aug. 2019).

[42] The CUP method applies where a direct comparison can be drawn between the price charged for a specific product in a controlled transaction and the price charged for a closely comparable product in an uncontrolled transaction in comparable circumstances. The method depends on finding a transaction between independent enterprises which is similar to a controlled transaction and has no differences that could have a material effect on the final price. *See* US: Internal Revenue Service, Treasury Regulation s. 1.482-3(b)(1); OECD, *supra* n. 11, at 337 in para. 92; G. Campos, *Transfer Pricing Survey of Major Trading Nations*, 50 Bull. Int'l Fiscal Documentation 217 (1996); Hay, Horner & Owens, *supra* n. 6, at 432 in para. 65.

[43] The RP method applies where there are no comparable sales. It is based on the price at which a product, which has been purchased from a connected enterprise, is resold to an independent enterprise. The resale price is then reduced by an appropriate gross margin, to cover the reseller's operating costs to provide an appropriate profit having taken into consideration the functions performed, assets used and risks assumed by the reseller. The balance is then regarded as the arm's length price. *See* US: Internal Revenue Service, Treasury Regulation s. 1.482-3(b)(2); OECD, *supra* n. 11, at 338 in para. 65; Campos, *supra* n. 42, at 217.

[44] The CP method requires an estimation of an arm's length consideration by adding an appropriate mark-up to the costs incurred by the supplier of goods or services in a controlled transaction. The mark-up is determined with reference to the mark-up earned by a similar independent supplier in an uncontrolled transaction bearing similar risks and employing similar assets to those of the taxpayer. *See* US: Internal Revenue Service, Treasury Regulation s. 1.482-3(b)(3); OECD, *supra* n. 11, at 342 in paras 115–199; Campos, *supra* n. 42, at 217.

[45] B. Hawkins, *CPM: The Worlds Transfer Pricing Method* (RSM 7 Oct. 2015).

[46] S. Picciotto, *International Business Taxation* 198 (Cambridge University Press 1992), http://taxjustice.blogspot.be/2013/06/international-business-taxation.html (accessed 10 May 2019); M. C. Durst & R. E. Culbertson, *Clearing Away the Sand; Retrospective Methods and Prospective Documentation in Transfer Pricing Today*, 57 NYU Tax L. Rev. 37–136 (2003); PWC, *supra* n. 41, at 824.

[47] The CPM method determines transfer prices by comparing entity-level operating results with those of uncontrolled taxpayers engaged in similar activities under similar circumstances. The CPM relies on the principle that similarly situated taxpayers tend to earn similar returns over time. *See* US: Internal Revenue Service, *Treasury Regulation* s. 1.482-1(a)(3); Durst & Culbertson, *supra* n. 46, at 824.

[48] The PS method applies by combining the profits earned by two related parties from one or a series of transactions and then dividing them using an economically valid defined basis that aims at replicating the division of profits that would have been anticipated in an agreement made at arm's length. *See* US: Internal Revenue Service, Treasury Regulation s. 1.482-6.

on attributing profits to PEs, the OECD pointed out that deciding on whether a transaction is truly comparable would always depend on a wide range of factors specific to each case, which would make it impossible to propose rules of general application for determining an arm's length price.[49] However with the increasing number of MNCs in the 1970s, many OECD countries became more concerned about transfer pricing, so the need for clear methods for determining an arm's length price became apparent. The OECD requested its Committee on Fiscal Affairs, to address the concerns, and in 1979 the OECD issued its first report on transfer pricing which reaffirmed the use of the ALP for preventing inappropriate profit allocation using transfer mispricing schemes.[50] In the absence of clear methods of determining an arm's length price among OECD countries, the 1979 report recommended the adoption of the transactional pricing methods developed by the USA; in particular the CUP, CPM, and RPM.[51] The report acknowledged that as the use of these methods would be impracticable in certain cases due to the complexities of real life business situations, other methods may have to be used to produce a figure which is acceptable for practical purposes.[52] OECD member countries took many years considering the recommendations of the 1979 report and it was only in 1994, after many uneasy compromises, that they endorsed the CUP, the RPM, the CPM and the PSM which were developed by the USA.[53] They rejected the CPM reasoning that it would attribute relatively low profit margins to foreign affiliates of US MNCs.[54] Instead, after some compromises, they introduced the 'transaction net margin method' (TNMM), [55] which is akin to the CPM. Having obtained consensus on the above, the OECD also considered it necessary to produce guidelines for tax administrations on how to deal with various transfer pricing matters. Thus, in 1995, the OECD published its first transfer pricing guidelines[56] (revised in 2010 and 2017), which included the five transactional methods that were agreed upon.[57]

3 The challenges of applying the ALP

The basic approach for applying the ALP is that an adjustment is made to the profits of an enterprise carrying out controlled transactions with a connected party by reference to the conditions which would have applied between independent enterprises carrying on uncontrolled comparable transactions in comparable circumstances (i.e. in comparable uncontrolled transactions).[58] Thus arriving at an arm's length price requires carrying out a 'comparability analyses' of a controlled transaction and an uncontrolled transaction[59] which entails comparing the functions performed,[60] assets used and the risks assumed[61] by the entities within the MNC group.[62] All of these factors depend very heavily on the facts and circumstances of each case. The comparability analysis operates by treating members of the MNC group as if they operate as separate entities rather than as inseparable parts of a single unified business.

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[49] OECD, *Report on the Apportionment of Profits of Permanent Establishments and Associated Enterprises*, Document FC/WP7 (67) 1) (OECD Publishing 1967).

[50] OECD, *Transfer Pricing and Multinational Enterprises Report of the OECD Committee on Fiscal Affairs* 12 (OECD Publishing 1979).

[51] *Ibid.*, para. 13.

[52] *Ibid.*

[53] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators*, 22(8/9) Intertax 318 in para. 12 (1994).

[54] Durst & Culbertson, *supra* n. 46, at 136.

[55] The TNMM examines the net profit margin that a taxpayer realizes from a controlled transaction, relative to an appropriate base of for example; costs, sales or assets. The profit level indicator of the tested party is compared to the profit level indicators of comparable independent parties. *See* Campos, *supra* n. 42, at 218.

[56] OECD, *supra* n. 53.The methods fall under two main categories; the 'traditional transactional' methods and the 'profit based methods'. Under the 'traditional transactional' methods fall the 'comparable uncontrolled price' method, the 'resale price' method and the 'cost plus' method. Under the 'profit based' methods fall the 'transactional net margin' method and the 'profit split' method. *See* OECD, *supra* n. 11, at 336–342.

[57] Para. 18 of the Commentary on Art. 7(2) of the OECD MTC.

[58] Essentially, a controlled transaction is one, which is between two enterprises that are connected to each other; and a comparable uncontrolled transaction is one that is between two independent parties that is comparable to the controlled transaction under examination. Controlled and uncontrolled transactions are comparable if none of the differences between the transactions could materially affect the factor being examined in the methodology (e.g. price or margin), or if reasonably accurate adjustments can be made to eliminate the material effects of such differences. *See* OECD, *supra* n. 11, at 27.

[59] US: Internal Revenue Service, Treasury Regulation s. 1.482-1(i)(4) defines 'controlled' to include any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

[60] This entails carrying out a functional analysis that identifies and compares the economically significant activities undertaken; e.g. research and development; manufacturing or production; transportation and warehousing; administrative functions. The functional analysis is intended to ensure that a party performing more functions should receive more income.

[61] The risks assumed, would for example cover: risks associated with the success or failure of research and development activities; financial risks (such as fluctuations in currency or interest rates); credit and collection risks; as well as product reliability and market fluctuation risks.

[62] The economic conditions of the transactions could include comparing the similarity of: geographical markets; the level of the market (whether wholesale or retail); the extent of competition in each market; the economic conditions of the particular industry and the alternatives realistically available to either party. *See* OECD, *Discussion Draft on BEPS Action 10: The Use of Profit Splits in the Context of Global Value Chains* (OECD Publishing Dec. 2014), para. 2. *See also* IMF/OECD, Report for the G20, *Progress Report on Tax Certainty* 16 (OECD Publishing June 2019); L. Spinosa & V. Chand, *Along-Term Solution for Taxing Digitised Business Models: Should the Permanent Establishment Definition Be Modified to Resolve the Issue of Should the Focus Be on a Shared Taxing Rights Mechanisim?*, 46(6/7) Intertax 476–494 (2018).

Critics of the comparability analysis equate finding a satisfactory comparable to 'finding a needle in a haystack'.[63] It is 'an ad hoc approach which depends on subjective judgment, leaving great room for discretion and creating considerable potential for conflict as well as uncertainty for taxpayers'.[64] The approach raises serious conceptual and practical difficulties[65] because it requires matching comparable transactions between non-arm's length entities and arm's length entities, whereas the transactions of MNCs are often not comparable to those of arm's length parties.[66] The approach compels intra-group arrangements to be re-characterised based on 'facts and circumstances' and on an analysis of functions, assets and risks, in the search of comparables which both theory and practice show do not exist or are extremely limited.

The separate entity approach upon which the ALP is based, creates major conceptual difficulties because; MNCs are integrated enterprises that do not normally operate as if their subsidiaries were separate enterprises.[67] Rather, they operate as a single unified enterprise managed from a central location by managers who are responsible for the enterprise as a whole.[68] It is through integration that MNCs achieve economies of scale in aspects such as transaction costs, risk management, brand development and logistics.[69] These measures of integration cannot be duplicated in the context of independent transactions conducted by two non-integrated businesses performing the same or similar functions and selling the same or similar products. For an integrated firm; capital, technology, central services and risk management are treated as overhead costs to be shared in all business activities. Performing a comparability analysis on these factors between controlled and uncontrolled entities is one of biggest challenges in transfer pricing, since these transactions are normally core centralized functions in MNCs.[70] Thus, applying the ALP by breaking a MNC into separate parts, generally produces many problems depending on the level of integration.[71] The Base Erosion and Profit Shifting (BEPS) Monitoring group is of the view that the emphasis placed on the separate entity approach is a misinterpretation of how the ALP in Article 9(1) of the OECD MTC is supposed to apply, because the article merely provides that where conditions between the two associated enterprises 'differ from those which would be made between independent enterprises', then any profits which would accrue to the enterprises as a result of those conditions may be included in the profits of that enterprise and taxed accordingly.[72] In effect, 'the wording of Article 9 *does not require related entities to be treated as if they were independent entities, rather the* article simply recognizes that the conditions between associated entities may differ from those made between independent enterprises; which is the rational for power to adjust those profits'.[73]

The fixation with the separate entity approach results in numerous anomalies: as taxpayers, their advisers and tax authorities are left to reconstruct, from largely dissimilar transactions or entities, what parties at arm's length would have charged in similar circumstances.[74] Since transfer pricing is not an exact science, both the tax administration and taxpayer have to exercise some judgment in determining an arm's length price.[75] In this manner, ALP becomes largely a matter of negotiation between tax authorities and MNCs, with no clear criteria for application. This creates a wide scope for subjective and discretionary decisions, which is not a very efficient approach. For the ALP to be implemented efficiently, it requires significant institutional capacity and human resources, at levels that are difficult for even OECD member countries, let alone for developing countries.[76]

The other challenge of applying the ALP is the difficulty of establishing whether the consideration is in fact abnormal (different from an arm's length price)

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[63] UN, *supra* n. 1, para. B.1.10.7.

[64] R. Collier & J. L Andrus, *Transfer Pricing and the Arm's Length Principle After BEPS* Ch. 6 (Oxford University Press 2017); Arnold & McIntyre, *supra* n. 4, at 74; *see also* BEPS Monitoring Group, *Submission to the UN Subcommittee on Article 9 (Associated Enterprises) on the Revision of the UN Practical Manual on Transfer Pricing for Developing Countries* 3 (Sept. 2018).

[65] Arnold & McIntyre, *supra* n. 4, at 74.

[66] F. Vincent, *Transfer Pricing and Attribution of Income to Permanent Establishments: The Case for Systematic Global Profits Splits (Just Don't Say Formulary Apportionment)*, 53(2) Can. Tax J. 409 at 410 (2005); R. J. Vann, *Problems in the International Division of the Business Income Tax Base* 25–26 (University of Sydney 2007).

[67] Hay, Horner & Owens, *supra* n. 6, at 428 in para. 36; OECD, *Review of Comparability and Profits Methods: Revision of Chapters I-III of The Transfer Pricing Guidelines* (OECD Publishing July 2010), para. 1.10, http://www.oecd.org/tax/transfer-pricing/45763692.pdf (accessed 5 Nov. 2018).

[68] R. S. Avi-Yonah & K. A. Clausing, *Business Profits (Article 7 OECD MTC)*, in *Source Versus Residence: Problems Arising from the Allocation of Taxing Rights in Tax Treaty Law and Possible Alternatives* 75 (M. Lang, P. Pistone, J. Schuch & C. Staringer eds, Kluwer Law International 2008).

[69] OECD, *supra* n. 11, at 324 in para. 26.

[70] Collier & Andrus, *supra* n. 64, Ch. 6.

[71] V. H. Miesel, H. H. Higinbotham & C. W. Yi, *International Transfer Pricing: Practical Solutions for Inter-Company Pricing – Part II*, 29 Int'l Tax J. 2 (2003).

[72] BEPS Monitoring Group, *supra* n. 64, at 5.

[73] *Ibid.*

[74] R. Couzin, *The OECD Project: Transfer Pricing Meets Permanent Establishments*, 53(2) Can. Tax J. 401, 405 (2005).

