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Finally to my parents, thank you for your patience and understanding while I tried to balance working, researching and writing and spending time with you.
ABSTRACT

UNDERSTANDING AND MANAGING RISKS AT THE INTERSECTION OF TRANSFER PRICING AND CUSTOMS VALUATION RULES

By

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SUPERVISOR: Ms C Fritz

FACULTY: Law

DEGREE: LLM (Taxation)

Transfer pricing and customs valuation rules, are both ultimately aimed at ensuring a transaction with an associated enterprise or related party is conducted at arm’s length. The literature on the intersection of these rules has identified, on the one hand, the potential for double taxation and, on the other hand, exploitation of the differences in these regimes by taxpayers.

After identifying the obstacles to harmonisation of customs valuation and transfer pricing rules and the opportunities for applying these rules in a harmonised way (in order to manage the risks associate with these rules), this mini-dissertation critically analyses the South African income tax and customs legislation and evaluates it by way of a case study based on the author’s recent experience. This analysis and case study illustrates that in general transfer pricing documentation cannot be used to show that the transaction value of the imported goods is arm’s length and that the prospects for harmonisation of transfer pricing and customs valuation rules in South Africa are poor.

The means of managing the transfer pricing and customs valuation risks identified in the existing literature and the case study are further analysed to identify whether they are feasible in South Africa. It is established that importers should incorporate information relevant to customs authorities in their transfer pricing documentation and use provisional declarations where future transfer pricing adjustments are expected. The importer should
also evaluate its transfer prices continually in order to avoid year-end transfer pricing adjustments.
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### LIST OF ABBREVIATIONS AND ACRONYMS

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<td>Advance Pricing Agreement</td>
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<td>C&amp;E Act</td>
<td>Customs and Excise Act (91 of 1964)</td>
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<tr>
<td>Customs Duty Act</td>
<td>Customs Duty Act (30 of 2014)</td>
</tr>
<tr>
<td>EU JPTF</td>
<td>European Union Joint Transfer Pricing Forum</td>
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<td>GATT</td>
<td>General Agreement on Tariffs and Trade</td>
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<tr>
<td>GVC</td>
<td>Agreement on the Implementation of Article VII of the General Agreement on Tariffs and Trade</td>
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<td>ICC</td>
<td>International Chamber of Commerce</td>
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<td>OECD</td>
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<td>OECD MTC</td>
<td>OECD Model Tax Convention on Income and on Capital 2014</td>
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<td>Practice Note 7</td>
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<td>SARS</td>
<td>South African Revenue Service</td>
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<tr>
<td>TAA</td>
<td>Tax Administration Act (28 of 2011)</td>
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<td>TCCV</td>
<td>Technical committee for customs valuations of the World Customs Organisation</td>
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<td>TP Guidelines</td>
<td>OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations</td>
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<td>VDN</td>
<td>Value Determination Number</td>
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<td>VOC</td>
<td>Voucher of correction</td>
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<tr>
<td>WCO</td>
<td>World Customs Organisation</td>
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<td>World Trade Organisation</td>
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CHAPTER 1: INTRODUCTION

1.1 BACKGROUND TO TRANSFER PRICING AND CUSTOMS VALUATION RULES

This mini-dissertation examines and evaluates the relationship between income tax transfer pricing (referred to hereafter as “transfer pricing”) rules and customs valuations rules, particularly in the South African context.

Transfer pricing refers to the price at which an enterprise transfers physical goods or provides services to an associated enterprise which forms part of the same multinational group. Based on the principles reflected primarily in article 9 of the OECD MTC, which forms the basis for most bilateral income tax treaties, associated enterprises which are members of the same multinational group must be taxed on an arm’s length basis when they transact with each other.¹

Customs valuation refers to the rules for determining the value of imported goods, mainly for the purpose of applying ad valorem rates of customs duties. Customs valuation is also an essential element for compiling trade statistics, monitoring quantitative restrictions, applying tariff preferences, and collecting national taxes.²

Transfer pricing and customs valuation rules, are both ultimately aimed at ensuring a transaction with an associated enterprise or related party is conducted at arm’s length. The literature on the intersection of these rules has identified, on the one hand, the potential for “double taxation”³ and, on the other hand, exploitation of the differences in these regimes by taxpayers.⁴

---

¹ TP Guidelines 18-19, para 6-11.
² WCO “What is Customs Valuation?” (2016)
³ This form of “double taxation” occurs when tax and customs authorities take contradictory positions on transfer prices. For example a taxpayer may be subject to a downward adjustment of its transfer prices by tax authorities (i.e. the transfer price of the goods is lowered) which will increase its taxable income, without a corresponding downward adjustment to the customs value of goods, which would result in a rebate of customs duty paid. Please see An, Gambardella & Ritchie, 2010:1035; Kennedy & Pearson, 2011: 503.
An importer may exploit the differences between transfer pricing and customs valuation rules by making an upward adjustment to the transfer price of imported goods (which decreases the importer’s taxable income), while avoiding an increase in the customs value (and the importer’s customs duty liability) in respect of the same imported goods.\(^5\)

From an importer’s perspective the potential for “double taxation” arises when tax and customs authorities take inconsistent approaches to audits. In an audit customs authorities aim to identify below arm’s length transfer prices, which result in less customs duty being payable. Tax authorities take the converse approach, seeking to identify above arm’s length transfer prices which would reduce a taxpayer’s taxable income.\(^6\)

There are also fundamental differences between these rules which exacerbate the inconsistent positions taken by different authorities. Many states have based their domestic legislation regarding customs valuations on the principles in GVC due to their obligations as members of the World Trade Organisation (hereafter the “WTO”).\(^7\) The influence of the Organisation for Economic Development and Co-operation (hereafter the “OECD”) has been pervasive on transfer pricing rules adopted by many countries, as the arm’s length standard is included in article 9 of the OECD MTC and in the TP Guidelines, but there is no general legal obligation on states to adopt specific transfer pricing rules.\(^8\)

Some of the material differences between these rules, amongst others, are:

(i) Transfer pricing rules aggregates the results of all transactions over a prescribed period, generally after the fact. Customs valuation rules, on the other hand, are based on a transaction-by-transaction approach, with the value being determined at the time of importation;\(^9\)

(ii) Transfer pricing rules provide a taxpayer with a choice of several methods of comparison when analysing transactions with an associated enterprise. The taxpayer’s choice of method is flexible, as the TP Guidelines do not stipulate when a

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\(^5\)Ainsworth, 2007:2; Murphy & Files, 2009:155.
\(^7\)Ainsworth 2007:30, 38; An, Gambardella & Ritchie, 2010:1036.
\(^8\)Ainsworth 2007:8-9.
particular method must be applied. However, the onus is on the taxpayer to justify its chosen method as the most appropriate method based on taxpayer's circumstances. Customs valuation rules allow a taxpayer importer to provide a wide variety of evidence to show that the price of the goods imported in a transaction between related parties has not been influenced by their relationship. However, if this test is not satisfied, customs valuation rules provide for the hierarchical application of several valuation methods which should approximate the price of the imported goods. When compared to the flexible methods in the TP Guidelines, the potential for inconsistent results arises;

(iii) Transfer pricing rules do not deal with “assists” (i.e. certain goods and services supplied by the importer to the seller free of charge or at a reduced cost for use in connection with the production and sale for export of the imported goods) as an addition to the transfer price of goods; and

(iv) Customs valuation rules only include certain royalty charges in the determination of the customs valuation of goods, whereas a transfer pricing analysis takes into account the wider concept of intangibles.

To address several of these concerns and explore the feasibility of harmonisation of customs valuation and transfer pricing rules, the World Customs Organisation (hereafter the “WCO”) and OECD held joint conferences in 2006 and 2007.

1.2 OECD AND WCO JOINT CONFERENCES ON TRANSFER PRICING AND CUSTOMS VALUATION

The first conference in 2006 concluded that there were diverging schools of thought on the question of harmonisation. Those in favour of harmonisation look to the basic principle that transfer pricing and customs valuation rules both seek to ensure that an arm’s length
standard applies in transactions between related parties. When these rules produce inconsistent results, their credibility is brought into question, there is a greater compliance cost for business and a greater enforcement cost for government. Their primary recommendation was to develop guidelines or notes to the GVC based on the OECD Guidelines, which are viewed as more detailed and precise than the GVC.\textsuperscript{14}

Those against convergence point out the different principles applicable to transfer pricing and customs valuation rules. They also expressed concern that developing convergence may be more costly than the status quo and capacity building issues in developing countries which would arise with convergence.\textsuperscript{15}

The conference ended with a question for further debate: Whether there are circumstances under which customs authorities could accept certain transfer pricing documentation or accept a transfer price for customs purposes, based on an advance pricing agreement. It was also suggested that joint audits or exchange of information between customs and tax authorities should be explored.\textsuperscript{16}

At the second conference in 2007 it was indicated that there was an increasing trend towards convergence with customs authorities reviewing transfer pricing documentation and joint action by customs and tax authorities. The two diverging schools of thought on convergence, identified at the previous conference, continued to exist, although authorities attending the conference agreed that there was a need to increase consistency between customs valuations and transfer pricing. It was suggested that authorities should explore joint approaches to compliance, audits and advance pricing agreements.\textsuperscript{17}

\textsuperscript{14} WCO/OECD Conference on Transfer Pricing and Customs Valuation: Summary Remarks by Kunio Mikuriya, WCO Deputy Secretary General Brussels (Belgium), 3-4 May 2006, 1.
\textsuperscript{15} WCO/OECD Conference on Transfer Pricing and Customs Valuation 2.
\textsuperscript{16} WCO/OECD Conference on Transfer Pricing and Customs Valuation 2.
\textsuperscript{17} Second WCO/OECD Conference on Transfer Pricing and Customs Valuation: Summary Remarks by Kunio Mikuriya, Deputy Secretary General, World Customs Organization Brussels (Belgium), (22-23 may 2007) 2.
1.3 PROBLEM STATEMENT

The issues considered in the section above are longstanding. The first substantial article appears to have been published by Jovanovich in 2000, more articles where then published around the same time as the OECD and WCO joint conferences in 2006 and 2007. Articles have been published more recently as well (e.g. by Lasinski-Sulecki in 2013). However, overall literature on the intersection between transfer pricing and customs valuation is limited. The literature is principally concerned with two issues:

(i) harmonising inconsistencies between income tax transfer pricing and customs valuation rules; and

(ii) customs valuation and transfer pricing risks facing multinational enterprises, which require co-ordinated risk management practices.

A longstanding issue in this field is whether the harmonisation of transfer pricing and customs valuation rules is possible. Notable articles in this field by Jovanovich\textsuperscript{18} and Ainsworth\textsuperscript{19}, amongst others,\textsuperscript{20} suggest that full harmonisation of the transfer pricing and customs valuations rules is challenging. Other articles indicate that a level of harmonisation is not only desirable but necessary due to the risks facing taxpayers who import goods acquired from related suppliers. Thus, harmonisation is not only desirable for importers (in order to reduce their costs in having to prepare transfer pricing documentation and a customs valuation) but is necessary to manage transfer pricing and customs valuation risks.\textsuperscript{21}

There is also some debate on the extent to which a transfer pricing adjustment can affect the customs valuation of goods (ie, how connected these regimes really are). In particular, it has been argued that a transfer pricing adjustment can be viewed as a legal fiction and for so long as the adjustment remains a fiction, there is no basis to increase (or decrease) the customs value of the goods which is based on the amount paid or due for the imported goods.

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\textsuperscript{18} Jovanovich, 2000:21-22, 133-134.
\textsuperscript{19} Ainsworth, 2007:10-12.
\textsuperscript{20} Methenitis & Wrapp, 2008:3-8; Ramanujan 2009:286-290; Lasinski-Sulecki, 2013: 178-179.
goods.\textsuperscript{22} While this may be correct, it does not address the potential for “double taxation”, raised by other authors, as a result of inconsistent treatment of importers (who import goods from related parties) by tax and customs authorities due to the fundamental differences between transfer pricing and customs valuation rules which are mentioned above.\textsuperscript{23}

Moreover, several authors practicing in the fields of customs and transfer pricing have identified scenarios arising from transfer pricing adjustments which may have significant customs duty implications. They indicate, that customs authorities may view transfer pricing adjustments by importers with some suspicion.\textsuperscript{24}

These articles rely on case studies to show how instances of “double taxation” may arise. However, these case studies:

(i) do not assess the differences between transfer pricing and customs valuation rules in detail;

(ii) generally do not consider complex case studies involving year-end adjustments and transfer pricing documentation;

(iii) are often brief, intending to illustrate a single point.

Thus, the intersection of these regimes has not been evaluated in sufficient detail, where case studies have been conducted.

On the other hand, academic writers have, through comparative analysis of the OECD Guidelines and the GVC, identified the fundamental differences between the two sets of rules and considered the practical difficulties that multinational enterprises may face in preparing transfer pricing documentation where conflicting transfer pricing and customs

\textsuperscript{22} Lasinski-Sulecki, 2013:179.

\textsuperscript{23} Refer to section 1.1 above. See also Ainsworth, 2007:149; Methenitis & Wrappe, 2008:14; An, Gambardella & Ritchie, 2010:1035; Kennedy, Claire and Pearson, 2011:502.

valuation rules are applied. However, they do not consider whether, based on certain facts and transfer pricing documentation, a year-end transfer pricing adjustment will require an adjustment to the customs value of goods.

Moreover, the focus of research in this field has been devoted mostly to the OECD Guidelines and GVC. There has been limited discussion around the harmonisation of South African Income Tax Act and C&E Act (or the Customs Duty Act).25

The key issue which arises, after having identified instances where harmonisation is possible, remains the management of risks associated with the transfer pricing and customs valuation rules. One of the particular concerns relates to year-end transfer pricing adjustments. Transfer pricing adjustments are aggregated and occur long after a transaction, adjustments to the customs value of imported goods are required to be made to each transaction.26 The International Chamber of Commerce (hereafter the “ICC”) appears to support the use of year-end transfer pricing adjustments and has called on customs administrations to accept aggregated value adjustments by applying a weighted average customs duty rate or allocating the adjustment value according to nomenclature code. It follows that the importer should also be able to file a single declaration, rather than amended declarations for each import transaction.27 This is also recommended by Michaletos, in one of the few South African articles.28

However, there are authors that regard post-importation transfer pricing adjustments, which are supported by contractual payments, as an undesirable means of maintaining an arm’s length relationship in intragroup transactions within a multinational enterprise.29 They have instead proposed more proactive measures, such as monitoring budgeted and actual financial performance of the importer during the year.30

25 The Customs Duty Act is not yet effective. The first phase of implementation of all new customs legislation is expected to occur before the end of the 2016/17 financial year, see: SARS Letter from J Michaletos, Chief Officer: Customs and Excise (16 May 2016).
28 Michaletos, 2013:45.
Moreover, it has recently been argued that transfer pricing adjustments, which result in payments between the related parties to bring their financial results in-line with their transfer pricing analysis, do not represent typical arm’s length behaviour between independent third parties.\textsuperscript{31} Thus, it is questionable whether post importation transfer pricing adjustments are desirable at all.

1.4 PURPOSE STATEMENT

The main purpose of this study is to evaluate the harmonisation of customs valuation and transfer pricing rules in the South African legal regime, particularly with regard to year-end transfer pricing adjustments, and to also to critically analyse the means of managing transfer pricing and customs valuation risk.

1.5 RESEARCH OBJECTIVES

The objectives of this dissertation are:

(i) To critically analyse the transfer pricing rules under the Income Tax Act and the customs valuation rules under the C&E Act (although the Customs Duty Act is also referred to) and consider how they impact importers making year-end adjustments;

(ii) To evaluate aforesaid customs valuation and transfer pricing rules by way of a case study, in order to determine whether the harmonisation of the aforesaid rules is practically feasible and to determine whether importer’s making year-end adjustments face any particular risks; and

(iii) To critically analyse the various means of managing customs valuation and transfer pricing risks.

\textsuperscript{31}Schoeneborn,2015:153.
1.6 IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY

The evaluation of South African tax and customs legislation by way of a case study is important as there have been few publications which have evaluated how South African customs valuation and transfer pricing rules apply to a more detailed case study involving a year-end transfer pricing adjustment where transfer pricing documentation is considered.

The case study may provide useful insights for importers and tax and customs authorities, in South Africa and abroad, relating to the application of customs valuation and transfer pricing rules to the cross-border sale of goods between related parties. The case study will also be relevant to authors and practitioners in this field due to the limited publication on the intersection of customs valuation and transfer pricing rules.

The second part of this study, which critically analyses the means of managing customs valuation and transfer pricing risks, is important as there are conflicting views on the desirability of making year-end adjustments for transfer pricing and customs purposes, whilst various other means of managing customs valuation and transfer pricing risks exist. Again, this study will make recommendations which will be relevant to the multinational enterprises, tax and customs authorities, in South Africa and abroad and practitioners (whether accountants or lawyers) in this field as it will weigh in on existing debate on year-end transfer pricing adjustments which is still a relatively new and unresolved issue.

1.7 RESEARCH METHODOLOGY

The research in this study is entirely qualitative in nature, based on:

(i) Articles written by academics and practitioners in the tax (specifically transfer pricing) and customs fields;

(ii) Legislation and interpretative statements issued by customs and tax authorities;

(iii) The GVC and TP Guidelines; and
(iv) Material prepared by the ICC and WCO.

The research seeks to understand how transfer pricing and customs valuation rules may result in “double taxation” on intra-group transactions by multinational enterprises as a result of principle differences in customs valuation and transfer pricing rules, their application by tax and customs authorities, and how these risks can be effectively managed.

1.8 STRUCTURE OF THE MINI-DISSERTATION

Chapter 1 provides an introduction and background to the present research and also sets out the research objective. The rationale for the present research is discussed, the delimitation of the present research is explained and the research methodology is briefly summarised.

Chapter 2 identifies the similarities and differences between transfer pricing rules, primarily based on the TP Guidelines, and customs valuation rules, principally the GVC, and their implementation by tax and customs authorities, which create risks for multinational enterprises and opportunities for arbitrage. The risk management strategies proposed in the USA and other countries are then explored.

Chapter 3 forms the basis for the critical analysis, including identification of similarities and differences, of customs valuation and transfer pricing rules and practice in South African legislation.

Chapter 4 evaluates the South African customs valuation and transfer pricing rules and practice by way of a case study. The case study and evaluation in particular, considers the use of year-end adjustments by importers.

Chapter 5 considers the outcome of the case study in chapter 4 and considers the various means for managing customs valuation and transfer pricing risks in South Africa.
Chapter 6 brings the dissertation to its conclusion. The chapter summarises the findings and conclusions from the other chapters, explains the contribution and limitations of the present study, and also makes suggestions for future research.
CHAPTER 2: THE HISTORY AND PRESENT STATUS OF EFFORTS TO HARMONISE CUSTOMS VALUATION AND TRANSFER PRICING RULES

2.1 INTRODUCTION

Transfer pricing and customs valuation rules have several elements which must be considered in order to gain a complete understanding of all of the ways in which these rules may be harmonised, or are irreconcilable. However, even when the customs and transfer pricing rules are not directly comparable, there opportunities for customs and tax authorities and taxpayers to engage successfully, resulting in some harmonisation of transfer pricing rules but also create additional risk for conflict between customs and tax authorities and taxpayers.

This chapter considers how customs valuation and transfer pricing rules establish that parties are related. It also compares and contrasts the valuation methods for customs and transfer pricing and related rules.

It further considers the different approaches of tax and customs authorities to the review of international transactions, the practical difficulties of harmonisation and the approaches taken by the authorities and taxpayers to achieving harmonisation of these regimes.

2.2 RULES DEFINING THE RELATIONSHIPS BETWEEN PARTIES FOR CUSTOMS VALUATION AND TRANSFER PRICING PURPOSES

The first comparison that will be undertaken concerns the definition of the relationship between two parties. The approximately 150 member states of the WTO have based their

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1 Customs and tax authorities are referred to separately due to the fact that some jurisdictions have separate authorities to administer customs and legislation, as opposed to SARS in South Africa which administers customs and tax legislation.
definition of a “related party” in their customs legislation on the GVC. In terms of article 15(4) of the GVC, parties are related if:¹

“(a) they are officers or directors of one another’s business;

(b) they are legally recognised partners in business;

(c) they are employer and employee;

(d) any person directly or indirectly owns, controls or holds 5 per cent or more of the outstanding voting stock or shares of both of them;

(e) one of them directly or indirectly controls the other;

(f) both of them are directly or indirectly controlled by a third person;

(i) together they directly or indirectly control a third person; or

(h) they are members of the same family.”