[75] OECD, *supra* n. 67, para. 1.13.

[76] S. Picciotto, *Taxing Multinational Enterprises as Unitary Firms*, ICTD Working Paper 53 (June 2016).

for purposes of avoiding taxes or for reasons unrelated to tax. There could be factors, other than tax considerations, that may distort the commercial and financial relations established between associated enterprises.[77] A MNC may maintain a new affiliate at a loss to create a market in a new place; it could also deliberately supply an associated company at a favourable price in order to enable it to survive a difficult period or to allow it to build up reserves during a start-up period. Such ventures could be undertaken with no tax consideration and yet they affect the final price that could be charged for the relevant goods or services.[78] Since an independent enterprise would not undertake such ventures, this makes it is difficult to find comparable transactions.[79] MNCs could also enter into special contractual agreements that could affect the purchase price, which an uncontrolled company may not have entered. For example, it may be that the commodity being exported is subject to price fluctuations on the spot market and the disputed price was established in terms of a long contract, which gave protection to the supplier against future potential decreases in the spot price. Other variations in prices for the same commodity could include contract provisions such as contract periods, quantities supplied, insurance and risk provisions, shipping costs and currency provisions.[80] The purchase price could also be affected by finance benefits, which a party may be providing to another, that are then factored into prices of commodities sold between the two parties. For example, a major international manufacturer might finance the acquisition of equipment and the establishment of manufacturing capacity in another city on a favourable basis, on condition that it be supplied manufactured components at a favourable price thereafter. In such circumstances the ALP is difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises. The mere fact that a transaction may not be found between independent parties does not of itself mean that it is not arm's length.[81]

Because the ALP usually requires taxpayers and tax administrations to compare uncontrolled transactions to the transactions of associated enterprises, it can demand a substantial amount of data which results in administrative burdens for both taxpayers and tax administrations.[82] This task requires taxpayers to comply with diverse documentation requirements that are time-consuming and expensive. Often, it is difficult to obtain adequate information to apply the ALP. The information that is accessible may be incomplete and difficult to interpret. If the information exists, it may be difficult to obtain due its geographical location or due to confidentiality concerns. In other cases, the information about an independent enterprise which could be relevant, may simply not exist or there may be no comparable to independent enterprises, if for example that industry has reached a high level of vertical integration.

While recognizing the foregoing, the OECD continues to advocate for the use of the ALP in the evaluation of transfer prices among associated enterprises.[83] In its 2010 'Review of comparability and profits methods',[84] the OECD acknowledged that while the ALP may not always be straightforward to apply in practice and even though it may be difficult to apply to integrated businesses, it is the most effective means for reflecting the economic realities of a controlled taxpayer's particular facts and circumstances, against a benchmark of the normal operation of the market.[85] In 2015 when the OECD issued its fifteen Action Package of measures to address 'BEPS',[86] it reiterated that the ALP can still effectively and efficiently allocate the income of MNCs among jurisdictions, even though there are instances where MNCs have been able to use and/or misapply the rules to separate income from the economic activities it produces and to shift such income into low-tax jurisdictions. The recommendations in Action Plans 8, 9 and 10 of the BEPS Reports,[87] resulted in the OECD's substantial revision of its Transfer pricing Guidelines in 2017 to ensure that transfer pricing outcomes, are in line with value creation. However, even during the BEPS deliberations, there were concerns among participants that the transfer pricing guidelines have become uncertain and obscure: making the transfer pricing process 'far more complex', mostly due to the 'level of factual detail' required for the

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77 OECD, *supra* n. 11, at 323 in para. 20(2).

78 M. van Blerck, *Transfer Pricing and Thin Capitalisation: The Basics*, 8 SA Tax Rev. 45–46 (1995).

79 Miesel, Higinbotham & Yi, *supra* n. 71, at 2.

80 OECD, *supra* n. 11, at 323; *see also* OECD, *supra* n. 67, para. 1.11.

81 *Ibid.*

82 OECD, *supra* n. 11, at 324; *see also* OECD, *supra* n. 67, para. 1.12.

83 *Ibid.*

84 *Ibid.*

85 OECD, *supra* n. 11, at 325; *see also* OECD, *supra* n. 67, para. 1.14.

86 OECD, *supra* n. 3, at 7 and 47.

87 OECD, *Aligning Transfer Pricing Outcomes with Value Creation: Actions 8-10 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing Oct. 2015).

functional analysis[88] which has resulted in increased transfer pricing disputes amongst OECD countries during the past twenty years.[89] The main underlying cause of these difficulties is that there is almost no practical guidance on how countries could develop an effective enforcement strategy of the transfer pricing methods.[90]

4 Challenges the comparability approach poses for developing countries

With increased globalization, curtailing transfer pricing has become a priority concern for developing countries, such as those in Africa, as their economies continue to attract large amounts of foreign direct investment from cross-border business operations by MNCs.[91] Many developing countries have moved beyond being the suppliers of raw materials for enterprises in developed countries; to attracting substantial foreign direct investments due to lower costs of labour, raw materials and friendly tax regimes. This has opened their economies to transfer pricing practices that impact on their tax revenues. The IMF notes that there is much tax planning by MNCs in developing countries, which does not just entail stretching the ALP but also flouting of the concept.[92] The UN acknowledged that whereas more research needed to be done on the size of the potential losses for developing countries, and whereas the situation would vary greatly from country to country, transfer pricing in intra-group transactions has a detrimental impact on developing countries' revenues.[93] Responding to these concerns many developing countries, have over the last two decades been active in enacting transfer pricing legislation or general anti-avoidance provisions to curtail transfer pricing.[94] The table below shows the African countries that have enacted specific transfer pricing legislation.

Country	*TP Legislation*	*ALP*	*TP Guidelines (TPG)*
Ghana	Introduced in 2000. Section 70 of Internal Revenue Act, 2000 (Act 592)	Commissioner empowered to adjust price of transactions between associates to reflect ALP.	Follows OECD TPG. Section 114(1)(d) Internal Revenue Act of 2000 effected TP Regulations (L. I 2188) effective 14 September 2012.
Uganda	Introduced in 2011. Sections 90 and 164 of Income Tax Act, Cap 340	Income and expenditure from transactions between controlled entities to be in accordance with ALP. URA empowered make adjustments in line with ALP.	Income Tax TP Regulations 2011, follow OECD TPG. If there is conflict with Domestic Tax Acts, the latter takes precedence.
South Africa	Introduced in 1995. Section 31 of Income Tax Act 58 of 1962	Tax payable in international transactions must be based on the ALP. Section 31(2) provides for a primary adjustment and Section 31 (3) the secondary adjustment.	SARS Practice Note 7 follows OECD TPG.

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88 Collier & Andrus, *supra* n. 64, paras 7.70–7.71.

89 OECD, *Mutual Agreement Procedure Statistics (OECD 2017)*, http://www.oecd.org/tax/dispute/mutual-agreement-procedure-statistics.htm (accessed 22 July 2019); BEPS Monitoring Group, *supra* n. 64, at 3.

90 *Ibid.*

91 UN, *supra* n. 1, para. A.1.

92 IMF, *Spillovers in International Corporate Taxation* 32 (IMF May 2014); The Platform for Collaboration on Tax (IMF, OECD, UN and WBG), *A Toolkit for Addressing Difficulties in Accessing Comparable Data for Transfer Pricing Analysis* (2018).

93 UN, *supra* n. 1, in the Foreword.

94 Graphene Economics Transfer Pricing Advisory, *Quick Reference Guide: Transfer Pricing Regulations in Africa* (Graphene Economics 2018), refers to the following countries that have either formal transfer pricing provisions or anti-avoidance provisions: Algeria, Angola, Benin, Botswana, Burkina Faso, Burundi, Cape Verde, Cameroon, Chad, Comoros, Republic of the Congo, Cote d'Ivoire, DRC, Egypt, Equatorial Guinea, Ethiopia, Gabon, Ghana, Guinea, Guinea-Bissau, Ivory Coast, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mauritius, Morocco, Mozambique, Namibia, Niger, Nigeria, Rwanda, Sao Tome and Principe, Senegal, Seychelles, Sierra Leone, South Africa, South Sudan, Swaziland, Tanzania, Togo, Tunisia, Uganda, Zambia and Zimbabwe.

Country	*TP Legislation*	*ALP*	*TP Guidelines (TPG)*
Kenya	Section 18(3) of Income Tax Act Cap. 470 Laws of Kenya.	ALP	Income Tax TP rules 2006, follows OECD TPG
Egypt	Article 30 of Income Tax Law, No 91 of 2005		TPG – Executive Regulations, Articles 38, 39 and 40
Morocco	Articles 213-II and 214-III of the Morocco Tax Code.		OECD TPG referred to
Algeria	Article 141 bis of Algerian Direct Tax Code; Article 192 of Algerian Direct Tax Code; Article 20 ter of Algerian Tax Procedure Code and Article 169 bis of Algerian Tax Procedure Code.		OECD TPG followed.
Malawi	Section 127A of Taxation Act Cap 41:01, effective 1 July 2017.	ALP applies	OECD TPG apply. Taxation (TP Regulations) 2017.
Namibia	Section 95 and 95A of the Income Tax Act introduced in 2005.		Practice Note 2 of 5 September 2006, has guidance on application of section 95A. Inland Revenue follows OECD TPG.
Angola	Presidential Decree 147/13 of 1/10/2013. Section II and Articles 10–13 (Statute of Large Taxpayers)	ALP to all related party transactions.	Article 50 of Law 19/14 of 22 October 2013 approves Industrial Tax Code, guidance on TP regulations uses OECD language
Tunisia	Introduced in 2009. Article 48 of the tax law	ALP applies to related party transactions	
Tanzania	Section 33 of Income Tax Act 2004	ALP applies	TP regulations issued 7 February 2014 follow OECD Guidelines and UN TP Manual but ITA prevails if there are any conflicts.
Zambia	Section 97 (A-D) of the Income Tax Act (Chapter 323 of the laws of Zambia) ('Act')	ALP applies	Income Tax (TP) Regulations of 2000, as amended by the Income Tax (TP) Amendment Regulations 2018, follows OECD TPG.
Cameroon	Article 18-3 of the New Finance Law 2014	ALP applies	OECD TPG may be relied upon to determine ALP.
Equatorial Guinea	Article 164 of General Taxation Codes (Law No. 4/ 2004 of 28 October 2004	The principle of assessment of intercompany pricing applies.	No reference to OECD TPG in the tax legislation

Country	*TP Legislation*	*ALP*	*TP Guidelines (TPG)*
Gabon	Section 12 of the General Tax Code		OECD TPG followed
Nigeria	Income Tax (TP) Regulations No. 1, 2012.	ALP applies	Regulations follow OECD TPG
Senegal	Introduced in 2013. Articles 17, 18, 570, 638 and 639 of the General Tax Code	ALP applies to related party transactions	Follows OECD TPG

Even though some African countries have enacted transfer pricing legislation, many of them do not have formal transfer pricing guidelines so they normally apply the OECD Transfer Pricing Guidelines[95] despite the fact that African countries are not OECD member countries and are not obliged to adhere to the OECD Guidelines. In the Kenyan case of *Unilever Kenya Limited v Commissioner of Income Tax*,[96] the High Court of Kenya considered whether the OECD Transfer Pricing Guidelines may be used to determine the appropriate transfer price in a transaction between associated enterprises pursuant to the Kenyan Income Tax Act.[97] It was held that in the absence of legal provisions to the contrary or specific guidance from the Kenya Revenue Authority, the court was prepared to refer to the OECD Transfer Pricing Guidelines and the transactional pricing methods set out therein. The judge held:

> I have no doubt in my mind that the OECD principles on income and on capital and the relevant guidelines such as "Transfer Pricing' principles, the CUP method adopted for calculations of what ought to be the income, the Cost Plus Return method as well as Resale Minus Method adopted for looking into compliance with ALPs are not just there for relaxed reading. These have been evolved in other jurisdictions after considerable debates and taking into account appropriate factors to arrive at results that are equitable to all parties. The ways of doing modern business have changed very substantially in the last 20 years or so and it would be fool-hardy for any court to disregard internationally accepted principles of business as long as these do not conflict with our own laws. To do otherwise would be highly short-sighted.[98]

Nevertheless, the applicability of the OECD Transfer Pricing Guidelines, which require carrying out a comparability analysis, is challenging for African countries because they do not have a wide and open market apt to produce reports on the prices of competing companies with commercialized comparables.[99] This is especially so when a company might be the only producer of a specific type of product, which makes a comparable search impracticable, if not impossible. The UN affirms that finding appropriate comparables in developing countries is possibly the biggest practical problem currently faced by enterprises and tax authorities alike.[100] This is complicated by the fact that there are very few organized companies in any given sector and there are hardly any African benchmarking databases.[101] The little comparable information that could be found is often incomplete and in a form which is difficult to analyse due to lack of resources.[102] Thus, African taxpayers often resort to comparing foreign operations in developed countries to price their controlled transactions. However most tax authorities insist that these prices need to be adjusted to make them comparable to a developing market business, as the market prices (or profit margins) in developed countries may not be directly applicable to the circumstances of African countries. This would involve making adjustments for geographical differences, market structure differences, appropriate interest rates and country risk differences.[103] African countries are however particularly ill-placed to apply such adjustments as this requires expert understanding

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95 KPMG, *Global Transfer Pricing Review* 15 (KPMG 2009).

96 KE:High Court of Kenya, *Unilever Kenya Ltd v. Commissioner of Income Tax (2005)* eKLR, Income Tax Appeal No. 753 of 2003.