Article 15(5) of the GVC provides that:

“In addition, persons who are associated in business with one another in that one is the sole agent, sole distributor or sole concessionaire, however described, of the other are deemed to be related for the purposes of the GVC if they fall within any of the above criteria.”

The definitions in articles 15(4) and (5) appear to contain some formalistic legal tests and some substantive economic tests for establishing whether parties can be considered related. Paragraphs (a), (b), (c), (d), (h) of article 15(4) of the GVC are common legally defined relationships (i.e. employer and employee). Paragraphs (e), (f) and (g) of article

¹ Ainsworth, 2007: 30.
15(4) of the GVC consider whether a party is controlled by another party, even though there is no direct relationship between them. These latter tests for control appear to have their origin in the United States’ customs legislation which contained similarly worded tests. This aspect of the GVC was influenced by United States customs legislation in which control by one party, over another, is considered by examining the economic relationship between the parties to determine whether one party actually controls another.\(^3\)

However, Ainsworth argues that the definition of “control” in the interpretative notes to the GVC, which provides that one person shall be deemed to control another when the former is legally or operationally in a position to exercise restraint or direction over the latter make the definitions in paragraphs (e), (f) and (g) of the article 15 purely legally defined relationships as well, as one party must have some legal or other authority to control the other party. This means, in his view, that article 15 the GVC sets out eight legally defined tests to determine whether parties are related, only.\(^4\) The interpretation of control in the GVC’s interpretative notes is regarded as interpreting control by referring to general forms of control as the result of a (the exercise of restraint or direction) and has thus been criticised as circular and vague.\(^5\)

In comparison there is no uniformity amongst countries in the definition of related or associated parties in relation to income tax. These definitions may focus on the economic substance of the relationship between the parties in order to determine that a relationship exists, like the United States’ customs legislation, whilst other definitions are more concerned with a formalistic legal definition of the relationship between the parties like those found in the GVC.\(^6\) Other countries may have no relationship rules for transfer pricing purposes or may have particularly stringent transfer pricing rules that apply to a transaction regardless of the relationship between the parties to the transaction.\(^7\)

Because of the differences between the standardised definition of “related parties” for customs and the individualised approach to defining relationships for transfer pricing

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\(^3\) Ainsworth 2007:30. 26 CFR § 1.482-1(i)(4) refers to “…any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the action of two or more taxpayers acting in concert or with a common goal or purpose.”

\(^4\) Ainsworth, 2007: 34.


\(^6\) Ainsworth, 2007:37.

\(^7\) Ainsworth, 2007: 37-38.
purposes it is possible that two persons may be related for transfer pricing purposes while not for customs purposes. In Ainsworth’s example, he considers circumstances where the relationship between two persons does not fall within one of the legally defined relationships in the GVC but one person does in substance exercise control over the other. Thus, these persons may be related for transfer pricing purposes in a jurisdiction which has a widely cast test for relationships between parties, but are not be related for customs purpose.  

For the purposes of transfer pricing and customs valuation rules the existence of a relationship between the parties is generally crucial. Transfer pricing rules usually only apply to transaction(s) between related parties. Customs valuation rules which require an importer to demonstrate that the price actually paid or payable for the goods reflects an arm’s length price may only be applied in certain circumstances, including circumstances where the importer and the seller are related for customs purposes.

### 2.3 CUSTOMS VALUATION METHODS

The principal measure for the valuation of goods under the GVC is the transaction value. If the customs authorities are concerned that the relationship between the parties influenced the price actually paid or payable for the goods the importer is given the opportunity to provide evidence to the contrary, or to show that the transaction closely approximates one of the “test values” at or around the time of importation, in which case the transaction value must be accepted by the customs authorities.

However, article 1.2(a) of the GVC contains important elements which relate to procedural fairness. It provides that:

“the fact that the buyer and the seller are related within the meaning of Article 15 shall not in itself be grounds for regarding the transaction value as unacceptable. In such case the circumstances surrounding the sale shall be

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8 Ainsworth, 2007: 35.
10 Article 1.2 of the GVC. These test values are the substitute methods referred to on pages 20 and 21, save for the fall-back method.
examined and the transaction value shall be accepted provided that the relationship did not influence the price. If, in the light of information provided by the importer or otherwise, the customs administration has grounds for considering that the relationship influenced the price, it shall communicate its grounds to the importer and the importer shall be given a reasonable opportunity to respond."

The important aspect of article 1.2(a) of the GVC is that the transaction value cannot be rejected out of hand. Of course, the onus is on the importer to provide adequate information to the customs administration to enable it to consider the circumstances surrounding the sale. Where the importer does provide information to the customs administration the information must be considered and in the event that the information is rejected, the grounds for the rejection must be communicated to the importer with a sufficient explanation of the reasons for rejecting the value declared by the importer, which would enable the importer to respond to the customs administration’s concerns.\(^\text{11}\)

If the importer’s response does not satisfy customs authorities that the circumstances of the sale did not influence the transaction value then the GVC allows the importer to demonstrate that prescribed substitute values closely approximate the transaction value of the goods.\(^\text{12}\) The substitute values are the same valuation methods prescribed in articles 2 to 7 of the GVC.

These valuation methods are:

(i) The transaction value of identical goods, which compares the value goods with like characteristics and component materials which enable them to perform the same function and be commercially interchangeable, limited adjustments are allowed in relation to commercial level and quantity of the goods;\(^\text{13}\)

\(^{11}\) WTO Thailand – Customs and Fiscal Measures on Cigarettes from the Philippines: Report of the Panel (15 November 2010) 166-168, 183-184 (hereinafter cited as the “Phillip Morris case”).

\(^{12}\) Jovanovich, 2000: 23, 57-58; Phillip Morris case 163.

\(^{13}\) GVC article 2; Ainsworth, 2007: 68.
(ii) The transaction value of similar goods which compares the value of goods which are not alike in all respects but still have like characteristics and component materials which enable them to perform the same function and be commercially interchangeable, considering the quality and reputation of the goods;\(^\text{14}\)

(iii) The “deductive value method”, reduces the unit price of the imported goods or identical or similar goods (sold in their greatest aggregate quantity) by a commission or other amount representing the distributor’s profit and general expenses, transportation costs after importation, additions to the transaction value as prescribed in article 8 of the GVC (such the costs of transportation, loading and unloading and insurance in the country of importation) and customs duties and taxes;\(^\text{15}\)

(iv) The “computed value method”, which combines the cost or value of materials, the cost of manufacturing or other processing, an amount for profit and general expenses equal to that in sales of goods of the same class or kind, which are made by producers in the country of origin, and any specific additions prescribed in article 8(2) of the GVC (such as the costs of transportation, loading and unloading and insurance prior to importation of the goods);\(^\text{16}\) and

(v) If the customs value of goods cannot be determined using the aforementioned methods then it must be determined using other reasonable means consistent with the principles of the GVC, based on the best information available in the country of importation. However, this value cannot be based on the selling price of the goods in the country of importation, the price at which the goods are sold locally in the country of export, the costs of production (other than computed values based on identical or similar goods), minimum values or arbitrary or fictitious values.\(^\text{17}\)

If the importer is unable to demonstrate to the customs administration that the transaction value is acceptable then the customs valuation methods in articles 2 to 7 of the GVC must

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\(^{14}\) GVC article 3; Ainsworth, 2007: 68.
\(^{15}\) GVC article 5; Ainsworth, 2007: 83.
\(^{16}\) GVC article 6; Ainsworth, 2007: 88-89.
\(^{17}\) GVC article 7.
be applied by the customs authority in strict sequential order (except that article 4 provides that the methods in articles 5 and 6 can be reversed at the request of the importer).  

2.4 TRANSFER PRICING METHODS

The TP Guidelines allow the use of any one or more of transfer pricing methods which need not be applied in any particular order ((unlike the GVC which requires strict sequential application of its valuation methods). The transfer pricing methods are:

(i) The “comparable uncontrolled price method”, which simply compares the price at which the taxpayer supplies goods or services in a transaction with an associated enterprise against the price at which the taxpayer or an independent person supplies the same goods or services in a similar transaction with a unrelated party;

(ii) The “resale price method”, which examines the price at which a product has been purchased from an associated enterprise and has been resold to an independent enterprise. The difference between these two prices is reduced by an appropriate gross margin which includes the taxpayer’s sales-related costs, other operational expenses and a profit amount which is commensurate to the functions performed, assets used and risks assumed by the taxpayer. What is left after these deductions is the arm’s length price for the product in the original transaction;

(iii) The “cost plus method”, which calculates the taxpayer’s costs of production in providing the goods or services to the associated enterprise and adds an appropriate gross profit percentage, determined through comparable transactions entered into by the same taxpayer or other persons;

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18 Please see the wording of articles 2 to 7 of the GVC which clearly indicate the sequence in which the tests are applied. Jovanovich, 2000: 24, 66.
20 Ainsworth, 2007: 47.
23 TP Guidelines 70-71, par 2.39-2.40; Ainsworth, 2007: 89.

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(iv) The “profit split method”, which divides the combined profits from the relevant transactions between the related parties based on the relative value of the functions performed by each party and external data which indicates how independent parties would split the profits between themselves. Alternatively, the combined profits from the transactions are split by first allocating a sufficient basic profit amongst the related parties based on market returns achieved by independent parties in similar transactions and then allocating the residual profits amongst the parties based on the dealings of independent parties but also the parties’ relative contributions in the transaction;\textsuperscript{24} and

(v) The “transactional net margin method”, which compares the net profit margin (relative to an appropriate base) that a party realises in a controlled transaction to the net profit margin that the party achieves in uncontrolled transactions involving goods of the same class or kind or the net margin that an independent firm achieves in a comparable transaction.\textsuperscript{25}

2.5 COMPARISON OF TRANSFER PRICING AND CUSTOMS VALUATION METHODS

Several authors have attempted to compare the various transfer pricing methods in the TP Guidelines with the customs valuation methods in the GVC. Their findings are that:

(i) The comparable uncontrolled price method under the TP Guidelines and the reference to the transaction value of identical or similar goods under the GVC are very similar, save that the adjustments which are allowed to be made to the comparable uncontrolled transaction are wider than those that are allowed to be made to the transaction value of the identical or similar goods – which are limited to the commercial level and quantity of the goods. The GVC has a preference for goods

\textsuperscript{24} TP Guidelines 93, par 2.108; Jovanovich, 2000: 92-93.