97 KE: Cap. 470 Laws of Kenya, as amended.

98 *Unilever Kenya Ltd v. Commissioner of Income Tax*, *supra* n. 96.

99 UN, *supra* n. 1, para. B.1.10.10.

100 *Ibid.*, para. B.1.10.7.

101 *Ibid.*, para. B.1.10.6.

102 *Ibid.*

103 IMF, *supra* n. 92, at 34.

of each company's business model and international structure.[104] This is further hampered by the fact that there is no guidance on how adjustments for such differences should be made.[105]

The quest to find comparables in Africa may require tax administrations to buy expensive private databases, which usually necessitates hiring experts to interpret the data, as the tax authorities do not often have sufficient resources or expertise to do so. This is compounded by the fact that only few African countries (for example South Africa, Ghana[106] and Kenya[107]) have specific transfer pricing units within their tax administrations to audit specific cases,[108] partly due to the high cost of implementing a transfer pricing audit.[109] When a transfer pricing analysis is carried out, it tends to be a long, complex, time consuming and contentious process, which may ultimately result in estimates fraught with conflicting interpretations.[110] This problem is compounded by the complexities of gathering taxpayer information to conduct a transfer pricing analysis due to the absence of documentation requirements in some countries or the inability to enforce existing requirements. Sometimes tax administrations lack the capacity to process and evaluate such information, partly because of the lack of technical expertise or because they do not have the necessary resources at their disposal to process the data.[111] This is compounded by the fact that some local tax administrations often lack the legal and technical skills needed to interpret, apply or enforce the transfer pricing rules.[112] Some tax administrations also lack understanding of the taxpayer's industry and business model to ably analyse the taxpayer's documents, choice of transfer pricing method and selection of comparables.[113] Efforts by developing countries to develop their skill, information and resource gaps are further hampered by the fact that tax officials often leave for better paid jobs in the private sector after acquiring the special skills.[114]

5 Some suggested alternative approaches

Due to the above challenges of applying the comparability approach, international bodies have suggested alternative approaches.[115] The African Tax Administration Forum (ATAF), which promotes and facilitates mutual cooperation among African tax administrators, is of the view that a different approach has to be adopted in drafting transfer pricing legislation which is fit for purpose for African countries.[116] In the same vein, the IMF notes that as much as all countries need to build their transfer pricing skills capacity and improve their public data availability for comparability studies,[117] a specific agenda for developing countries is needed to protect and expand their corporate tax bases in the face of challenges in applying the ALP.[118] The IMF recommends that developing countries need to have appropriate and simplified transfer pricing rules in place.[119]

In 2013, the UN issued a 'Practical Manual on Transfer Pricing for Developing Countries' to provide guidance on the policy and administrative aspects of applying the transfer pricing analysis to some transactions of MNCs.[120] The UN's 2017 second edition of the Manual, drew upon the feedback received on the first edition, the on-going developments in transfer pricing and the experiences and realities of transfer pricing for developing countries at their relevant stages of capacity

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[104] *Ibid.*

[105] *Ibid.*

[106] Ghana setup of such a unit in its large business centre in 2013. C. Becker, *International News – Nigeria: Transfer Pricing Africa (Part II), SAIT* (21 Oct. 2014), https://www.thesait.org.za/news/198754/Nigeria-Transfer-pricing-Africa-part-II.htm (accessed 18 Dec. 2018).

[107] PWC, *Country Study Kenya: Appendix D*, in para. 3.2, http://edz.bib.uni-mannheim.de/daten/edz-h/gdz/11/trpr_dev_count_app_d.pdf (accessed 18 Dec. 2018).

[108] UN, *supra* n. 1, para. C.5.1.1.

[109] International Mining for Development Centre, *Transfer Pricing in the Mining Section: An African Perspective – A Briefing Note* 5 (Sept. 2014).

[110] UN, *supra* n. 1, para. B.1.10.9.

[111] PWC, EuropeAID, *Implementing the Tax and Development Policy Agenda: Transfer Pricing and Developing Countries* 1 (2012); ATAF, *Giving Africa a Voice on the Burning Issue of Base Erosion and Profit Shifting* 1 (Apr. 2015).

[112] ATAF, *The Place of Africa in the Shift Towards Global Tax Governance: Can the Taxation of the Digital Economy be an Opportunity for more Inclusiveness* 17–18 (2019), https://irp-cdn.multiscreensite.com/a521d626/files/uploaded/ATAF%20PAPER%5B1%5D.pdf (accessed 30 Aug. 2019); International Mining for Development Centre, *supra* n. 109, at 5.

[113] UN, *supra* n. 1, para. A.4.12; PWC, EuropeAID, *supra* n. 111, at 1.

[114] UN, *supra* n. 1, para. B.1.10.3.

[115] A. Turina, *Back to Grass Roots: The Arm's Length Standard, Comparability and Transparency – Some Perspectives from the Emerging World*, 10(2) World Tax J. 45 (2018).

[116] ATAF, *supra* n. 111, at 1.

[117] IMF, *supra* n. 92, at 34; The Platform for Collaboration on Tax, *supra* n. 92.

[118] *Ibid.*

[119] *Ibid.*

[120] UN, *supra* n. 1, the Foreword.

development.[121] The UN Manual offers some alternative approaches to the comparability analysis approach (such as safe harbours and advance pricing agreements (APAs) – discussed below) which if effectively applied in developing countries, could give a fair and predictable result to MNCs investing in such countries.[122]

The OECD has also recognized the growing need to address the practical and administrative aspects of implementing its transfer pricing guidelines noting that; while there is a need for developing transfer pricing guidance for complex transactions, it is also essential to promote a cost-effective use of taxpayer and tax administration's resources for improved compliance and enforcement processes.[123] In 2011, the OECD conducted a survey of alternative measures that its member and Observer countries[124] applied to simplify the application of their transfer pricing rules. Although the alternative simplification measures identified are optional,[125] the OECD urged that since countries often have scarce administrative resources to enforce transfer pricing rules and since taxpayers face increasing compliance burdens, governments should direct compliance and enforcement efforts to the riskiest, biggest and most complex transactions.[126] Following the 2011 survey, in 2014 the OECD issued a discussion draft on 'transfer pricing comparability data and developing countries',[127] in which it recommends placing reliance on alternative approaches which do not focus on direct comparable data.[128] Examples are the use of: safe harbours; the simplified method for service fees, the sixth method for commodities and APAs – all explained below.[129]

In 2017, the Platform for Collaboration on Tax (comprising the IMF, OECD, UN and the World Bank) issued a discussion draft on a 'toolkit for addressing difficulties in accessing comparable data', which provides guidance on the use of the above-mentioned approaches.[130] The central aim of these approaches is to avoid the need for the time-consuming and often illusory search for comparable transactions.

Various developing countries are considering how and whether to formulate an enforcement strategy for these approaches.[131] This author submits that the appropriateness of each of these approaches depends on: each country's special circumstances, the characteristic of its economy, the type of MNCs investing in the country as well as its level of administrative capacity to deal with transfer pricing and international tax matters. The discussion that follows explains how these alternative approaches operate, as well as their advantages and drawbacks. Examples are also provided of some African countries that have adopted the approaches and the positions taken by others that have not adopted the approaches.

5.1 *Use of Safe Harbours for Common Low Risk Distribution, Manufacturing, Contract Research and Development Functions*

Since conducting a comparability analysis under the ALP can be a fact and resource-intensive process that imposes a heavy administrative burden on taxpayers and tax administrations,[132] the OECD recommends use of 'safe harbours' in a transfer pricing regime.[133] A 'safe harbour' is a provision that applies to a defined category of taxpayers or transactions and relieves eligible taxpayers from certain obligations imposed by a country's general transfer pricing rules, thereby reducing the need to find comparable data.[134] Although in the initial 1995 Transfer Pricing Guidelines, the OECD indicated that the safe harbour provisions are incompatible with the ALP, many OECD member countries were applying safe harbours to relieve compliance burdens, so in 2013 the OECD introduced Section E in Chapter IV of the Transfer Pricing Guidelines to provide guidance on the

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[121] *Ibid.*

[122] *Ibid.*

[123] OECD, *Multi-Country Analysis of Existing Transfer Pricing Simplification Measures* (OECD Publishing June 2011), para. 3, http://www.oecd.org/tax/transfer-pricing/48131481.pdf (accessed 5 Nov. 2018).

[124] OECD Observer countries are: Argentina, the People's Republic of China, India, the Russian Federation and South Africa. *Ibid.*

[125] OECD, *supra* n. 123, para. 12.

[126] *Ibid.*, para. 3.

[127] OECD, *Transfer Pricing Comparability Data and Developing Countries* 8 (2014).

[128] Other recommendations were that developing countries should improve the availability of comparables from local sources; and that global commercial databases should include data from developing countries and provide them access to those databases.

[129] OECD, *supra* n. 127, at 7.

[130] Platform for Collaboration on Tax, *supra* n. 92, at 51.

[131] OECD, *supra* n. 127, at 7.

[132] OECD, *Revised Section E on Safe Harbours in Chapter IV of The Transfer Pricing Guidelines* (OECD Publishing 16 May 2013), para. 4.93.

[133] *Ibid.*, at 2.

[134] Platform for Collaboration on Tax, *supra* n. 92, at 51.

use of safe harbours.[135] The provisions allow taxpayers to establish transfer prices in a specific way. For example, a safe harbour could exempt a defined category of taxpayers or transactions from the application of all or part of the general transfer pricing rules.[136] Alternatively, eligible taxpayers may elect to follow a simple set of prescribed transfer pricing rules provided by the tax administration in connection with clearly defined transactions. Often safe harbours are elected by; small enterprises, taxpayers involved in less complex transactions or low-value transactions. Safe harbours are especially recommended for transfer pricing cases involving; low risk distribution functions, low risk manufacturing functions, low risk research and development functions[137] and the provision of services that do not use valuable intangibles or assuming significant risk.[138] Often these are common transfer pricing functions carried out by numerous similarly situated taxpayers that take up a great deal of time and effort when processed on a case by case basis.[139] Safe harbour regimes apply by setting profit ranges or margins for certain functions; such as: distribution margins and manufacturing markups which are often quite consistent across many countries and industries. Settled ranges for these functions could have the effect of substantially reducing the number of transfer pricing audits, competent authority dockets and transfer pricing controversies, if reasonable ranges are agreed upon and published.[140] Taxpayers that manage to ensure that their financial results fall within the agreed safe harbour range would be relieved from burdensome compliance obligations, including some or all associated transfer pricing documentation requirements.[141] Prices established under such rules would be automatically accepted by the tax administration.[142] A commonly cited precedent for this type of approach is the agreement between the United States and Mexico regarding safe harbour profit ranges for 'assembly plants' or factories that operate on a duty free basis, often referred to as maquiladora operations in Spanish.[143]

5.1.1 *Advantages of Safe Harbours*

The most significant benefit of a safe harbour is to eliminate the need for a taxpayer to conduct a full comparability analysis and benchmarking study for transfer pricing. This mitigates compliance burdens for taxpayers for preparing transfer pricing documentation and the difficulties of obtaining and analysing costly data.[144] For developing countries, the compliance burden of the ALP may be disproportionate for smaller taxpayers, transactions that involve low transfer pricing risks and less complex transactions.[145] Safe harbours provide certainty that the taxpayer's transfer prices will be accepted by the tax administration, with limited or no scrutiny, provided the taxpayer can price qualifying transactions within the parameters set by the safe harbour.[146] Safe harbours can also increase the levels of tax compliance among small taxpayers that may think that their transfer pricing practices will escape scrutiny, but would be encouraged to oblige if they are assured that they would not need to expend resources on searching for complex comparable transactions.[147]

Safe harbours provide a degree of administrative simplicity for tax administrations by relieving them from conducting comparability analyses when auditing specific cases.[148] Although the eligibility of particular taxpayers or transactions for the safe harbour would need to be carefully evaluated, such evaluations would not necessarily have to be performed by auditors with transfer pricing expertise. Only simple audits would be carried out to verify that the transaction in question falls within the scope of the safe harbour.[149] Tax administrations thus can shift audit and examination resources from smaller taxpayers and less complex transactions to more complex and higher-risk transactions involving big

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[135] OECD, *OECD Approves the Revision of the Section on Safe Harbours in the Transfer Pricing Guidelines* (21 May 2013), http://www.oecd.org/tax/oecd-approves-revision-section-e-tp-guidelines.htm (accessed 14 Sept. 2015).

[136] OECD, *supra* n. 132, para. 4.99.

[137] *Ibid.*, at 10.

[138] Platform for Collaboration on Tax, *supra* n. 92, at 55.

[139] OECD, *supra* n. 132, at 10.

[140] *Ibid.*, at 11.

[141] *Ibid.*, para. 4.100.

[142] *Ibid.*

[143] *Ibid.*

[144] Platform for Collaboration on Tax, *supra* n. 92, at 66.

[145] OECD, *supra* n. 132, para. 4.96.

[146] *Ibid.*, para. 4.106; Platform for Collaboration on Tax, *supra* n. 92, at 51.

[147] OECD, *supra* n. 132, para. 4.104; Turina, *supra* n. 115, at 45; Collier & Andrus, *supra* n. 64, at 35.