\textsuperscript{25} TP Guidelines 77, par 2.58; Jovanovich, 2000: 93-94.
produced by the same seller and within the same country of importation unlike the TP Guidelines;  

(ii) The deductive value method and resale price method are similar in that both methods emphasise the functional comparability of the importer. However, the greater differences in these methods arise from the deductive value method’s insistence on comparing value of goods in the country of importation only and requiring that the value of the goods imported must be compared with the value of similar or identical goods imported within a short period of time;  

(iii) The cost plus method and the computed value method are considered very similar by Ainsworth, Ramanujan and Murphy and Files. However, there are certain difficulties which arise when using the computed value method. To be able to calculate the customs value of goods using the computed value method the importer would need to obtain confidential information relating to the foreign supplier’s manufacturing costs. The foreign supplier may not be willing to disclose this information to the importer. There is also a concern that the accounting records of the foreign supplier may not be completely consistent with domestic accounting rules and again, in relation to the computed value method, the comparison of the manufacturer’s profits must be to other manufacturers in the same country; and  

(iv) The two profit based methods were both introduced recently to respond to the problem of the valuation of intangibles, which makes them incompatible with customs valuation methods, which are not meant to value intangibles. Instead, customs valuation rules include the value of certain intangibles (e.g. licence fees and royalties) in the price of the imported goods. Thus, these methods are not comparable with any of the customs valuation methods under the GVC.  

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29 Ainsworth, 2007: 84.  
Ainsworth concludes from his comparisons that transfer pricing and customs valuation methods are similar, but not completely compatible. In his view, the prospects for harmonisation of the various methods, from a legal point of view, are poor.  

Jovanovich does not attempt to directly compare the various transfer pricing and customs valuation methods. His proposal is to use transfer pricing methods to determine that the transaction value of goods has not been influenced by the relationship between the parties for customs purposes. The reason is that while the requirement that the relationship between the parties did not influence the transaction value of the goods can be viewed as a transfer pricing provision, the other valuation methods proposed in articles 2 to 6 of the GVC are not transfer pricing provisions. They only apply after the transaction value of the goods has been rejected because it does not represent an arm's length value. However, Jovanovich is of the view that results obtained from the transfer pricing methods and the substitute value methods may produce inconsistent results. This is an indication that harmonisation at the level considered by Ainsworth is problematic.

Jovanovich concludes that the application of transfer pricing rules and the customs “circumstances surrounding the sale” test provide an opportunity to harmonise the analysis of related-party transactions. As Methenitis and Wrappe also point out, the “circumstances surrounding the sale” test and transfer pricing methods are intended to accommodate reasonable economic analysis.

Jovanovich argues that there are several elements of the “circumstances surrounding the sale test” and the TP Guidelines that are similar. These are, amongst other things:

(i) Both sets of rules require the comparison of the controlled transaction with uncontrolled transactions which have been undertaken on the same or similar

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conditions with a preference for internal comparables, albeit that the TP Guidelines do allow for the use of external comparables where no internal comparables exist;\(^{38}\)

(ii) Both sets of rules require, or at least permit in relation to customs valuations, some analysis of the functions performed, assets used and risks borne by each party to a transaction in order to determine whether the controlled and uncontrolled transactions are sufficiently comparable;\(^{39}\)

(iii) The TP Guidelines require that the economic circumstances in which the controlled and uncontrolled transactions took place should be sufficiently comparable while the GVC indicates that the price of the goods in a controlled transaction will not have been influenced by the relationship between the parties if the price of the goods had been settled in a manner consistent with normal pricing policies of the relevant industry;\(^{40}\) and

(iv) Both the TP Guidelines and the GVC allow the taxpayer/importer to justify their low prices that do not appear to be arm’s length if the taxpayer/importer can show that the business strategy will ultimately result in the taxpayer producing a profit in a period of time, or as is stated in the GVC, there are valid commercial reasons for the low prices.\(^{41}\)

Thus, Jovanovich submits that there are possibilities for harmonisation of transfer pricing and customs valuation rules where the “circumstances of the sale test” is applicable, supplemented by the TP Guidelines.\(^{42}\) This approach was also adopted by tax and customs authorities represented at the WCO and OECD joint conference on transfer pricing and customs valuations as the most feasible means of harmonising transfer pricing and customs rules.\(^{43}\)

\(^{41}\) Jovanovich, 2000: 45-46.
\(^{42}\) Jovanovich, 2000: 134.
\(^{43}\) Casanovas & Malla, 2015: 24.
However, there are other differences between the GVC and TP Guidelines which are difficult to harmonise in practice and for which specific adjustments to the customs value of the goods or transfer prices are required.\textsuperscript{44}

One of the differences is that the transfer pricing methods under the TP Guidelines generally provide a range of figures which fall within the range of values that can be considered arm’s length. This is because not all independent enterprises transact at the same price. Customs valuations generally require an importer to produce an exact value. However, as Jovanovich argues, a range of equally reliable figures provided by an importer can be used to show that transaction value of goods imported was not influenced by the “circumstances of the sale”.\textsuperscript{45}

In customs valuations the analysis is made on a transaction-by-transaction basis whereas a transfer pricing analysis concerns the aggregated results of all of the importer’s transactions during the fiscal year. Jovanovich suggests that an analysis of these aggregated results may have some evidentiary value in the “circumstances surrounding the sale test” in relation to economic factors influencing the price of the goods, the functional analysis of the importer and the business strategy of the importer. However, where a transaction involves the sale of a bundle of different goods, the transaction value of each different good must be evaluated separately in order to determine whether the price of the good has not been influenced by the relationship between the parties.\textsuperscript{46}

This transaction-by-transaction approach results in an additional difficulty because the customs value of an imported good is analysed at the time of importation (a specific point in time) whereas for income tax purposes the transactions entered into are analysed after the fact when the taxpayer is required to file its return.\textsuperscript{47} This difference is further compounded by the requirement that the comparability analysis for customs must logically take place at the time of importation. In contrast, the comparability analysis undertaken for income tax purposes uses yearly or multiple years’ data. However, yearly data could be

\begin{itemize}
\item \textsuperscript{44} Jovanovich, 2000: 137-138.
\item \textsuperscript{45} Jovanovich, 2000: 52.
\item \textsuperscript{46} Jovanovich, 2000: 48-49; Methenitis & Wrappe, 2008: 20.
\item \textsuperscript{47} Cottani, 2007:288; Methenitis & Wrappe, 2008:14; An, Gambardella & Ritchie, 2010:1036; Lasinski Sulecki, 2013: 178.
\end{itemize}
used for comparability purposes when applying the “circumstances surrounding the sale test”.  

An area of significant divergence between the customs valuation and transfer pricing methods is the valuation of intangibles and how the parties are compensated for their contribution of intangibles associated with a transaction (for example the contribution to brand development through marketing).

For income tax purposes, the role of trade intangibles (eg patents, trade secrets or know-how) in transfer pricing is uncontroversial. The main issue relates to the value of the intangible and thus, the amount of the royalty paid to the owner of the intangible. The role of commercial intangibles (such as market research, public relations and quality control) in transfer pricing is much more contentious as tax authorities seek to ensure that each party is adequately compensated for its contribution to these commercial intangibles. The TP Guidelines recommend the use of the comparable uncontrolled price method, but also the transactional net margin method and the profit split method in analyses involving intangibles. Notably, the latter two transfer pricing methods were specifically developed in response to the problems arising from the valuation of intangibles in a transaction.

Customs valuation rules also take account of the role of intangibles in a transaction, but not in the same manner. Even though royalties and licence fees are specifically included in the transaction value of imported goods under certain conditions, the value of other intangibles such as goodwill are ignored. Moreover, even though the royalty or licence fee may be included in the transaction value, customs authorities do not value the intangible in respect of which the royalty or licence fee is paid.

For customs valuation purposes royalties and licence fees are added to the value of imported goods if the royalty or licence fee:

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50 Cottani, 2007: 286.
54 Cottani, 2007: 288.
(i) has not been included in the price actually paid or payable for the imported goods already;

(ii) is related to the goods being valued; must be paid as a condition of the sale (in other words, the transaction would not have been entered into without the payment of a royalty or licence fee).

Customs valuations rules also include the value of certain “assists” in the dutiable value of imported goods. These are goods and services supplied by the importer free of charge or at a reduced cost and to the extent that the cost of the goods or services has not been included in the price paid or payable for the goods. Only certain goods and services are relevant:55

(i) Materials components, parts and similar items incorporated into the goods;

(ii) Tools, dies, moulds and similar items used in the production of the imported goods;

(iii) Materials consumed in the production of the imported goods; and

(iv) Engineering development, artwork, design work, plans and sketches undertaken anywhere other than in the country of importation which are necessary for the production of the goods.

Transfer pricing rules do not deal with assists in the same manner. Thus, in order to achieve harmonisation the results of a transfer pricing or customs analysis may have to be adjusted to exclude the value of assists in order to achieve an accurate comparison of the results.56

Even if these substantive differences between the transfer pricing and customs methods can be overcome, there are also practical differences which create even further challenges for the harmonisation of transfer pricing and customs rules.

First, a practical difficulty arises when a transfer pricing adjustment is made after the end of a tax year. This sort of adjustment may be an indication that the value declared for customs purposes was not the price actually paid or payable for the goods, or did not reflect an arm’s length value. Accordingly, this may trigger a customs audit, which may in turn lead to an upward adjustment to customs duties by customs authorities. However, in many countries, a downward transfer pricing adjustment may not necessarily lead to a reduction in customs duties. Lasinski-Sulecki argues that this is the correct position legally because:  

(i) A transfer pricing adjustment is merely a legal fiction which does not necessarily result in a change to the amount legally owed by the purchaser;  

(ii) It is uncommon for parties to treat an amount which is paid to the seller after the transaction has occurred as a condition of the sale; and  

(iii) In many instances, a refund of duties paid is only available where the duties were not legally owing at the time that the goods were imported and even then, where the change in the amount legally owed is the result of deliberate action by the parties then customs authorities may still refuse to refund the duties paid. 

Jovanovich, to an extent appears to agree with this point as he regards a discount which is paid to an importer after the date on which the goods were valued for customs purposes as having no effect on the customs value of the goods retrospectively. 