[148] *Ibid.*

[149] *Ibid.*

taxpayers.[150] The use of safe harbours is thus considered useful for developing countries, in the design of a transfer pricing compliance environment that makes optimal use of the limited resources available.[151]

5.1.2 *Drawbacks of Using Safe Harbours*

Despite the advantages, safe harbours may not be the most appropriate method applicable to the facts and circumstances of the taxpayer. This is unlike the ALP, which allows the use of the most appropriate method, in determining an arm's length price.[152] Since safe harbours involve a trade-off between strict compliance with the ALP and administrability, they are not tailored to fit exactly the varying facts and circumstances of individual taxpayers and transactions.[153] Unilateral safe harbours can, at times, provide a windfall to taxpayers whose specific facts might suggest that income above the safe harbour level would be more consistent with arm's length dealing. This is especially so for; transactions involving the sale of goods to a local distribution affiliate for resale on a limited risk basis in the local market, contract manufacturing arrangements and contract research arrangements. It is perhaps for this reason that few countries, if any, have developed functioning safe harbours for dealing with these common types of transfer pricing issues.[154] This challenge is often alleviated if taxpayers have the option to either elect the safe harbour or the ALP. However, tax administrations often find that the option to elect creates potential for loss of tax revenue, as a taxpayer may elect to pay tax on the lesser of the safe harbour amount or the arm's length amount that is more favourable to their circumstances in a particular year. Countries can ameliorated this challenge by providing conditions under which taxpayers would be eligible to elect the safe harbour. For example, taxpayers could be required to notify the tax authority in advance of their decision to elect the safe harbour and to commit to its use for a certain number of years. [155]

Safe harbours can pose a risk for double taxation. If a tax administration sets safe harbour parameters at levels either above or below arm's length prices, it may induce taxpayers to modify the prices they would have charged a controlled party, in order to avoid transfer pricing scrutiny in the safe harbour country.[156] Where the taxpayer reports income above arm's length levels, this benefits the country providing the safe harbour, as more taxable income would be reported by the taxpayer. However, less taxable income will be reported in the country of its foreign associated enterprise, which may challenge the price set based on the safe harbour, with the result that the taxpayer may be exposed to double taxation.[157]

Safe harbours can also pose a risk for double non-taxation. Where a country applies a unilateral safe harbour which allows taxpayers to elect the safe harbour if their income is below arm's length levels, it would be difficult to determine whether the income reported by the taxpayer in other countries is consistent or above the arm's length levels. The burden of under-taxation would thus fall exclusively upon the country providing the safe harbour whereas the other country taxes on an arm's length basis. In such a case, double non-taxation could arise and result in distortions of investment and trade.[158] To ameliorate such outcomes, care should be taken by the country applying a unilateral safe harbour to ensure that the outcome can be modified under 'mutual agreement procedure' if there is a double taxation treaty in place.[159]

Artificial tax-planning arrangements may be entered into to exploit the safe harbour provisions. For instance, if safe harbours apply to simple or small transactions, taxpayers may be tempted to break transactions into parts to make them seem simple or small.[160] If a safe harbour is based on an industry average, tax planning opportunities may be adopted by taxpayers with better than average profitability to shift profits out of a country. For example, a company which sells at an arm's length price and gets a mark-up of 15% on controlled sales, could elect a safe harbour provision which provides a 10% mark-up. The company may then shift the remaining 5% to a low tax jurisdiction. When applied on a large scale, this could result in significant revenue loss for the country offering the safe harbour.[161] It has been suggested such schemes can be prevented by

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[150] OECD, *supra* n. 132, para. 4.103; Turina, *supra* n. 115, at 45; Collier & Andrus, *supra* n. 64, at 35.

[151] OECD, *supra* n. 132, para. 4.97.

[152] *Ibid.*, para. 4.109; Turina *supra* n. 115, at 45; Collier & Andrus, *supra* n. 64, at 35.

[153] OECD, *supra* n. 132, para. 4.110.

[154] *Ibid.*, at 10.

[155] *Ibid.*, para. 4.111.

[156] *Ibid.*, paras 4.97 and 4.112.

[157] *Ibid.*, paras 4.97 and 4.113; Turina, *supra* n. 115, at 45.

[158] OECD, *supra* n. 132, at 7.

[159] *Ibid.*, para. 4.115. Mutual agreement procedure is provided for in Art. 25 of the OECD MTC.

[160] OECD, *supra* n. 132, para. 4.120; Collier & Andrus, *supra* n. 64, at 35.

[161] OECD, *supra* n. 132, paras 4.97 and 4.121.

adopting safe harbours on a bilateral or multilateral basis,[162] whereby two or more countries agree on the category of transactions and/or taxpayers to which the safe harbour provisions apply.[163] However, an extensive network of bilateral and multilateral safe harbours could encourage 'safe harbour shopping' whereby transactions could be routed through territories with more favourable safe harbours. If the countries that have signed a bilateral safe harbour provision have entered into a tax treaty, exchange of information provisions in Article 25(3) of the OECD MTC could ensure consistent reporting of income in each country.[164]

Safe harbours may raise equity and uniformity issues since two distinct sets of rules would be created in the transfer pricing area. These concerns can be ameliorated by ensuring that safe harbour rules are clearly drafted to minimize the possibility of similar and possibly competing taxpayers finding themselves on opposite sides of the safe harbour threshold. Precise criteria for the safe harbour rules should be drafted to prevent similar taxpayers receiving different tax treatment, as preferential tax treatment could potentially lead to discrimination and competitive distortions.[165]

5.1.3 *Recommendations for the Design of Safe Harbours*

Despite the above drawbacks, the benefits of safe harbours for smaller and less complex transactions outweigh the challenges, as, safe harbours have the potential of providing taxpayers with greater certainty, relieving transfer pricing compliance and administration; which is time consuming and costly.[166] For more complex and higher risk transfer pricing matters, safe harbours are unlikely to provide a workable alternative to a rigorous case-by-case application of the ALP.[167] For a country to make a policy decision to introduced a safe harbour rule, it has to acknowledge that the decision involves a basic trade-off, as to whether it is prepared to suffer some erosion of its tax base in implementing a safe harbour; or whether the administrative and simplification benefits of a safe harbour outweigh the costs of applying the ALP.[168] When a policy decision is taken to introduce a safe harbour, the tax administration has to design the provisions carefully to ensure their effectiveness.[169] The UN Manual recommends that safe harbours should be targeted and designed properly[170] so that they do not pose a negative impact on the tax revenues of the country implementing the safe harbour and the countries whose associated enterprises elect the safe harbour.[171] The IMF recommends that carefully designed safe harbours that apply a fixed mark up to certain costs can play a greater role than generally recognized.[172] The problems of non-arm's length results arising under safe harbours could be largely eliminated if tax administrations can ensure that any margins contained in the safe harbour are approximated to the arm's length position.[173] The potential for safe harbours leading to double taxation or double non-taxation can be ameliorated by avoiding unilateral safe harbours and rather adopting bilateral or multilateral ones with trading partners in a mutual agreement procedure between the countries.[174] Such agreements should be reviewed and modified regularly so that they are up to date and reflect developments in the broader economy. The agreements could also be published in advance so that the taxpayers can consistently apply the acceptable pricing parameters in each of the affected countries.[175] When negotiating bilateral safe harbours for low risk distribution services, low risk manufacturing services and low risk research and development services; the competent authorities of developing countries can use the sample Memoranda of Understanding that is annexed to Section E of the OECD Guidelines.[176] For developing countries with serious resource constraints, bilateral safe harbours entered into with a number of

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[162] Platform for Collaboration on Tax, *supra* n. 92, at 66.

[163] OECD, *supra* n. 132, at 11–12.

[164] Art. 25(3) provides: 'The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.' This can cover bilateral transfer pricing safe harbours to 'resolves difficulties or doubts arising in the interpretation or application' of Art. 9 of the Treaty. *See ibid.*, at 11.

[165] OECD, *supra* n. 132, para. 4.124.

[166] *Ibid.*, paras 4.126–4.127.

[167] *Ibid.*, para. 4.130.

[168] UN, *supra* n. 1, para. B.1.7.6; *ibid.*, para. 4.123.

[169] OECD, *supra* n. 132, para. 4.131.

[170] UN, *supra* n. 1, para. B8.8.8.

[171] OECD, *supra* n. 132, para. 4.95.

[172] IMF, *supra* n. 92, at 32.

[173] Platform for Collaboration on Tax, *supra* n. 92, at 57.

[174] OECD, *supra* n. 132, at 7; *ibid.*

[175] OECD, *supra* n. 132, at 7 and at 11.

[176] *Ibid.*, at 10.

treaty partners could provide a means of protecting the local tax base in common transfer pricing fact patterns without an inordinate enforcement effort.[177]

Although safe harbours may be elective, with an 'opt-in' or 'opt-out' option,[178] the experience of countries such as India, Mexico and the Dominican Republic shows that safe harbours designed with strict elective requirements for taxpayers, often undermines their effectiveness.[179] If a taxpayer decides that a particular safe harbour will cost too much in extra tax, it may opt out of the safe harbour and apply a transfer pricing method. This forces the tax authority back into the quagmire of the complex comparability that it may not have the capacity to deal with. It is recommended that safe harbours for designated transactions should be designed as presumed to apply, with the possibility of opting out for only exceptional or unusual cases that are strictly defined. The OECD transfer pricing guidelines refer to this as a 'rebuttable presumption',[180] so that taxpayers are only allowed to rebut the presumptive safe harbour method, if they comply with the grounds specified.

Examples on the use of safe harbours in Africa are as follows. In Nigeria, Regulation 15 of the 2012 Transfer Pricing regulations (now repealed) provided safe harbours for two categories of transactions. Firstly, for transactions priced in line with an existing law; for instance the price of crude oil disposed of by an oil producing company under the Petroleum Profit Tax Act; and secondly transactions whose prices had been approved by a Government regulatory agency. The regulations exempted these transactions from transfer pricing rules provided the Federal Inland Revenue Service (FIRS) was satisfied that the transaction was at arm's length. The 2012 regulations were however criticized for defeating the purpose of the safe harbours, as the taxpayer would have to file documents to fulfil the arm's length standard.[181] In 2018 Nigeria issued new transfer pricing regulations, which provide (in regulation 22) that a taxpayer may be exempt from preparing transfer pricing documentation in respect of a related party transaction where the transaction is priced in accordance with specific guidelines that may be published by the FIRS from time to time (the scope of which were yet to be published at the writing of this article).[182]

The South African Revenue Service (SARS) is currently taking a cautious approach with respect to safe harbours and is of the view that for developing countries, the introduction of safe harbours is perhaps best considered when the tax authorities have established a high degree of understanding of transactions, which pose low risk.[183] SARS is of the view that whilst safe harbours have their benefits, such as the ease of audit administration, it is important that countries give careful consideration to what they could be sanctioning when they introduce safe harbours, such as tax leakage that can arise from the application of safe harbours.[184]

Kenya is also cautious about safe harbours especially their tendency to cause double taxation. The Kenyan government is of the view that safe harbours that are too restrictive and rigid may not be conducive to foreign investment and trade.[185]

5.1.4 *Perspectives on the Use of Fixed Ratios as 'Safe Harbours'*

It is necessary to point out that some countries consider fixed debt/equity ratios that are used to prevent 'thin capitalization'[186] as safe harbours; although there is a debate internationally as to whether thin capitalization ratios should be regarded as transfer pricing simplification rules or as anti-abuse rules.[187] Basically, thin capitalization is a profit shifting scheme employed by MNCs to fund their subsidiaries with unusual proportions of loan to equity capital in order to gain tax advantages.[188] Often this can result in excessive interest deductions that can deplete country's tax bases. Since most African countries are net borrowers rather than net lenders, they will usually be net payers of interest. Zambia for instance, is managing a growing and debilitating debt stock that is reflected by the huge allocations made towards debt servicing over the last three years.[189] It is therefore little wonder that one of

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177 *Ibid.*, at 11.

178 Platform for Collaboration on Tax, *supra* n. 92, at 55.

179 UN, *supra* n. 1, para. B8.8.8.

180 OECD, *supra* n. 11, para. 4.104.

181 S. Adu, *What do the Nigerian Safe Harbour Rules Have in Common with the Movie Safe House?* (PWC 2017), https://www.pwc.com/ng/en/assets/pdf/nigerian-safe-habour-rules-transfer-pricing.pdf (accessed 18 Dec. 2018).

182 PWC, *Nigeria: The Safe Harbour Provision in the 2018 TP Regulations: What Can Be Done to Make It Effective?* (Nov. 2018), (accessed 18 Dec. 2018).

183 UN, *supra* n. 1, para. D.5.10.1.

184 *Ibid.*

185 PWC, *supra* n. 107, para. 4.3.2.4.

186 A. W. Oguttu, *International Tax Law: Offshore Tax Avoidance in South Africa* 232 (Juta 2015).

187 OECD, *supra* n. 123, para. 7.

188 Blerck, *supra* n. 78, at 44.

189 Deloitte, *Zambia Budget 2019* 4 (Deloitte 2018).

the most prevalent profit shifting schemes that poses significant risk to African tax bases, relates to excessive cross boarder interest deductions. The OECD has historically recommended use of the ALP to prevent thin capitalization, in that, comparable data is used to determine whether the interest rate is an arm's length rate or whether a prima facie loan is a disguised equity contribution.[190] However, applying the ALP to thin capitalization is often very difficult since compatibility can be affected by a number of factors, such as: differences in the financial agreements, capital investments, geographical risks, collaterals relating to the transaction and the risks assumed by the taxpayers.[191] Although the 1979 OECD Report on 'Transfer Pricing and Multinational Enterprises'[192] acknowledged these challenges, there have not been clear guidelines for determining the parameters within which the ALP applies in the context of thin capitalization. With the lack of clear guidelines, over the years, many countries were compelled to apply fixed debt/equity ratios for setting the parameters within which the ALP will apply.[193]

In terms of the fixed ratio approach, if the debtor company's total debts exceed a certain proportion of its equity capital, then the interest on the loan or the interest on the excess of the loan over the approved proportion is automatically disallowed or treated as a dividend.[194] Some countries use fixed ratios in a restrictive manner as if it is the sole determinate issue, whereas others use fixed ratios as a 'safe harbour' that gives the taxpayer the option of showing that the debt to equity ratio is at arm's length.[195]

Many African countries apply fixed ratios because of the simplicity of the approach. In Kenya, Section 16(2)(j) of the Income Tax Act (Chapter 470 of the laws of Kenya) sets a thin capitalization ratio of 3:1 but for companies operating in the extractive sector (mining and oil and gas), the Ninth Schedule to Kenya's Income Tax Act prescribes a debt to equity ratio of 2:1. In Uganda, Section 89 of the Income Tax Act, Cap 340 (repealed in 2018) was previously used to restrict the amount of interest that is deductible to that part of interest arising from debt that does not exceed the 1.5 to 1 ratio. In Ghana, Section 71 of the Internal Revenue Act 896 of 2015, disallows deductions for any interest paid on debt in excess of a debt to equity ratio of 2:1. In Zambia, thin capitalization rules in Section 97A of the Income Tax Act, Cap 323 of the Laws of Zambia, only apply in relation to mining companies whereby interest deductions are limited if a company has a debt to equity ratio exceeding 3:1. In South Africa, before 1 April 2012, both the ALP and the fixed ratio approach were applied to curb thin capitalization.[196] The then 31(3) of Income Tax Act 68 of 1962 (amended), read together with SARS Practice Note 2 (now withdrawn),[197] considered interest to be excessive if the financial assistance/fixed capital ratio exceeded the 3:1 safe harbour ratio.[198] This fixed ratio alleviated documentation requirements, prevented penalties and reduced compliance burdens.[199] However, in 2011 the fixed ratio was repealed and SARS Practice Note 2 was withdrawn.[200] South Africa amended its transfer pricing provisions in Section 31 of its Income Tax Act, so that the ALP applies to both transfer pricing and thin capitalization to ensure consistency with international trends and to minimize the scope for interpretational difficulties domestically and under tax treaties.[201] The removal of the fixed ratio has however been criticized for leaving a vacuum, as there are now no set parameters as to exactly how excessive financial assistance is to be determined.[202] In 2013, SARS issued a Draft Interpretation Note on thin capitalization (which is not yet finalized),[203] in which SARS explains that it applies a risk-based audit approach in selecting potential thin capitalization cases for audit. SARS considers transactions in which the Debt: earnings before interest, taxes, depreciation and amortisation (EBITDA) ratio of the South African taxpayer exceeds 3:1 to be of greater risk. SARS explains that the ratio is not a safe harbour but it is used

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190 OECD, *supra* n. 6, at 21 in para. 48.

191 M. Markham, *The Transfer Pricing of Intangibles* 28 (Kluwer Law International 2005).

192 OECD, *supra* n. 6, at 29 in para. 70.

193 *Ibid.*, at 15.

194 *Ibid.*

195 *Ibid.*, at 16.

196 Oguttu, *supra* n. 186, at 228–229.

197 ZA: SARS, *Determination of Taxable Income Where Financial Assistance Has Been Granted by a Non-Resident of the Republic to a Resident of the Republic*, Practice Note 2 (24 May 1996), para. 2.2; *see also* P. Roper, *Offshore Options* 66 (Durban 1999).

198 SARS Practice Note 2, *supra* n. 197, para. 2.2; *see also* H. Louw, Transfer Pricing in South Africa, Cliffe Dekker Hofmeyr Legal Brief (2 Aug. 2012), http://www.polity.org.za/article/transfer-pricing-in-south-africa-2012-08-02 (accessed 18 Sept. 2018); OECD, *supra* n. 123, at 107.

199 SARS Practice Note 2, *supra* n. 197, para. 2.2.

200 L. Olivier & M. Honiball, *International Tax: A South African Perspective* 664 (4th ed., ADC Press 2011).

201 ZA: Explanatory Memorandum on the Taxation Laws Amendment Bill of 2010 in para. 5.3 Part II(C).

202 Olivier & Honiball, *supra* n. 200, at 654.

203 ZA: SARS Draft Interpretation Note, *Determination of the Taxable Income of Certain Persons from International Transactions: Thin Capitalisation* 3 (2013).

as a potential risk identifier that indicates the level of risk set by SARS for purposes of selecting cases for audit and that the ratio may vary in different industries and according to the creditworthiness of a particular taxpayer.[204]

Although the OECD does not advocate for the fixed ratio approach, it acknowledges that unlike the ALP, fixed ratios provide some certainty to both tax authorities and MNCs as to how excessive debt to a foreign subsidiary can be determined.[205] There are however, drawbacks in a strict adherence to a fixed ratio, as it may ignore the inherent commercial realities and risks of a particular business and work to disadvantage of the MNC.[206] A fixed ratio might also be arbitrary as the nature of financial transactions and practices differ widely: from country to country, within a given country and between different categories of enterprises.[207] The use of hard and fast debt/equity ratios[208] may also result in charging more than an arm's length profit on the relevant transaction.[209] This poses a greater risk of economic double taxation and the possibility that the tax authorities of the country of the lender could find it difficult to accept the result and give satisfactory relief from the double taxation.[210] The lower the ratio of debt to equity permitted by hard and fast debt-equity ratios, the more rigid the practice of applying it. This may result in inconsistencies with the ALP and disadvantages to taxpayers. Similarly, the higher the ratio, the greater will be the likelihood of getting a result that unduly favours taxpayers.[211]

Although the OECD's first report on thin capitalization in 1987, recommended that fixed ratios should be used as a 'safe-harbour' rule, leaving the relevant company the option of showing that the actual ratio of the company's debt to its equity is compatible with the ALP,[212] its 2010 Transfer Pricing Guidelines,[213] which dealt extensively with the concept of safe harbours, did not deal with safe harbours with regard to thin capitalization.[214] When the OECD revised Section E on safe harbours in chapter IV of its Transfer Pricing Guidelines, in 2013 it indicated that the safe harbour guidelines do not extend to thin capitalization provisions designed to prevent excessive debt in a foreign subsidiary.[215]

However, in Action 4 of the OECD BEPS Project, the OECD recommended that countries should apply a fixed ratio (which is essentially as safe harbour rule) coupled with a group ratio rule to entities in multinational groups in order to prevent excessive interest deductions.[216] This measure is in principle recommended by the OECD to counter profit shifting schemes, not necessarily as a simplified method. The use of the method does nevertheless imply that countries do not have apply the complicated comparability analysis to curtail excessive interest deductions. The fixed ratio limits an entity's net deductions for interest and payments economically equivalent to interest, to a percentage of its EBITDA.[217] As a minimum, this ratio should be applied to all entities within a multinational group. To ensure that countries apply a fixed ratio that is low enough to tackle BEPS, while recognizing that not all countries are in the same position, the OECD recommended an approach that includes a corridor of possible ratios of between 10% and 30%.[218] Action 4 of the OECD BEPS Project includes factors that countries can take into consideration when determining the appropriate benchmark fixed ratio. A country may consider applying a higher benchmark fixed ratio rule where the jurisdiction in question:

– operates the benchmark fixed ratio in isolation and not in conjunction with a group ratio rule;
– does not permit the carry forward of unused interest or the carry back of disallowed interest expenditure;
– applies other targeted rules that specifically address BEPS risks as envisaged under Action 4;
– has higher interest rates relative to other countries; or
– is required to apply the same treatment to different types of entities which are considered legally comparable even if those entities pose varying levels of BEPS risks.

Notes

204 *Ibid.*

205 OECD, *supra* n. 6, para. 71.

206 G. Richardson, D. Hanlon & L. Nethercott, *Thin Capitalisation Rules: An Anglo-American Comparison*, 37 Spring Int'l Tax J. 45 (1998).

207 OECD, *supra* n. 6, at 29 in para. 71.

208 *Ibid.*, at 33 in para. 82.

209 *Ibid.*, at 35 in para. 89.

210 *Ibid.*, at 30 in para. 72 and at 32 in para. 79.

211 *Ibid.*, at 32 in para. 79.

212 *Ibid.*, at 31 in para. 79.

213 OECD, *supra* n. 11, para. E 4.95.

214 *Ibid.*

215 OECD, *supra* n. 132, para. 4.101.

216 OECD, *Limiting Base Erosion Involving Interest and Other Financial Payment: Action 4 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing Oct. 2015), paras 23, 78 and 99.

217 *Ibid.*

218 *Ibid.*

The fixed ratio rule is however a blunt tool which does not take into account the fact that groups operating in different sectors may require different amounts of leverage, and even within a sector, some groups are more highly leveraged for non-tax reasons (which could result in double taxation for groups which are leveraged above the level). Thus, the OECD recommends that the fixed ration rule can be supplemented by a worldwide group ratio rule which allows an entity to exceed this limit in certain circumstances.[219] This would allow an entity with net interest expense above a country's fixed ratio to deduct interest up to the level of the net interest/EBITDA ratio of its worldwide group.[220] Countries may also apply an uplift of up to 10% to the group's net third party interest expense to prevent double taxation. The earnings-based worldwide group ratio rule can also be replaced by different group ratio rules, such as the 'equity escape' rule (which compares an entity's level of equity and assets to those held by its group). A country may also choose not to introduce any group ratio rule. In that case it should apply the fixed ratio rule to entities in multinational and domestic groups without improper discrimination. [221]

The recommended approach also allows countries to supplement the fixed ratio rule and group ratio rule with other provisions that reduce the impact of the rules on entities or situations which pose less BEPS risk, such as:

- A *de minimis* threshold which carves-out entities which have a low level of net interest expense.[222]
- An exclusion for interest paid to third party lenders on loans used to fund public-benefit projects (subject to some conditions). In some cases, an entity may be highly leveraged but due to the nature of the projects and the close link to the public sector, the BEPS risk is reduced.[223]
- Provisions that allow the carry forward of disallowed interest expense and/or unused interest capacity (where an entity's actual net interest deductions are below the maximum permitted) for use in future years. This will reduce the impact of earnings volatility on the ability of an entity to deduct interest expense. The carry forward of disallowed interest expense will also help entities which incur interest expenses on long-term investments that are expected to generate taxable income only in later years, and will allow entities with losses to claim interest deductions when they return to profit.[224]

In line with the OECD's recommendation, in 2018, ATAF came up with an approach for drafting interest deductibility legislation for its member countries.[225] ATAF is of the view that the fixed ratio rule is a straightforward rule to apply and ensures that an entity's interest deductions are directly linked to its economic activity. It also directly links the deductions to an entity's taxable income, which makes the rule reasonably robust against tax planning.[226]

In line with the OECD recommendations, in Zambia, the Minister of Finance announced on 28 September 2018 that legislation would be introduced, commencing in 1 January 2019, to restrict interest deduction on loans to 30% of EBITDA for purposes of company income tax. This measure excludes businesses on the turnover tax system and those registered under the Banking and Financial Services Act and Insurance Act.[227] Thus Section 29(1)(a) of Zambia, Income Tax (Amendment) Act[228] was enacted to allow for the deduction of gross interest expense not exceeding 30% of EBITDA. Section 29(2) provides that only one deduction is allowed in respect of the same matter in a charge year. Disallowed interest may be carried forward, subject to the 30% EBITDA limitation, for a maximum period of five years.

In Uganda, the thin capitalization provisions that were in Section 89 of the Income Tax Act, which applied a debt to equity ratio of 1.5 to 1, were repealed in 2018 and replaced with interest deductibility limitations in Section 25 of the Income Tax Act.[229] The section states that:

(1) For all debts owed by a taxpayer who is a member of a group, the amount of deductible interest in respect of all debts shall not exceed 30% of the tax EBITDA.

(2) Any taxpayer whose interest exceeds 30% of EBITDA may carry forward the excess interest for not more than three years, and the excess interest shall be treated as incurred during the next year of income.

This Ugandan provision effectively caps deductible interest expense during the year of income and any excess

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[219] *Ibid.*, paras 24 and 116.

[220] *Ibid.*, para. 119.

[221] *Ibid.*, para. 119.

[222] *Ibid.*, at 1 and 26.

[223] *Ibid.*, at 12.

[224] *Ibid.*

[225] ATAF, *Suggested Approach to Drafting Interest Deductibility Legislation: Excluding the Banking and Insurance Sector* 2 (ATAF Publications 2018).

[226] *Ibid.*

[227] PWC, *Zambia 2019 National Budget* 4 (2018), https://www.pwc.com/zm/en/assets/pdf/zambia-budget-2019.pdf (accessed 27 Aug. 2019).

[228] ZM: Income Tax (Amendment) Act No. 17 of 2018.

[229] UG: Income Tax (Amendment) Bill, 2018, which came into effect on 1 July 2018.

interest expense is deferred for future deduction within the following three years of income, after which the interest expense would lose its deductibility for income tax purposes.