The second difficulty is that transfer pricing adjustments are effected by way of aggregated adjustments in the company’s income tax return and, in some cases, the company’s accounts. Adjustments for customs duty purposes must generally be made to each transaction and thus, each customs declaration. In South Africa, this means that a voucher of correction must be passed for each import transaction in order to amend each

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SAD500 form.\textsuperscript{61} On the other hand, in Europe some customs authorities accept aggregated lump sum adjustments.\textsuperscript{62}

The third problem is that only a few countries have voluntary disclosure programmes which allow importers to correct their customs declarations. Many countries do not have voluntary disclosure programmes in place. Thus, importers in these countries risk the imposition of penalties when they attempt to correct incorrect declarations.\textsuperscript{63}

The same difficulty arises in relation to royalty payments made by importers. The royalty payable by the importer is generally determined at the end of the importer’s fiscal year and then paid to the seller or other part who owns the intellectual property. It is difficult to allocate an amount representing the royalties paid by the importer to each individual import transaction.\textsuperscript{64}

2.6 ADDRESSING THE PRACTICAL DIFFICULTIES RELATING TO HARMONISATION OF TRANSFER PRICING AND CUSTOMS RULES

2.6.1 Introduction

Given the number of theoretical differences between the various transfer pricing and customs valuation rules, the WCO and OECD joint conference in 2007 concluded that the most feasible means of harmonisation of these rules lies in the application of article 1.2 of the GVC (i.e. the “circumstances surrounding the sale test”) which permits economic analysis to determine whether a transaction value is arm’s length. It was suggested that a transfer pricing analysis could be used for customs valuation purposes if the analysis segmented the importer’s financial information. It was also recommended that importers: \textsuperscript{65}

(i) test their transfer prices regularly in order to reduce year-end adjustments; and

\textsuperscript{61} Michaletos, 2013: 45. The SAD 500 form is the Customs Declaration Form, which must be completed as prescribed for the clearance of goods for different purposes (see the Customs and Excise Act (Act No 91 of 1964): Rules (1995) rule 00.05(e)).

\textsuperscript{62} Vijaraghavan, 2015: 205.

\textsuperscript{63} Ann Gambardella & Ritchie, 2010: 1038; Nichols, 2011: 441. Please refer to 5.4 below regarding the South African position on the amendment of declarations and applicable penalties.

\textsuperscript{64} Ainsworth, 2007: 132; Ann Gambardella & Ritchie, 2010: 1039.

\textsuperscript{65} Casanovas & Malla, 2015: 24.
(ii) implement a price review system, as imports under a distribution agreement with a price review clause will enable the importer to delay the final customs value determination.

Following this conference a focus group on transfer pricing was established. As mentioned above, the focus of the OECD and WCO was to explore the possibilities for harmonisation of transfer pricing and customs valuations methods. Thus, the focus of the WCO and OECD shifted to utilising information in a transfer pricing report for customs purposes, including.\textsuperscript{66}

(i) Satisfying the “circumstances surrounding the sale” test;

(ii) The treatment of year-end adjustments by importers; and

(iii) Price review clauses.

The focus group considered 11 case studies in order to explore these three issues. Three of the case studies were presented to the technical committee for customs valuations of the WCO (hereafter the “TCCV”). These three case studies dealt with the use of transfer pricing documentation prepared according to the cost-plus method, the resale price method and the transactional net margin method\textsuperscript{67} and also dealt with the use of price review clauses. The case studies were analysed on an individual basis in which the TP Guidelines were applied in a manner which is consistent with the GVC. The aim of this exercise was to provide guidance to importers and customs authorities.\textsuperscript{68}

The TCCV then began work on a single comprehensive case study dealing with the TP Guidelines. This next case study indicated that the language of the interpretation note to Article 1.2 of the GVC was broad enough to permit the use of the TP Guidelines when applying the “circumstances surrounding the sale” test.\textsuperscript{69}

\begin{itemize}
  \item\textsuperscript{66} Casanovas & Malla, 2015: 24.
  \item\textsuperscript{67} Refer to 2.4 above for explanations of the cost-plus method, the resale price method and the transactional net margin method.
  \item\textsuperscript{68} Jovanovich, 2015: 139-142.
  \item\textsuperscript{69} Jovanovich, 2015: 139-142.
\end{itemize}
However, an examination of this case study was suspended as the secretariat of the WCO had prepared a daft commentary which would be considered by the TCCV. This draft commentary was adopted as commentary 23.1. In Commentary 23.1 the TCCV recognises.\(^\text{70}\)

(i) That a transfer pricing study may provide relevant information to customs authorities regarding the “circumstances surrounding the sale” test;

(ii) That a transfer pricing study might not be relevant or adequate in examining the circumstances surrounding the sale of imported goods because of differences between the customs evaluation methodologies in the GVC and the TP Guidelines;

(iii) “[T]he use of a transfer pricing study as a possible basis for examining the circumstances of the sale should be considered on a case by case basis”, which Jovanovich takes to mean that customs authorities must consider the information provided in a transfer pricing report and cannot reject it out of hand.\(^\text{71}\)

### 2.6.2 Provisional customs declarations

One way to address this difficulty is to allow the importer to declare a provisional value to customs authorities upon entry of the goods and to reconcile the entry once any transfer pricing adjustments have been made. In the United States and the European Union a reconciliation program is available to importers to mark entries with certain undetermined elements which must be reconciled within a limited period after the goods have been imported.\(^\text{72}\)

In the United States, the program is used on the basis that the importer must make a declaration based on the best available information on the understanding that only certain elements of the customs value of the goods remain outstanding but will be reconciled at a


\(^{71}\) Commentary 23.1 par 9; Jovanovich, 2015: 143.

later date. Thus, the importer must use the program with reasonable care, as the purpose is to allow the reconciliation of entries where certain information was outstanding, it is not to enable the importer to defer its liability for customs duty. Upon declaration of the imports for customs purposes, the importer, through an electronic interface indicates that certain entries will be subject to reconciliation. This can be done individually, or over an aggregated number of items within a certain time period. The unknown information must then be declared in the subsequent reconciliation. In relation to individual entries, the importer calculates the new customs duty amount for each entry upon reconciliation, whereas with an aggregated entry the new customs duty amount is calculated for all marked entries. However, when using the aggregate method, the importer must waive its right to a refund of any duties.\(^{73}\)

The conditions for the use of the reconciliation program in relation to transfer pricing adjustments – that the adjustments are based on an objective formula established at the time of importation – created significant difficulty for importers seeking to rely on transfer pricing documentation or an APA. This is because the objective formula required that the factors of the customs value which are subject to reconciliation should not be within the parties’ control. However, Customs and Border Protection amended its practice to allow adjustments based on an importer’s transfer policy where the following requirements are met:\(^{74}\)

(i) A written intercompany transfer pricing policy which is in place before the relevant transaction and which sets out how the transfer price must be established in compliance with transfer pricing regulations;

(ii) The importer is a United States taxpayer and files its income tax return in accordance with the transfer pricing policy;

(iii) The transfer pricing policy specifically covers the relevant product;

\(^{73}\) Offerman, 1999: 709-711.

(iv) The transfer pricing policy specifies the adjustments to be made and detailed information and calculations are provided by the importer;

(v) There are no other conditions which indicate that the transfer pricing adjustments do not result in an arm’s length price for the relevant goods.

Another option proposed by, amongst others, the ICC is for customs authorities to recognise aggregated adjustments to customs valuations in a single customs declaration if a corresponding transfer pricing adjustment has been made. It was also proposed that penalties should not be imposed in these circumstances. The two proposed methods of calculating the adjusted customs duties involve:75

(i) the application of a weighted average customs duty rate calculated as the total customs duties paid in the relevant year divided by the total customs value of imported goods during the year; or

(ii) an allocation of lump sum amounts to categories of imported goods according to nomenclature codes.

In the South African context Michaletos has called on government to address the need for a lump sum adjustment, through a bulk VOC, and to provide guidance on how adjustments should be made by an importer who imports various items which are subject to different rates of customs duty.76

2.6.3 Advance pricing agreements and transfer pricing documentation

Another proposal by Ann Gambardella and Ritchie is for taxpayers to involve customs authorities in the negotiation of an advance pricing agreement with tax authorities.77 Alternatively tax and customs authorities could also establish a joint advance pricing agreement program such as the one proposed in Australia.78

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75 ICC 6-7.
76 Michaletos, 2013: 45.
and Border Protection has in specific cases issued rulings in which it was able to establish a transaction value based on information provided to the Internal Revenue Service in an APA process. The information provided included:79

(i) Detailed information about the importer, the manufacturer and how the transfer pricing methodology was developed;

(ii) The APA concerned all product lines imported by the applicant;

(iii) Benchmarking studies which related to the seller's functions (i.e. functional analysis) and also the relevant industry; and

(iv) The APA provided for compensating adjustments which were required to be reported to Customs and Border Protection, with payment of additional duties in the event of an upward adjustment.

The reason the importer is required to provide information regarding all of its product lines is not immediately apparent as one would expect that it is sufficient for a transfer pricing analysis to establish a general profit margin applicable to all goods imported. However, in practice this requirement is important for customs authorities because of the differences in duty rates between goods. This difference makes it possible for the related parties to lower the price of goods with high duty rates and increase the price of goods with low duty rates while maintaining an arm’s length profit level in aggregate.80

Despite the above, the position remains that an APA or transfer pricing documentation is generally not sufficient to support the transaction value for customs purposes. However, the APA or transfer pricing documentation may contain relevant documentation to establish whether the transaction value of goods has been influenced by the relationship between the parties and the onus is on the importer to identify the relevant information and provide supporting documentation.81 This information includes, amongst other things:82

80 Methenitis and Wrappe, 2008: 23.
(i) segregated transfer pricing data (i.e. costs and profit margins) for each type of product imported;

(ii) a study benchmarking the profits of the manufacturer of the imported goods against profits of similar manufacturers.

### 2.6.4 Reducing reliance on transfer pricing adjustments

Another solution that has been proposed is for the importer to reduce its reliance on year-end transfer pricing adjustments (which are needed when the importer’s actual financial results differ from projected results) by monitoring financial performance closely and testing transfer prices throughout the year. Significant year-end adjustments can indicate that the transaction value of goods did not represent an arm’s length value (i.e. was influenced by the relationship between the parties). Thus, taxpayers should carefully monitor variance between actual and budgeted performance during the relevant year and make prospective changes to the price of goods in order to reduce any variance between actual and budgeted performance.83

This approach may be desirable for several reasons. Schoeneborn argues that year-end transfer pricing adjustments, which result in payments between the related parties to bring their financial results in-line with their transfer pricing study, do not represent typical arm’s length behaviour between independent third parties, as independent parties acting at arm’s length would not share their profits they earned following the transactions between them.84 The same concern was expressed by the private sector at the European Union Joint Transfer Pricing Forum (hereafter the “EU JTPF”), as they sought guidance on how to reconcile these adjustments with the TP Guidelines, which provide limited guidance on year-end adjustments.85

These adjustments also raise several other difficulties, being whether:

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84 Schoeneborn, 2015:153.
(i) the adjustment can be related to particular transactions;

(ii) the adjustment amounts are actually relevant to customs valuations of goods;

(iii) the adjustments are actually incurred in the production of the party’s income;\(^6\)

(iv) any underlying payment be permitted in countries with exchange control regulations, if there is a further payment by one party.

There is also a risk of double taxation, in relation to income tax, when related parties make these adjustments. An adjustment implies an increase in revenue which will be welcomed by the tax authorities in one country but it also implies a potential loss of revenue for tax authorities in the other country, who may be inclined to disallow the tax deduction claimed by the taxpayer pursuant to the adjustment.\(^7\) In any event, not all countries may accept these kinds of year-end adjustments. 11 of the 27 European Union members present at the EU JPTF did not regard the adjustments as permissible or did not have a policy dealing with the acceptability of year-end adjustments.\(^8\) Recently, the EU JPTF has proposed several strict criteria for an adjustment to be regarded as acceptable.\(^9\)

(i) All details regarding the adjustments must be agreed in advance in writing and the computation formula for determining the adjustment must be clearly described;

(ii) The implementation of the year-end adjustments must be uniformly and consistently applied by both parties before they file their income tax returns; and

(iii) The parties must be able to explain why the forecast results did not materialise, with reference to specific facts and circumstances.

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\(^7\) Dirk & Lim, 2012 1014-1015.

\(^8\) Dirk & Lim, 2012: 1016.

\(^9\) Schoeneborn, 2015: 155
The use of year-end adjustments is particularly prevalent in the ex post approach (also known as outcomes based testing) to transfer pricing, as opposed to the ex-ante approach (also known as the price setting approach).

Hanken and Dorward, in their research, reviewed proposed amendments to the TP Guidelines by the OECD which indicated that both prospective and retrospective adjustments are possible but given the difficulty in setting transfer prices based on current information an ex-ante approach to price setting is more logical.  

To allow tax authorities and taxpayers to perform a transfer analysis through benchmarking studies based on information available:

(i) After the date the taxpayer filed its return is obviously unfair to the taxpayer as it would be based on information which was not available to the taxpayer at the time it established and tested its transfer pricing;

(ii) At the time that the taxpayer files its return should be rejected as the deadlines for filing returns vary from jurisdiction to jurisdiction and thus, result in tax authorities applying different benchmarking studies because of the differences in information available to taxpayers at the various times tax returns are filed in the jurisdictions;

(iii) At the time that the taxpayer prepares its financial statements is possible as this is that the taxpayer can make an adjustment to its accounts. However, benchmarking information from other companies would still not be available for the relevant year; and

(iv) The date at which transfer prices were determined, prior to the start of the financial year is most logical and reasonable as it is possible for the taxpayer to determine an arm’s length margin (assuming the transactional net margin method is applied) based on benchmarking studies on earlier years.

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This price setting approach may be preferable because it mimics the behaviour of arm’s length parties who are likely to make prospective adjustments.\(^{92}\) Where a transfer adjustment is still required because the taxpayer’s actual margin falls outside of the arm’s length range Hanken and Dorward indicate that prospective adjustments may be more acceptable to the European tax authorities. They are also of the view that adjustment clauses in contracts should indicate clearly and consistently which transfer pricing method is applied and how, if any the price adjustment mechanism works. A broad agreement to set transfer prices which are consistent with the arm’s length principal may be too ambiguous, increasing the risk of double taxation. However, the ex-ante approach is practically more difficult to implement in comparison to the outcomes based approach (which does not require continuous monitoring of transfer prices) and requires resilient and accurate forecasting.\(^{93}\)

The TP Guidelines do not express a preference for the price setting approach or the outcomes testing approach.\(^{94}\) The application of these approaches varies from country to country.\(^{95}\) As with the choice of methods under the TP Guidelines, the taxpayer’s election to use the price setting approach or the outcomes based approach must be based on the facts of each case and the taxpayer should be able to demonstrate that the particular approach will provide the most reliable result. The TP Guidelines seem to suggest that some deference must be given to the taxpayer’s election, particularly in relation to the TNMM.\(^{96}\)

On the other hand, in relation to the price setting approach, tax authorities can challenge the taxpayer’s budgeting processes when challenging the transfer price set by the taxpayer. Wittendorf also suggests that taxpayer’s who apply the price setting approach may experience greater variances from established transfer prices and thus, greater scrutiny from tax authorities. Thus, taxpayer’s applying the price setting approach should carefully monitor variances between budgeted and actual results. \(^{97}\)

\(^{92}\) Hanken & Dorward, 2014: 412.
\(^{93}\) Hanken & Dorward, 2014: 412.
\(^{95}\) TP Guidelines 127.
\(^{96}\) Wittendorf, 2012: 88.
\(^{97}\) Wittendorf, 2012: 88-89.
Wittendorf also acknowledges that the outcomes based approach has its own difficulties in relation to year-end adjustments. Most jurisdictions do not provide guidance on the acceptability of year-end adjustments.\(^98\)

Comments on the proposed draft on timing issues by the OECD by businesses and consultants do not show a preference for the price setting approach or outcomes based approach. This is likely attributable to the differences in interests of the businesses relating to industry specifics, actual and individual arm’s length behaviour of corporate groups, information technology systems, human resources, product range and input and retail costs.\(^99\)

### 2.7 CONCLUSIONS

In 2.2 of this Chapter the means by which customs valuation and transfer pricing rules establish that parties are related was considered in order to determine whether they bear any similarities or differences, which may impact on harmonisation of customs valuation and transfer pricing rules. It was established that the related party rules used in customs valuations, which have been adopted by WTO member states, appear to be largely formalistic. On the other hand there are no uniform rules on relationships for income tax purposes and thus, the rules may have formalistic or substantive economic elements. It is also possible the transfer pricing rules may be applied to certain transactions between unrelated persons. As a result, it is possible for parties to be related for customs purposes but not transfer pricing purposes, or vice versa.

In 2.3 to 2.5 of this Chapter the valuation methods for customs and transfer pricing and related rules were compared and contrasted in order to determine whether harmonisation of these rules is possible in theory. It was established that transfer pricing and customs valuation methods are similar but not completely compatible. There are also wider generalised differences which exist in relation to the time at which transfer prices and customs values are compared, the use of multiple years’ data in transfer pricing compared to the limited time period for comparison for customs purposes, the aggregation of

\(^{98}\) Wittendorf, 2012: 89.

transactions for transfer pricing opposed to the transaction-by-transaction approach to customs valuations and the treatment of intangible and assists. That said, transfer pricing and customs valuation methods do share some fundamental similarities which potentially allow for harmonisation of transfer pricing and customs valuation rules where an importer is required to demonstrate that its relationship with a supplier did not influence the transaction value of the imported goods;

Despite these difficulties, the interaction between tax and customs authorities at joint WCO and OECD summits on harmonisation of transfer pricing and customs valuation rules resulted in a conclusion that the most feasible means of harmonisation of these rules lies in the application of article 1.2 of the GVC. Several other recommendations were made to address the challenges which importers face the conflicting aspects of transfer pricing and customs valuation rules including incorporating information relevant customs authorities in transfer pricing documentation and advance pricing agreements, minimising transfer pricing adjustments, aggregated customs duty adjustments, using provisional customs declarations and price review clauses (in distribution agreements);

Following on from the conclusions of the joint WCO and OECD summits 2.6 of this Chapter considered the practical difficulties of harmonisation and the approaches taken by the authorities and taxpayers to achieving harmonisation of these regimes. It was established that it is important for the importer’s transfer pricing documentation to provide a segregated analysis of each produce line acquired and distributed by the importer and specifies a formula on which transfer pricing adjustments will be made.

The same information should be provided when negotiating an APA with tax authorities when the importer intends to involve customs authorities in the negotiation of the APA, a means which also been considered to facilitate the harmonisation of customs valuation and transfer pricing rules.

Moreover, if the importer can provide this information then it may be possible for an importer to declare a provisional value, which it can reconcile at a later stage in the event of a transfer pricing adjustment, thereby enabling the importer to declare the correct transaction value to the customs authority. This means that the importer may avoid any
penalties associated with the under-declaring the customs value of the goods and avoid the overpayment of customs duties in the event that the customs value of the goods is adjusted downward at the end of the fiscal year;

It was also established that year-end transfer pricing adjustments may be an indication that the importer did not declare the correct customs value to the customs authority at the time of importation. Therefore an taxpayer should also monitor its budgeted and actual results closely throughout the year and make pro-active adjustments to transfer prices. This approach may also be desirable from a transfer pricing perspective even though both the outcomes based and price setting approaches are permissible under the TP Guidelines.

There are also a number of jurisdictions which are resistant to upward transfer pricing adjustments or have not formulated a policy to deal with such adjustments and as Hanken and Dorward have demonstrated, the most logical and reasonable time at which a taxpayer can establish its transfer prices for goods is at the beginning of the taxpayer’s fiscal year, based on benchmarking studies in prior years (thus, favouring the price setting approach).
3 CHAPTER 3: SOUTH AFRICAN APPROACH TO TRANSFER PRICING AND CUSTOMS VALUATIONS

3.1 INTRODUCTION

In Chapter 2 the prospects for harmonisation of customs valuation and transfer pricing rules were considered in relation to the GVC and TP Guidelines. The literature in respect of the GVC and the TP Guidelines provide a useful base for understanding the issues which exist in relation to the South African legislation. There has been very limited published research in this field in South Africa and concerning the South African legislation, which is of course the legislation which will be evaluated in the case study in Chapter 4. Thus, keeping in mind the issues raised in Chapter 2, this chapter will examine the transfer pricing and customs valuation rules in the C&E Act and the Income Tax Act.