However, many African tax administration have expressed concerns on how they would verify information regarding the group ration rule where the information is held outside the African country. If a country introduces a group ratio alongside the fixed ratio rule, its tax administration will have to verify the group ratio reported by the taxpayer. The tax administration may for instance have to verify the information from the group consolidated accounts. However, such information could be abroad and may not be held by the local taxpayer.[230] Although such information may be obtained using the OECD 'Multilateral Convention of the Mutual Assistance in Tax Matters'[231] (which facilitates administrative cooperation so as to counter international tax evasion and other forms of non-compliance), many African countries are not signed up to this Convention. ATAF suggests that where a country introduces a group ratio rule, it may wish to consider introducing a provision to the effect that additional interest that would be deductible for tax purposes under the group rule will only be deductible if the taxpayer provides the tax administration the information needed to verify the reported group ratio.[232] The OECD recognizes that applying the group ratio may not be straightforward in practice, so in 2016, it came up with a discussion draft on the design and operation of the group ratio rule (which is yet to be finalized).[233]

While still on this topic that deals with provisions to prevent excessive debt deductions, it is important to highlight the debate on whether national thin capitalization rules conflict with the non-discrimination tax treaty provisions in Article 24 of the OECD MTC. This is because, thin capitalization rules target companies that are owned or controlled by non-residents and generally to do not apply if a company is owned or controlled by a resident.[234] However, when an investor that is tax resident in a given state, funds (using debt rather than equity) a company that it owns or controls in same state, the deduction for interest expense is proportioned in that country's revenue base with respect to the interest income earned by the investor. The only difference could be the tax rate that applies to the two taxpayers.[235] In a treaty context, this discrimination is clear in Article 24(4) of the OECD MTC which provides inter alia that; except where Article 9(1) applies, interest paid by an enterprise of a Contracting State to a resident of the other Contracting State should be deductible under the same conditions as if it had been paid to a resident of the first mentioned State. In effect, the application of Article 9(1) to thin capitalized transactions of companies that are owned or controlled by non-residents are excluded from the discriminatory provisions in Article 24(4). The implication is that Article 9(1) overrides the non-discrimination provisions.[236] However, this often results in adverse tax consequences for non-resident investors but not for resident investors.[237]

Unlike Article 24(4) in which the application of the ALP is excluded from the non-discrimination provisions, Article 24(5) does not contain such an exclusion. Article 24(5) prohibits a Contracting State from imposing less favourable treatment on an enterprise, when the capital of that enterprise is owned or controlled, wholly or partly, directly or indirectly, by residents of the other Contracting State. This implies that under Article 24(5), it is discriminatory to disallow an interest deduction where a company is controlled by non-residents, if the interest deduction would be allowed where the company was controlled by residents.[238] It is argued that since Article 31 of the Vienna Convention on the Law of Treaties[239] provides that 'a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose', Article 24(5) would render many countries' thin capitalization rules ineffective.[240]

Notes

230 ATAF, *supra* n. 225, at 11.

231 OECD, *Multilateral Convention of the Mutual Assistance in Tax Matters, Amended by the 2010 Protocol* (OECD Publishing 2011), https://read.oecd-ilibrary.org/taxation/the-multilateral-convention-on-mutual-administrative-assistance-in-tax-matters_9789264115606-en#page8 (accessed 22 July 2019).

232 ATAF, *supra* n. 225, at 11.

233 OECD, *BEPS Action 4: Elements of Design and Operation of the Group Ratio Rule*, Public Discussion Draft (OECD Publishing July 2016), https://www.oecd.org/tax/beps/discussion-draft-beps-action-4-elements-of-the-design-of-group-ratio-rule.pdf (accessed 22 July 2019).

234 C. Elliffe, *Trans-tasman Thin Capitalisation Rules and Treaties: Implications for New Zealand and Australia on Tighter Thin Capitalisation Ratios*, 28 Austl. Tax Forum 607 (2013).

235 *Ibid.*, at 607–608.

236 I. Nepote, *Article 24-Non-Discrimination*, in *History of Tax Treaties-The Relevance of the OECD Documents for the Interpretation of Tax Treaties* 680 (T. Ecker and G. Ressler eds, Linde 2011).

237 Elliffe, *supra* n. 234, at 607–608.

238 *Ibid.*, at 608.

239 UN, *Vienna Convention on the Law of Treaties* (23 May 1969). Entered into force on 27 Jan. 1980. United Nations, *Treaty Series – Treaties and International Agreements Registered of Filed and Recorded with the Secretariat of the United Nations* vol. 1155, 331 (1987).

240 Elliffe, *supra* n. 234, at 610.

In its 1986 report on thin capitalization,[241] the OECD explained that the object of Article 24(5) is to prevent the deterrence of inbound investment (tax protectionism) rather than interference with the rules that prevented the transfer of arm's-length profits in the guise of interest.[242] The OECD 1986 report acknowledged that the wording of Article 24(5) is too broad and would not prevent the transfer of profits in the form of interest, so it attempted to resolve this conflict by asserting that the ALP exception to non-discrimination in Article 24(4) should be imported into Article 24(5) so that countries' thin capitalization rules are not considered to be in violation of Article 24(4).[243] The views in the OECD 1986 report led to changes in the 1992 Commentary to Article 24.[244] This implies that for treaties signed before then, the interpretation that imports the ALP exception to non-discrimination in Article 24(4) into Article 24(5) would not apply.[245] However, this interpretation would apply for treaties based on the 1992 version of the MTC as by then, countries had an understanding that Article 24(5) should be interpreted in a restricted way that does not override the ALP or conflict with national thin capitalization rules.[246] This interpretation was confirmed when the OECD issued its 2008 report on the 'Application and Interpretation of Article 24',[247] and subsequently in its 2010 version of the MTC. Currently, paragraph 79 of the Commentary on Article 24 explains that since Article 9(1) forms the context within which Article 24(5) 'must be read (as required by required by the Vienna Convention on the law of Treaties), adjustments which are compatible with the provisions could not be considered to violate the provisions of[248] Article 24(5).

5.2 *The Simplified Method for Low Value-Adding Intra-Group Services*

MNCs normally require a wide scope of services, ranging from administrative, technical, financial legal, central auditing, personnel training and commercial services to effectively run their businesses. Although members of MNC groups may acquire such services from independent enterprises, MNCs normally arrange for these services to be utilized intra-group, where they are; centrally managed, coordinated and controlled by the parent company or a specially designated group member.[249] This arrangement ensures that services are offered at a cheaper cost for the group as a whole than would be the case if they were offered by an independent entity. To prevent transfer pricing, the OECD recommends that service fees must be at arm's length. However, applying the ALP and the comparability approach to service fees is cumbersome as it is difficult to verify whether the fees are appropriate. Chapter VII of the Transfer Pricing Guidelines provides that establishing the arm's length price of intra-group services has to follow a two-step approach.

The first step requires determining whether the intra-group services were in fact provided to one or more members of the same MNC group. This determination requires applying the 'benefit test', to prove that the service provided the recipient with some economic benefit or commercial value that enhanced the recipient's commercial position. The proof lies in considering if an independent enterprise in the same circumstances would have been prepared to pay for the service or would have performed the service in-house; if not, it cannot be considered as an intra-group service.[250] The OECD notes that the following cannot be considered chargeable intra-group services: shareholder activities (which provide an economic benefit solely to the parent company or a regional holding company); duplicated services (already performed by an associated enterprise or an independent entity); incidental benefits to other group members (for example reorganization of the MNC, the acquisition of new members or the termination of a division); and on-call services (which provide financial, managerial, technical, legal or tax advice to members of the MNC group at any time).[251]

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[241] OECD, *Thin Capitalisation* (OECD Publishing 26 Nov. 1986), para. 46, https://www.oecd-ilibrary.org/docserver/9789264175181-97-en.pdf?expires=1565176499&id=id&accname=oid011488&checksum=9508A404EB4C97ECB619761E36E58F31 (accessed 27 Aug. 2019).

[242] *Ibid.*, para. 66(b).

[243] Commentary to Art. 24 OECD MTC (2017), para. 79.

[244] Elliffe, *supra* n. 234, at 611.

[245] *Ibid.* in footnote 20, at 611, gives an example of the approach of the Bundesfinanzhof in DE: *Re Treaty Discrimination and Fiscal Unity* (2011) 13 ITLR 839 and the Conseil d'Etat, in FR: *Re Société Andritz Sprout Bauer* (2003) 6 ITLR 604, which refused to acknowledge that the ALP suggested by the Commentary is appropriate and correct for a treaty concluded in 1964 and 1959 (with the protocol of 30 Oct. 1970) respectively.

[246] Elliffe, *supra* n. 234, at 611.

[247] OECD, *Application and Interpretation of Article 24 (Non-Discrimination): Public Discussion Draft* (OECD Publishing May 2007), para. 88, https://www.oecd.org/ctp/treaties/38516170.pdf (accessed on 27 Aug. 2019). The report is adopted by the OECD Committee on Fiscal Affairs on 20 June 2008.

[248] Commentary to Art. 24 OECD MTC (2017), para. 79.

[249] OECD, *supra* n. 87, at 143.

[250] OECD, *supra* n. 11, at 206.

[251] *Ibid.*, at 207–210.

The second step requires determining whether the intra-group charge for the services is at arm's length,[252] in that it reflects the charge that would have been paid by the independent enterprises in similar circumstances.[253] The arm's length charge for intra-group services can be determined by using either the direct-charge method or the indirect-charge method.[254] The direct-charge method applies when intra-group services are rendered by one group member to meet the specific need of another group member, and the charges for such services are clearly identified. Where the direct-charge method is difficult to apply (for example when estimating the actual benefit of the centralied services within a MNC group), indirect methods such as: the use of cost allocation factors and apportionment methods, can be applied as a basis for calculating an arm's length charge.[255] Whereas the direct-charge method may be easier to apply in that the taxpayer can substantiate it with documentation, the burden of maintaining detailed documentation to demonstrate the provision of the service or a direct benefit, poses a practical limit to the approach. The challenge with the indirect method, which requires charges to be calculated on an allocation basis, is that it poses a risk of double taxation owing to the obscuring of the relationship between the charge and the services provided.[256]

It is thus little wonder that tax administrations find it difficult to apply the ALP to intra-group services, as in practice the determination of whether the recipient of the service got the relevant economic and commercial benefit is very subjective and it requires greater effort than the amount the charge warrants. The economic benefit of services cannot always be measured in actual monetary terms, so, the opinion of the taxpayer has to be relied upon rather than the facts of the matter. This becomes problematic when the taxpayer's judgement has the potential to translate into a significant tax adjustment in their favour.[257] Tax administrations try to address these challenges by setting out documentation and burden of proof requirements; which pose costly compliance burdens for taxpayers.[258] In Action 10 of its 2015 BEPS Reports, the OECD acknowledged that the nature of services makes it difficult to meet the 'benefit test' under the ALP.[259] Consequently, the OECD added Section D to Chapter VII of the Transfer Pricing Guidelines, which entails an elective simplified approach for determining an arm's length charge for low value-adding intra-group services (including a simplified benefits test). The low value-adding intra-group services to which the simplified approach should apply, are those that are: of a supportive nature; not part of the core business of the MNC group; do not require the use or creation of unique and valuable intangibles; do not involve the assumption or control of substantial or significant risk by the service provider and do not give rise to the creation of significant risk for the service provider.[260] Examples include: accounting and auditing; processing and management of accounts; human resource activities; monitoring and compilation of data; information technology services; public relations support; legal services; activities with regard to tax obligations as well as general services of an administrative or clerical nature.[261] Activities that do not qualify as low value-adding intra-group services are: services that constitute the core business of the MNC group, such as: research and development services; manufacturing and production services; purchasing of materials used in the manufacturing or production process; sales, marketing and distribution activities; financial transactions; extraction, exploration, or processing of natural resources; insurance and reinsurance; as well as services of corporate senior management.[262]

The simplified approach recognizes that the arm's length price for low value adding intra-group services is closely related to costs. It thus operates by allocating the costs of providing each category of services to those group companies which benefit from using those services, and then applies the same mark-up to all those services.[263] The approach only requires tax administrations to consider the benefits of categories of services, but not on a specific charge basis. For example in the case of payroll processing, a taxpayer only has to demonstrate that assistance was provided. It does not have to specify the individual actions that gave rise to the cost charged. A single

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[252] *Ibid.*, para. 7.5.

[253] *Ibid.*, at 210.

[254] *Ibid.*, at 211–212.

[255] *Ibid.*

[256] OECD, *Comments Received on the Request for Input: Scoping of the Future Revisions of Chapter VII (Intra-Group Services) of the Transfer Pricing Guidelines* 8 (OECD Publishing 28 June 2018).

[257] UN, *supra* n. 1, para. D.5.7.7.

[258] *Ibid.*, para. D.5.7.8.

[259] *Ibid.*, para. D.5.7.2.

[260] OECD, *supra* n. 11, para. 7.45.

[261] *Ibid.*, para. 7.47.

[262] OECD, *supra* n. 87, at 153–154.

[263] OECD, *supra* n. 11, para. 7.43.

annual invoice describing a category of services should suffice to support the charge, without the need for supporting documents.[264] Thus, a MNC is presumed to have complied with the requirement of providing sufficient evidence that the benefits test is met, so that a fully fledged transfer pricing analysis does not have to be conducted.[265]

The first step in applying the simplified approach is for the MNE group to calculate, on an annual basis, a pool of all costs incurred by all members of the group in performing each category of low value-adding intra-group services.[266] The second step, is to identify and remove from the pool, those costs that are attributable to services performed by one group member solely on behalf of one other group member.[267] The third step is to allocate among group members, the costs in the pool that benefit multiple members of the group; using allocation keys relevant to the nature of the services.[268] The arm's length charge for the group member providing the low value-adding intra-group services, would be determined by applying a profit mark-up to all costs in the pool with the exception of any pass-through costs. The mark-up shall be equal to 5% of the relevant cost and it does not need to be justified by a benchmarking study.[269] The approach may require the MNC to submit limited documentation requirements (upon request by the tax administration).[270] This would include: a description of the categories of low value-adding intra-group services provided and the identity of the beneficiaries; written contracts or agreements for the provision of services; documentation showing the determination of the cost pool and the mark-up applied thereon; and the calculations showing the application of the specified allocation keys.[271] To protect their tax base, tax administrations may include a threshold (which might be based on fixed financial ratios of the service recipient or on total service costs to turnover of the MNC group) upon which a taxpayer would be denied the use of the simplified approach, if the level of low value-adding intra-group service fee exceeds the threshold. In that case, the tax administration may require a full functional analysis and a comparability analysis for low value-adding intra-group service charge above the threshold.[272] MNCs electing to adopt the simplified method, would as far as practicable, be expected to apply it consistently in all countries they operate.[273]

5.2.1 *Advantages of the Simplified Method for Low Value-Adding Intra-Group Services*

For MNCs, the benefits of the simplified approach include: reduced compliance effort to meet the benefits test as well as greater certainty that the price charged for the qualifying activities will be accepted.[274]

For tax administrations, the simplified approach reduces the administration involved in pricing low value-adding services. The approach achieves an appropriate balance between theoretical sophistication and practical application that is commensurate with the tax at stake in the countries paying and receiving the charge.[275] This approach is beneficial for tax authorities with limited resources to perform transfer pricing audits to verify if the intra-group services charge is at arm's length[276] and it ensures that tax administrations are provided with targeted documentation to enable efficient review of compliance risks.[277]

5.2.2 *Implementation of the Simplified Method for Low Value-Adding Intra-Group Services in Africa*

Although the 2011 OECD survey showed that some OECD countries (Australia, Austria, Japan, Netherlands, New Zealand and the United States) apply the simplified method for low value-added services,[278] its use in African

Notes

264 *Ibid.*, para. 7.57.

265 OECD, *supra* n. 87; OECD, *supra* n. 11, in para. 7.43.

266 OECD, *supra* n. 11, para. 7.56.

267 *Ibid.*, para. 7.57.

268 For example, the allocation key for employment services might be each company's share of total group headcount; IT services might use the share of total users; fleet management services might use the share of total vehicles and accounting support services might use the share of total transactions or assets. *Ibid.*, paras 7.58–7.59.

269 OECD, *supra* n. 11, para. 7.61.

270 *Ibid.*, para. 7.55.

271 *Ibid.*, para. 7.64.

272 *Ibid.*, para. 7.63.

273 OECD, *supra* n. 87, at 153–156.

274 OECD, *supra* n. 11, para. 7.52.

275 *Ibid.*; L. Yi Ying, *The Arm's Length Pricing for Intra-Group Services – Transfer Pricing*, MCom Dissertation University of the Witwatersrand (2017).

276 OECD, *supra* n. 11, para. 7.52.

277 OECD, *supra* n. 87, at 153–156.

278 OECD, *supra* n. 11, para. 11.

countries is limited due to concerns that it might be abused. South Africa has for example, consistently stated that it will not apply the simplified method.[279] Instead, SARS is taking a pragmatic but firm approach of evaluating payments for intra-group services, such that where clear commercial justification or reasonableness for those payments is lacking, the payments are disallowed.[280] South African is adamant in using the ALP for services fees even though taxpayers may seek to exploit the limitations of the ALP to their advantage.[281] On 22 February 2017, South Africa's Minister of Finance indicated that SARS would be updating Practice Note 7 on transfer pricing to include new guidance on the ALP in light of Action 8–10 of the BEPS Action Plan.[282] There is however no indication from SARS that it will adopt the simplified approach for low value-adding intra-group services.

Unlike the position in South Africa, further afield in Zambia, the Income Tax (Transfer Pricing) Regulations of 2000, were amended by the Income Tax (Transfer Pricing) Regulations 2018 (published on 6 April 2018), to provide rules for low value add intra-group services at cost plus 5%, provided that the service charge is based on an appropriate cost allocation method. Any mark-up beyond 5% has to undergo a comparability analysis. Zambia's regulations define low value adding group services as those that: no group entity provides to third parties, create no intangibles nor involve the assumption or creation of significant risks.[283]

It would be in the interest of other African countries that face challenges in the application of the ALP to services, to adopt the simplified method for low value added intragroup services, after evaluating whether the country's special social-economic circumstances won't open the approach to abusive practices. Concerns about the design of the provisions could be resolved by reference to the toolkit developed by the Platform for Collaboration on Tax, to equip developing countries to protect their tax bases from excessive intra-group service charges.[284]

5.3 *Use of the Sixth Method for Transfer Pricing of Commodities*

The transfer pricing of commodities is a concern for developing countries that depend on the commodity sector as the main source of economic activity, employment and government revenues.[285] In South Africa, SARS identified the following key transfer pricing risks in the mining industry; fragmentation of the supply chain using intermediary marketing and sales entities; excessive debt deductions through thin capitalization; intra-group charges including services and royalty payments.[286] Despite these concern, the IMF highlights that transfer pricing of commodities in developing countries has received relatively little attention in terms of transfer pricing guidance.[287] In September 2014, the International Mining for Development Centre identified a strong need for a study focusing specifically on the administration of transfer pricing in the African mining sector.[288] The difficulties of conducting a transfer pricing comparability analysis in the mining sector are compounded by the relative complexity of the sector, which can involve hard-to-value intangibles, the lack of industry specific knowledge and experience within tax administrations.[289] These factors place significant pressure on many tax administrations, limiting their capacity to adequately monitor and address transfer pricing risks in the mining sector.[290] Tax administrations also face difficulties in accessing information on offshore entities that may be party to the transaction, often this is complicated by the treaty networks that the parties take advantage of.[291]

In response to these challenges, some developing countries have adopted alternative approaches for pricing com-

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[279] UN, *supra* n. 1, para. D.5.7.3.

[280] *Ibid.*, para. D.5.7.8.

[281] *Ibid.*, para. D.5.11.2; Y. Y. Lee, *The Arm's Length Pricing for Intra-Group Services – Transfer Pricing* 36 (University of the Witwatersrand, Research Report 2017), http://wiredspace.wits.ac.za/jspui/bitstream/10539/24696/1/Research%20report_Final.pdf (accessed 30 Aug. 2019).

[282] South Africa National Treasury, *Budget Speech* 137 (Feb. 2017), (accessed 27 Aug. 2019).

[283] BDO Zambia, *2018 Transfer Pricing Regulations* (May 2018), https://www.bdo.co.zm/getattachment/Insights/Publications/2018-Transfer-Pricing-Regulations/Final-BDO-Transfer-Pricing-Alert-May-2018.pdf.aspx?lang=en-GB&ext=.pdf&disposition=attachment. (accessed 30 Aug. 2019).

[284] Platform for Collaboration on Tax, *supra* n. 92.

[285] OECD, *Discussion Draft on a BEPS Action 10: Cross-border Commodity Transactions* (OECD Publishing 2015), para. 1.

[286] N. Gosai, *Transfer Pricing in the Mining Industry* (Dec. 2011), http://www.eisourcebook.org/cms/files/attachments/other/Transfer%20Pricing%20in%20the%20Mining%20Industry%20(RSA%20view).pdf (accessed 3 Aug. 2015).

[287] IMF, *supra* n. n 92, at 32.

[288] International Mining for Development Centre, *supra* n. 109.

[289] *Ibid.*, at 5.

[290] *Ibid.*, at 5.

[291] Gosai, *supra* n. 286.

modities, such as the sixth method, which was initially applied in Argentina but is now used by other South American countries such as Brazil, Peru and Chile.[292] India is also applying this method.[293] The method is used to determine an arm's-length price for importing and exporting commodities such as; grains, seeds, oil, gas, mining and fishing.[294] Although the application of the method may differ from country to country, a common feature is that it makes specific reference to the use of publicly quoted commodity prices of transactions between associated enterprises, as a guide for pricing commodities.[295] Although the sixth method may be considered as an anti-avoidance measure, its adoption reflects an intention of simplifying the application of the ALP to the complexity of commodity transactions, for which comparable data may be scarce.[296]

5.3.1 *Advantages of the Sixth Method and an Example of Its Use in Africa*

The sixth method provides greater certainty and simplicity because it uses a relatively objective point of reference for pricing commodities since they are traded on public exchanges. The method is considered; predictable, easy to administer, it does not involve subjective judgment or detailed examination of facts and circumstances and it ensures efficient tax collection for tax authorities.[297] In mineral rich African countries, there have been calls from civil society that the sixth method should be implemented, but there is not much use of the method presumably because there has not been international guidance in the consistent use of the method.[298] A notable use of the method is in Zambia.[299] The transfer pricing provisions in Section 97A(13) of Zambia's Income Tax Act refer to, the use of a 'reference price' for pricing transactions involving the sale of base or precious metals directly or indirectly between related or associated parties using: the monthly average London Metal Exchange cash price; the monthly average Metal Bulletin cash price (if the base metals or precious metal prices are not quoted on the London Metal Exchange); the monthly average cash price of any other metal exchange market as approved by the Commissioner-General (if it is not quoted on the London Metal Exchange or Metal Bulletin).[300]

5.3.2 *Drawbacks of the Sixth Method*

There are however some challenges in the use of the sixth method. Firstly, it may not be recognized by a counter party to a cross-border transaction, as it is not one of the traditional recognized methods of arriving at a transfer price.[301] Furthermore, unlike the other recognized transfer pricing methods, it does not allow for comparability adjustments to the publicly available price, so it does not take into account the economic factors pertaining to the transaction.[302] Thus it can be inaccurate compared to the standard application of the ALP.[303] A further disadvantage is the risk of potential double taxation as there is a possibility of over compensation of one of the associated parties to the transaction at the expense of the other.[304]

5.3.3 *OECD Guidance on the Sixth Method*

Despite these challenges and the increasing use of this method, matters pertaining to the transfer pricing of commodities were not initially covered in the OECD BEPS Agenda. But upon the insistence of developing countries, the OECD included cross-border commodities in Action 10 of the BEPS Reports[305] in which it describes commodities as physical products for which a quoted price is used by independent parties to set prices.[306] Consequently, the OECD revised Chapter II of its Transfer Pricing Guidelines to protect the tax bases of commodity dependent countries, by ensuring that parties performing value-adding functions in relation to commodities are remunerated with arm's length

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[292] International Mining for Development Centre, *supra* n. 109, at 9.

[293] V. Grondona, *Transfer Pricing: Concepts and Practices of the 'Sixth Method' in Transfer Pricing*, South Centre Tax Cooperation Policy Brief No 2, 1 (Jan. 2018).

[294] UN, *supra* n. 1, para. B.1.5.10.

[295] Platform for Collaboration on Tax, *supra* n. 92, para. 2.4.2.

[296] *Ibid.*

[297] UN, *supra* n. 1, at 215.

[298] International Mining for Development Centre, *supra* n. 109, at 9.

[299] ZM: Income Tax Act, Ch. 323 of the Laws of Zambia.

[300] ZM: Income Tax Act Ch. 323 of the Laws of Zambia, s. 97A (14).

[301] UN, *supra* n. 1, at 214.

[302] *Ibid.*

[303] *Ibid.*

[304] *Ibid.*

[305] OECD, *supra* n. 285.

[306] *Ibid.*, para. 2.

compensation.[307] The OECD recommends that the effective implementation of its guidelines demands that tax administrations should have knowledge of how the commodity markets operate and how commodity businesses contribute to value at various stages in the value chain.[308] With respect to the difficulties tax administrations face in obtaining information to verify the price of commodities, the guidance states that the CUP method can be an appropriate transfer pricing method; and that quoted or publicly available prices can be used under the CUP method as a reference to determine the arm's length price for controlled commodity transactions.[309] The OECD also provided guidance on comparability adjustments for commodities, and it undertook to carry out research to identify common adjustments to quoted prices that account for physical and functional differences in the controlled transaction,[310] especially with respect to mineral commodities that are traded as ores or in intermediate forms.[311] When the 'Platform for Collaboration on Tax' issued a 'discussion draft toolkit for addressing difficulties in accessing comparable data' in 2017,[312] it noted that using quoted prices as a basis for determining an arm's length price for commodities, is likely to be more reliable where there are transparent, deep and liquid markets for the target products and where the approach used is in line with industry practices.[313] However, since the pricing approach may change over time, there is potential for misalignment with industry practices where prescribed approaches are set out in legislation that takes time to be amended. To ensure arm's length pricing, the 'Platform for Collaboration on Tax' advises that a flexible approach should be adopted to allow for appropriate comparability adjustments, and for taxpayers to 'opt out' where they can demonstrate sufficient compliance with business practices.[314]

The OECD's guidance has however been criticized for not being that helpful in providing clarity on the effective, efficient and consistent application of the sixth method. The OECD focused on ensuring effective pricing of commodities under the CUP method by using comparable adjustments and yet the rationale for the sixth method was to avoid the complexities of applying the ALP. With the lack of clear guidance on the use of the sixth method itself, it is advised that African countries, which are mainly price takers with very small markets, should not attempt to adopt the sixth method individually as this would impact on foreign investment. Rather, they should push for clearer international guidance on the use of this method and then embark on its use in regional blocks with larger markets for MNCs investing in the region.