This review will:

(i) consider how the C&E Act and Income Tax Act define related or connected parties, taking account of the underlying rules in the GATT and GVC (particularly as this type of analysis is not possible at an international level);

(ii) taking into account the findings in Chapter 2 in relation to the GVC and TP Guidelines and any conflicts between domestic and international rules, analyse the customs valuation rules in the C&E Act and the transfer pricing rules in the Income Tax Act in order to establish how they interact; and

(iii) establish whether there are any practices of SARS which are relevant to the application of the domestic customs valuation and transfer pricing rules which may affect the case study in Chapter 4 and how these compare to, or contrast with, international practices.
3.2 CUSTOMS VALUATIONS

3.2.1 Introduction

South Africa is a member of the WTO. Thus, unsurprisingly South Africa’s customs legislation concerning customs valuations reflects the principles of the GVC.

The South African legislation giving effect to the GVC has historically been set out in the C&E Act. However, the legislature has enacted the Customs Duty Act to replace parts of the C&E Act\(^1\) concerning, amongst other things, the valuation of goods, the payment of customs duties and imposition of penalties.\(^2\)

Even though the Customs Duty Act has been enacted it is not yet in effect. SARS is currently drafting the rules to the Customs Control Act\(^3\) and the Customs Duty Act and consulting with stakeholders on these rules. It is not clear when effective date for both Acts will be proclaimed but SARS has indicated that the first phase of implementation of all customs legislation is expected to occur before 28 February 2017.\(^4\) This mini-dissertation primarily refers to the C&E Act because SARS’ practice guidance in various external directives is based on the C&E Act. The Customs Duty Act will be referred to in relation to amendments which affect customs valuations.

Section 66(1)(d) of the C&E Act prescribes that the transaction value of imported goods is the price actually paid or payable for the goods, provided that (and subject to section 66(3)

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\(^1\) Chapter X regarding customs valuations will be deleted by section 59 of the Customs and Excise Amendment Act (32 of 2014) and referenced to valuations under Customs Duty Act, while the C&E Act will become the “Excise Duty Act” in terms of section 87 of the Customs and Excise Amendment Act (32 of 2014) and will continue to regulate the control of excisable goods.

\(^2\) National Treasury Memorandum on Objects Of Customs And Excise Amendment Bill, 2013 para 1.4: This change was necessary because the C&E Act was primarily focused on the control of imported goods, and although the C&E Act has been amended to keep up with prevailing practices and soften and modernise the system, the basic structure of the C&E Act remains unchanged. The C&E Act is still fundamentally rigid in relation to issues of customs control, making it unsuitable for the implementation of a modern system of customs control in accordance with current international trends and best practice. Thus, SARS began a process of drafting new customs legislation to give effect to various international conventions and establish a clear and logical legislative framework that compliments other legislation which relies on customs control.

\(^3\) (31 of 2014)

\(^4\) Michaletos Letter from J Michaletos, Chief Officer: Customs and Excise (16 May 2016)
of the C&E Act) the seller and importer (i.e. purchaser of the goods) are not related within the meaning of section 66(2)(a) of the C&E Act.

3.2.2 Where the transaction value cannot be accepted because the parties are related

As regards section 66(1)(d) of the C&E Act above, if it is established that transacting parties are related then the onus is on the importer to demonstrate that the relationship between the transaction parties did not influence the price paid or payable for the goods. If the importer is able to show that its relationship with the supplier did not influence the price actually paid or payable for the goods, then the transaction value of the goods (under the primary valuation method) may be utilised.

The rules which determine whether the transacting parties are related are set out in section 66(2) of the C&E Act:

“(2) (a) for the purposes of subsection (1)(d) two persons shall be deemed to be related only if-

(i) they are officers or directors of one another's business;

(ii) they are legally recognized partners in business;

(iii) the one is employed by the other;

(iv) any person directly or indirectly owns, controls or holds five per cent or more of the equity share capital in both of them; or

(v) one of them directly or indirectly controls the other;

(vi) both of them are directly or indirectly controlled by a third person;

(vii) together they directly or indirectly control a third person; or
(viii) they are members of the same family.

(b) A business relationship between a seller and a buyer whereby the one acts as the sole agent, distributor or concessionary of the other is not a business relationship for purposes of section 129(1)(i), provided that they are not otherwise related within the meaning of subsection (1)(a), (b) or (c) of this section.”

Section 66(2)(a) of the C&E Act generally reflects a number of principles set out in various parts of the GVC, specifically the relationships referred to in article 15(4) and (5) of the GVC. Ainsworth notes that the test for a “controlling” relationship between two persons in article 15 of the GVC is a legally defined test because of the manner in which the commentary in the interpretative note to article 15 of the GVC defines the concept of “control”. The note states that: “For the purposes of this Agreement, one person shall be deemed to control another when the former is legally or operationally in a position to exercise restraint or direction over the latter.”

In terms of section 74A of the C&E Act, the interpretative note the GVC and the notes thereto are binding in relation to the valuation of goods in terms of sections 65, 66 and 67 of the C&E Act. Thus, based on Ainsworth’s argument the relationships referred to in section 66(2)(a) of the C&E Act would also be legally defined relationships. However, it is submitted that this argument is not necessarily correct.

As mentioned above, this definition of control has been criticised as being vague and circular. However, regardless of whether the interpretation is vague or circular, it is submitted that such an interpretation of the “control” does not exclude other definitions of a controlling relationship and thus, does not make the test for control a purely legal test. Based on the plain meaning of the interpretative note to article 15 of the GVC, it merely deems a party to control another party where some element of legal or operation control is present. This does not exclude any other interpretation of “control”. Thus, it is submitted that the definition of control in section 66(2)(a) of the C&E Act may be open to an interpretation which would allow SARS and South African courts to examine the economic
relationship between parties. A wider interpretation of “control” has been adopted in section 27(2) of the Income Tax Act (40 of 1925). Specifically, in *ITC284* “control” was interpreted in its widest sense:⁵

“There is no doubt in our minds that whether one attaches the ordinary popular meaning of the word ‘control’ or any special meaning, or dictionary meaning, that the clause in the Act is intended to cover all those meanings.”

Interestingly, the court was willing to consider any special meaning of “control” as well as the ordinary meaning.

In *ITC1741*, a court was called on to interpret an earlier definition of “connected person” which was worded similar to relationship described in section 130(1)(c)(viii), where a company is connected to – “any other company if both such companies are controlled or owned directly or indirectly by the same persons”. The court held that control did not mean “legal control”. Instead, in the absence of any statutory definition, control meant *de facto* control, i.e. control as a matter of fact.⁶ SARS has adopted this interpretation of “control” in its interpretation note concerning the “connected person” definition.⁷

When “control” is considered in this light, it is submitted that there is no reason to restrict the interpretation of the word “control” to the meaning in the interpretative note to article 15 of the GVC.

### 3.2.3 The circumstances surrounding the sale test

As regards the rest of section 66 of the C&E Act, the “circumstances surrounding the sale” test in article 1.2(a) of the GVC and the tests article 1.2(b) of the GVC are closely reflected in section 66(3) of the C&E Act. In terms of section 66(3) of the C&E Act, the fact that the importer (i.e., the purchaser of the goods) and seller are related shall not in itself be a ground for not accepting the transaction value where such relationship did not influence

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⁵ *ITC284* (1933) 7 SATC 268 (U) 270.

⁶ SARS Interpretation Note 67 Issue 2 (14 February 2014) 24 (hereafter “IN67”); *ITC1741* 65 SATC 106, 113-114.

⁷ IN67 24.
the price paid or payable or the importer proves that the transaction value closely approximates the transaction value of identical or similar goods sold at comparable trade and quantity levels to unrelated purchasers in South Africa at our about the same time as the goods to be valued, or the deductive value or computed value of identical or similar goods imported into South Africa at or about the same time as the goods to be valued.

Generally in practice SARS will accept a declaration from the importer stating it is related to the supplier, but that relationship does not influence the price, at the time of entry. The declaration is only likely to be tested in a post-clearance audit. In the post-clearance audit SARS will require the importer to complete a valuation questionnaire which provides detailed information on how the value of the goods is determined by the importer and submit supporting documents which verify the value declared by the importer.\(^8\) The valuation questionnaire is used by SARS where the transaction value of goods may be disputed in the course of an audit or where an importer requests SARS to make a value determination.\(^9\)

The value determination process is regulated by section 65(4)(a)(i) of the C&E Act, which provides that SARS may determine the transaction value of any imported goods as provided in section 66 C&E Act, in writing. In terms of section 65(4)(a)(ii) of the C&E Act, the determination operates only in respect of the goods mentioned therein and the person in whose name it is issued and is generally effective from the date of the determination is issued.

In terms of section 65(4)(b) of the C&E Act the amendment or new determination may be made with effect from, amongst other times:

(i) the date of first entry of the goods in question in circumstances where a false declaration\(^10\) is made for the purposes of the C&E Act;


\(^10\) In terms of section 82(2) of the C&E Act an invoice or other document relating to any denomination, description, class, grade or quantity of goods is deemed to contain a false statement if the price charged by the exporter or any value, price, commission, discount, cost, charge, expense, royalty, freight, duty, tax,
(ii) the date of the amendment of the previous determination or the date of the new determination.

This section is subject a proviso that any amendment of a determination or a new determination which has retrospective effect only applies to goods entered for home consumption during a period of two years immediately preceding the date of such amendment or new determination. However, this limitation does not apply where the underpayment of duty is due to any fraud, misrepresentation, non-disclosure of material facts or a false declaration.11

SARS must amend any determination or withdraw it and make a new determination if it was made in error or any condition or obligation on which it was issued is no longer fulfilled or on any other good cause shown.12

In the value determination process it appears that, based on SARS’ current practice, SARS will not accept information contained in transfer pricing documentation to establish that the relationship between the parties did not influence the price actually paid or payable for the goods. SARS indicates that transfer pricing documentation “…can only be used for verification purposes and cannot be considered as sufficient evidence that the relationship between the importer and supplier did not influence the price actually paid or payable.”13 However, if the importer can include the following information in its transfer pricing documentation:14

drawback, refund, rebate, remission or other information whatever declared therein which has a bearing on value for the purposes of payment of any duties –

(i) is influenced, adjusted or amended as a result of any separate transaction, arrangement, agreement or other consideration of any nature whatever particulars of which are not specified in such invoice or document; or

(ii) represents any average or adjustment or amendment, particulars of which are not disclosed in such invoice or document, of such values, prices, commissions, discounts, costs, charges, expenses, royalties, freight, duties, taxes, drawbacks, refunds, rebates, remissions or other information in respect of goods of the same or of different denominations, descriptions, classes, grades or quantities supplied by the same supplier.