5.4 *Use of Advanced Pricing Agreements*

Even though a MNC may seek to comply with domestic transfer pricing rules by setting the appropriate transfer prices and preparing comprehensive documentation, there is always the risk that tax authorities will disagree with the approach taken, which may result in preparing additional documentation, managing tax audits and conducting litigation.[315] As transfer pricing is often referred to as 'an art', not an exact science, it does require the exercise of judgment on the part of both the tax administration and taxpayer in an attempt to reconcile their differences. This can be done by signing an APA,[316] which is a binding written contract between a taxpayer and the revenue authority in which the parties agree on the best transfer-pricing method for determining the arm's length price.[317] A foreign revenue authority or more than two foreign revenue authorities may be included as party to the agreement. Such an APA is referred to as a bilateral or multilateral APA (respectively).[318] Use of APAs, helps in resolving transfer-pricing disputes and uncertainties, regarding the methods to be used by a taxpayer to arrive at an arm's length price.[319] APAs open up a possibility for taxpayers to get an approval in advance from the tax authorities on the pricing method to be applied in controlled transactions.[320] Taxpayers and the tax authorities

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[307] *Ibid.*, para. 3.

[308] *Ibid.*, para. 7.

[309] *Ibid.*, para. 6.

[310] *Ibid.*, para. 4.

[311] *Ibid.*, para. 7.

[312] Platform for Collaboration on Tax, *supra* n. 92, para. 2.4.2.

[313] *Ibid.*

[314] *Ibid.*

[315] UN, *supra* n. 1, para. A.4.14.

[316] OECD, *supra* n. 62, para. 30.

[317] Oguttu, *supra* n. 186, at 221.

[318] A. W. Oguttu, *Resolving Transfer Pricing Disputes: Are Advance Pricing Agreements the Way Forward for South Africa?*, 18 SA Mercantile L.J. 461 at 468 (2006).

[319] M. M. Levey, S. C. Wrappe & K. Chung, *The Future of Transfer-Pricing Disputes: All Roads Lead to Competent Authority*, 27 Tax Mgmt. Int'l J. 8, 379 (1998); Y. Hadari, *Resolution of International Transfer-Pricing Disputes*, 46 Can. Tax J. 47 (1998).

[320] Oguttu, *supra* n. 318, at 468; C. Rolfe & A. Casley, *Towards Reconciliation in Transfer Pricing*, Corporate Finance 37 (1996).

could also agree on other pricing principles such as how to come up with an arm's-length range of results, comparable and appropriate adjustments, and the proper application of the chosen arm's-length method to the taxpayer's particular facts and circumstances.[321] For an APA to be effective, the taxpayer would have to fully disclose to the tax authorities, all the facts of the relevant business or industry it is involved in, and the tax authority has a duty not to disclose the taxpayer's trade secrets.[322] Once an APA is finalized, it satisfies the arm's-length standard provided the taxpayer complies with its terms. The duration of an APA is normally for a fixed number of years, usually from three to five years, and is renewable.[323]

5.4.1 *Advantages of APAs*

While not directly addressing the issue of a lack of comparable information.[324] APAs can help to accelerate the procedure of arriving at arm's-length prices thus avoiding long drawn-out audits, queries and controversies, which often result in expensive transfer-pricing disputes.-[325] APAs can be particularly useful in complex situations where comparable information is not available or where a transactional profit split is found to be the most appropriate method.[326] Because of these advantages, commentators have suggested that developing countries should consider using APAs to deal with their transfer pricing challenges, since it generally requires less manpower on the part of the tax authorities to negotiate and monitor compliance with an APA than conducting a fully fledged transfer pricing audit.[327] This allows tax authorities to better utilize their scarce resources in other areas of tax administration.[328] APAs can also improve the relationship between the taxpayers and tax administration, through cooperative compliance,[329] since they provide a less adversarial and more open environment for understanding and evaluating a MNC's environment, operations and transfer pricing methodology.[330] It is however notable that APAs have been mainly introduced by developed countries such as in the USA, the United Kingdom, Australia, Canada, Germany, Japan, Spain, Korea and New Zealand.[331]

5.4.2 *Disadvantages of APAs*

APAs have been criticized for requiring the employment and retention of costly specialized personnel, which explains why in developing countries, they have been adopted at a much slower pace.[332] APA negotiations can be quite complex and contentious just as any negotiations in which issues are difficult and participants have very different interests. APAs do not solve all transfer-pricing problems and they are not suitable for all types of transactions. APAs work best for transactions undertaken by generally compliant taxpayers,[333] and they are most useful for relatively straightforward issues involving tangible property, services and routine intangibles, but not so helpful in resolving difficult issues like those involving high value intangibles.[334] The other concern is that APAs are often developed in private negotiations with a limited number of enterprises. This may have the negative effect of affecting subsequent parties that had no opportunity to influence the original agreement. In addition, since APAs are entered into for a fixed number of years, this may be disadvantageous to the taxpayer if the period is too long, that the taxpayer loses flexibility in making business decisions.[335] The APA procedure may also result in tax considerations rather than business reasons influencing transfer-pricing principles.[336] It is therefore important that great care is taken to ensure the APA is about setting

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[321] S.-O. Lodin, *Is the American Approach Fair? – Some Critical Views on the Transfer Pricing Issues*, 23(5) Intertax 243 (May 1995); T. C. Pearson & D. R. Schmidt, *Transfer Pricing Tax Concerns for Global Financial Companies*, 76 Taxes 25 (1998).

[322] Olivier & Honiball, *supra* n. 200, at 245.

[323] Levey, Wrappe & Chung, *supra* n. 319, at 3.

[324] Platform for Collaboration on Tax, *supra* n. 92, at 62.

[325] Federal Tax Conference Discussion Paper, *The Real World of Transfer Pricing Today*, 77 Taxes 175 (1999); Hadari, *supra* n. 319, at 45; Olivier & Honiball, *supra* n. 200, at 245.

[326] Platform for Collaboration on Tax, *supra* n. 92, at 62.

[327] Campos, *supra* n. 42, at 214.

[328] *Ibid.*

[329] UN, *supra* n. 1, para. C.1.3.2.4.

[330] OECD, *supra* n. 62, para. 30.

[331] Federal Tax Conference Paper, *supra* n. 325, at 175; Rolfe & Casley, *supra* n. 320, at 37; D. R. Wright, *Transfer Pricing in the United States: Recent Events and Expectations for the Future*, 55(9) Bull. Int'l Fiscal Documentation 421 (2001); H. Becker, *The Future of Transfer Pricing*, 50 Bull. Int'l Fiscal Documentation 536 (1996); K. Vogel, *Interpretation of Tax Law and Treaties and Transfer Pricing in Japan and Germany* 205–220 (Kluwer Law International 1998).

[332] The Federal Tax Conference Paper, *supra* n. 325, at 175; Hadari, *supra* n. 319, at 176.

[333] Platform for Collaboration on Tax, *supra* n. 92, at 62.

[334] Federal Tax Conference Paper, *supra* n. 325, at 175.

[335] Vogel, *supra* n. 331, at 215.

[336] Lodin, *supra* n. 321, at 243.

the most appropriate method of arriving at an arm's length price rather than making specific predictions about future events which may differ from the facts and circumstances in each actual case.[337]

5.4.3 *Developments on APA Programs in Africa*

Despite the above shortcomings, it cannot be denied that APAs can be a viable alternative option in avoiding the complex comparability analysis of the ALP. However, there are only a few APAs signed by developing countries, and often these are unilateral APAs for outbound, headquarter companies.[338]

In Africa, a few countries started adopting APAs.[339] In Uganda, the 2011 Transfer pricing Regulations provide for APAs.[340] Section 9 thereof provides that a person may request the Commissioner to enter into an APA to establish an appropriate set of criteria for determining whether the person has complied with the ALP for certain future controlled transactions undertaken over a fixed period of time. Under section 5 of the Regulations, the Commissioner may enter into an APA with the person either alone or together with the competent authorities of the country or countries of the person's associate or associates. In 2017, Morocco issued a decree providing that APAs would be implemented retrospectively from 1 January 2015.[341] Companies operating in Morocco, which are directly or indirectly dependent on a foreign-based company may file an application for an APA with the Moroccan Tax Administration at least six months before commencement of the business activities. The first Morocco APA will be for the 2019 fiscal year and will cover up to four years. In 2018, Nigeria's FIRS released Income Tax (Transfer Pricing) Regulations, which apply to financial years beginning after 12 March 2018 to replace the Income Tax (Transfer Pricing) Regulations of 2012. The 2018 Regulations provided for APAs to be effected upon the publication of relevant notices and guidelines by the FIRS.

Despite these developments on APAs in Africa, in general developing country tax administrations tend to be less comfortable about signing APAs due to the increased BEPS risk and complexity inherent in those transactions. There are also concerns about limited resources, lack of skills, lack of practical experience with APAs[342] as well as the lack of a governance framework required to conclude such negotiations.[343] In South Africa for example, SARS has declared that APAs will not be made available to South African taxpayers in the foreseeable future,[344] presumably because of a lack of administrative capacity within SARS to administer APAs (this stance has not changed up to date).[345] SARS is of the view that despite the benefits of APAs, there are also significant challenges that require cautious consideration.[346] Kenya is also reluctant to have APAs due to lack of resources to employ specialized staff.[347]

5.4.4 *Policy Considerations Before Adopting APAs*

A policy consideration for a developing country to adopt APAs requires it to first consider its socio economic circumstances and balance the need to provide certainty to taxpayers with the need for effective administration and tax collection. Since APAs are generally resource intensive, tax administrations may wish to weigh the advantages against competing resource needs, especially in the early years of enacting transfer pricing rules.[348] A country will have to consider whether to build its audit capacity or its APA capacity. Given that practically an APA consideration is analogous to an audit approach, it makes sense that a country with little audit capability should not be entering into APAs.[349] Where companies applying for an APA are considered to be lower risk, it may be questionable whether scarce audit resources should be focused on

Notes

[337] F. M. Horner, *International Co-operation and Understanding: What's New About the OECD's Transfer Pricing Guidelines*, 50 U. Miami LR. 593 (Apr. 1996).

[338] UN, *supra* n. 1, para. C.1.3.2.3.

[339] These are Egypt, Morocco, Nigeria, Tanzania and Uganda. Graphene Economics Transfer Pricing Advisory, *supra* n. 94. The Maps in the guide are based on information as at 16 Nov. 2018.

[340] UG: Income Tax (Transfer Pricing) Regulations, 2011, Statutory Instrument Supplement No.1, to The Uganda Gazette No. 2 Volume CIV dated 14 Jan. 2011.

[341] Mazars, *Transfer Pricing Rules: Morocco* (2018), https://www.mazars.ma/Accueil/Notre-expertise/Financial-Advisory-Services/Transfer-Pricing-Rules-2018 (accessed 7 Dec. 2018).

[342] UN, *supra* n. 1, para. C.1.3.2.3.

[343] OECD, *supra* n. 62, para. 31.

[344] SARS, *Practice Note: No 7 Section 31 of the Income Tax Act 1962: Determination of Taxable Income of Certain Persons from International Taxation: Transfer Pricing* (6 Aug. 1999), para. 6.2.

[345] Olivier & Honiball, *supra* n. 200, at 45.

[346] UN, *supra* n. 1, para. D 5.10.1.

[347] PWC, *supra* n. 107, para. 3.2.

[348] Platform for Collaboration on Tax, *supra* n. 92, at 62.

[349] UN, *supra* n. 1, para. D 5.10.2.

APAs.[350] A country would also have to consider whether it should use its resources to develop an APA programme or to develop key knowledge of how transfer pricing occurs in certain industries or transactions. The UN recommends that if APAs are to be adopted in developing countries, they should apply to unique cases, and should ideally be adopted bilaterally with another country[351] to reduce the potential for double taxation or double non-taxation.[352] Bilateral APAs can also eliminate the risk of so called 'sweetheart tax deals' that could abuse the system, especially if transparency is fostered though exchange of information provisions.[353] In 2017, the OECD issued guidelines in Section F, Chapter IV of the Transfer pricing Guidelines for conducting bilateral APAs under the mutual agreement procedure in Article 25 of the OECD MTC, which would be instrumental for developing countries to refer to.

6 Conclusion

This article has traced the historical developments that lead to the adoption of the ALP for curtailing transfer pricing; and the consensus reached by countries to apply the transactional pricing methods (originally developed by the USA) for determining an arm's length price. However, the comparability analysis that underpins the application of the transactional pricing methods continues to be a vexing matter for developing countries due to various policy, legislative, conceptual and administrative challenges. Acknowledging these challenges, various international groups such as the UN, IMF and OECD have recommended other alternative approaches discussed in this article, that developing countries may adopt so that they do not have to carry out a fully fledged comparability analysis in certain circumstances. The pros and cons of the relevant methods have been discussed and examples are provided of some African countries that have adopted these measures. The underlying message of this article is that the appropriateness of any of the alternative approaches, depends on each country's special circumstances, the characteristic of it economy; the type of MNCs investing in the country, and its level of administrative capacity to deal with transfer pricing and as well as other interconnected international tax matters. The article has shown that the policy options that countries have to consider, will entail a trade-off of competing options. It is hoped that the article will be found useful for other developing countries as they consider whether or not to adopt the alternative approaches.

Notes

[350] Platform for Collaboration on Tax, *supra* n. 92, at 62.

[351] UN, *supra* n. 1, para. C.1.3.2.4.

[352] OECD, *supra* n. 62, para. 30.

[353] Platform for Collaboration on Tax, *supra* n. 92, at 62.