11Section 44(11)(c) of the C&E Act
12 Section 65(4)(a) of the C&E Act.
14 The relevant information identified in 2.6.2 and 2.6.3 above. Please see Grace Toro & Caballero, 2012: 47; Vijaraghavan, 2015 193.
(i) Detailed information about the importer, the manufacturer and how the transfer pricing methodology was developed;

(ii) Segregated transfer pricing data (i.e. costs and profit margins) for each type of product imported;

(iii) The study should benchmark the profits of the manufacturer of the imported goods against profits of similar manufacturers; and

(iv) The benchmarking should relate to the seller's functions (i.e. functional analysis) and also the relevant industry,

then there is no reason why, in principle, an importer should not be allowed to show from its transfer pricing documentation that its relationship with the supplier did not influence the price actually paid or payable for the goods acquired from that supplier.

If SARS is not satisfied with the information provided by the importer, the importer is also able to produce substitute values which approximate the transaction value of the goods.\(^ {15}\) However the comparable test values must have been established in relation to an actual assessment of goods by SARS. This is significant because it means that a particular valuation method cannot be applied if the importer has not previously used that method to value imported goods in an actual transaction.\(^ {16}\)

If upon analysis of the information provided by the importer, SARS is satisfied with the declared value no further action is taken and a VDN number is provided to the importer. If SARS is not satisfied with the declared value, it will determine an acceptable value using the methods in:

(i) Section 66(4) (identical goods method);

(ii) Section 66(5) (similar goods method);

\(^ {15}\) Section 66(3)(b) of the C&E Act.
\(^ {16}\) SARS Customs External Directive: Method 1 Valuation of Imports 27.

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(iii) Section 66(7) (the deductive value method); 

(iv) Section 66(8) (the computed value method); and 

(v) Section 66(9) (known as the fall-back method, which is applied where none of the other methods is applicable),

must be applied in strict sequential order save that the deductive value method in section 66(7) and computed value method in section 66(8) of the C&E Act may be applied in reverse, at the request of the importer. This is in accordance with the GVC. As regards the valuation methods in sections 66(4) to (9), these methods closely reflect the methods in articles 2 to 7 of the GVC.

After applying these methods, SARS will communicate the transaction value of the imported goods to the importer, together with a VDN. This value must be used for all future import transactions with the same party, the VDN must be included in all SAD forms and the importer must pass vouchers of correction for all transactions which occurred in the past two years.\(^\text{17}\)

3.2.4 Rejection of the primary valuation method on other grounds

Section 129(1)(b) of the Customs Duty Act deserves special consideration because no equivalent provision exists in section 76 of the C&E Act (which will be replaced by section 129 (1) of the Customs Duty Act). Section 129(1)(b) of the Customs Duty Act states that the primary valuation method (i.e. the transaction value) may not be accepted if the goods were imported pursuant to a contract of purchase and sale but the contract was concluded otherwise than in the ordinary course of trade under fully competitive conditions. This provision appears to have its origin in the text of paragraph 2 of article 7 of the GATT. Paragraph 2(a) of article 7 states that:

\(^{17}\) SARS Customs External Directive: Valuation of Imports 37.
“The value for customs purposes of imported merchandise should be based on the actual value of the imported merchandise on which duty is assessed, or of like merchandise, and should not be based on the value of merchandise of national origin or on arbitrary or fictitious values.”

Paragraph 2(b) of Article 7 defines the “actual value” as “… the price at which, at a time and place determined by the legislation of the country of importation, such or like merchandise is sold or offered for sale in the ordinary course of trade under fully competitive conditions.” The interpretative text to this article states that a member state may interpret the phrase “in the ordinary course of trade under fully competitive conditions” to exclude any transaction where the purchaser of the imported goods and seller are not independent of each other and price is not the sole consideration for the goods supplied.\(^\text{18}\)

It is not immediately clear why section 129(1)(b) was introduced into the Customs Duty Act. The purpose of the GVC is, amongst other things, to elaborate rules for the application of VII of the GATT in order to provide greater uniformity and certainty in its implementation.\(^\text{19}\) Thus, one would expect that where parties are not independent of each other, the procedures referred to in section 129(1)(i) and section 130 of the Customs Duty Act (the replacement to sections 66(1) and (3), based on article 1.1(d) and 1.2 of the GVC) should be applicable in order to ensure that the customs value is arm’s length.

In light of section 129(1)(i) of the Customs Duty Act, section 129(1)(b) of the Customs Duty Act may be redundant unless the provision is intended to allow SARS to reject the transaction value of any imported goods in circumstances where parties are not related for the purposes of section 130 of the Customs Duty Act but SARS still has residual concerns regarding the relationship between the parties and intends to reject the transaction value of the goods. This approach would be problematic because it results in an outcome which is contrary to the GVC’s purpose to introduce uniformity and certainty to customs valuations.

\(^{18}\) Annex I Ad Article VII of the GATT.
\(^{19}\) GVC General Introductory Commentary: Preamble.
3.3 ADDITIONS TO THE CUSTOMS VALUE

Once the value of the imported goods has been determined using the required valuation method, section 67(1) of the C&E Act prescribes the additions to the value of the goods. These amounts are, only to the extent that they do not already form part of the price actually paid or payable by the importer:

(i) Any commission other than buying commission;

(ii) Brokerage;

(iii) The cost of:

   a. Packing, including the cost of labour and materials; and

   b. The cost of containers, which must be dealt with as being one with the goods;

(iv) The value of any of the following items which were supplied to the seller directly or indirectly by the importer free of charge or at reduced cost for use in the production, manufacture or sale of the goods:

   a. Materials, components, parts and articles forming part of the goods;

   b. Tools, dies, moulds and articles used in the production or manufacture of the goods;

   c. Materials consumed in the production or manufacture of the goods; and

   d. Engineering work, development work, art work, design work, plans and sketches undertaken elsewhere than in South Africa and necessary for the production or manufacture of the goods;
(v) Royalties paid as a condition of the sale of the goods for export to South Africa, but excluding charges for the right or licence to reproduce the goods in South Africa;

(vi) The value of any part of the proceeds of any subsequent resale, disposal or use of the goods that accrues directly or indirectly to the seller; and

(vii) Transportation, loading, unloading, handling, insurance and associated costs incidental to delivery of the goods at the port or place of export in the country of exportation and placing those goods on board a vessel, aircraft, railway carriage or vehicle at that port or place.

An addition of particular relevance to the case study in Chapter 4 and discussed further in this chapter is royalties, which must be added to the customs value of the goods. SARS indicates that a royalty is only dutiable if it is related to the goods being valued and the payment of the royalty is a condition of the sale of the goods. In practice, if the royalty is paid in fulfilment of a contract of sale its payment is clearly a condition of the sale of the goods. However, even if there is no express term in the agreement one must still examine all circumstances surrounding the transaction as the payment would still be a condition of the sale of the goods if the supplier would not have sold the goods, or the importer could not have purchased the goods without paying the royalty.\(^\text{20}\)

Further, in SARS view, a royalty paid in connection with a trademark which relates to goods re-sold by the importer with limited processing, where the goods are marketed under the trademark and the importer is not free to obtain the goods from unrelated suppliers, is a dutiable royalty.\(^\text{21}\) If the royalty is dutiable, the onus is on the importer to establish the amount which must be added to the value of the goods.\(^\text{22}\)

\(^{21}\)SARS Customs External Directive: Method 1 Valuation of Imports 20-22.
\(^{22}\)SARS Customs External Directive: Method 1 Valuation of Imports 40-41.
3.4 REFUNDS OF CUSTOMS DUTIES

Relevant to the issue of “double taxation” in Chapter 1\(^{23}\) are the circumstances in which an importer may claim a refund of customs duties from SARS if it makes a year-end adjustment or its transfer price is challenged by SARS.

In terms of section 76(2) of the C&E Act SARS must consider any application for a refund by an applicant who contends that it has paid customs duty for which the applicant was not liable by reason of, amongst other things, a bill of entry has been substituted\(^{24}\) or the customs duty was assessed on a value higher than the dutiable value of the goods.\(^{25}\)

A bill of entry is substituted when an importer adjusts that bill of entry by means of a voucher of correction cancellation of the bill of entry and substitution by a fresh bill of entry. This is permitted when the original bill of entry does not comply with section 39 of the C&E Act, including because the true value of the goods was not declared or the correct duty was not paid, or is invalid in terms of section 39(1) of the C&E Act.

It is important to note that, in terms of section 76(3) of the C&E Act, any application for a refund must not relate to more than one bill of entry, unless otherwise allowed by SARS. This means that an overpayment of customs duties in respect of several transactions could become an administratively burdensome task.

Also, in terms of section 76(4) of the C&E Act an application for a refund may not be considered by the SARS unless it is duly completed, in the prescribed form (supported by the necessary documents and other evidence to prove that such refund is due) and is received within a period of two years from the date on which the customs duty was paid.

There is no reason to suggest that where the transaction value of imported goods proves to be incorrect because of a year-end adjustment by the importer. However, as noted in Chapter 2, where the change in the customs duty is the result of deliberate action by the

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\(^{23}\) Please see 1.1 and 1.3 above.

\(^{24}\) Please see section 76(2)(f) of the C&E Act.

\(^{25}\) Please see section 76(2)(b) of the C&E Act.
parties then customs authorities may still refuse to refund the duties paid. Certainly, where the transaction is subject to section 31 of the Income Tax Act and the parties make actual year-end adjustments to transfer prices, SARS would have to accept the transfer price of the goods as the transaction value of those goods for customs valuation purposes. This may be problematic in light of SARS' view that transfer pricing documentation can only be used for verification purposes and cannot be considered as sufficient evidence that the relationship between the importer and supplier did not influence the transaction value of the goods.

3.5 TRANSFER PRICING

3.5.1 Section 31 of the Income Tax Act

The South African transfer pricing rules are principally contained in section 31 of the Income Tax Act. Section 31 of the Income Tax Act will apply to non-arm’s length dealings between the following “connected persons”:

(i) A resident and a non-resident;

(ii) A non-resident and a permanent establishment of a non-resident, where that permanent establishment is located in South Africa;

(iii) A resident and a permanent establishment of another resident located outside of South Africa; or

(iv) A non-resident and a controlled foreign company of a resident.

A “connected person” is defined in section 1 of the Income Tax Act as:

(a) in relation to natural persons:

26 Please see 2.5 above.
27 Please see 3.2.3 above.
28 Please see the definition of “affected transaction” in section 31(1) of the Income Tax Act.
(i) any relative of the person; and

(ii) any trust of which such natural person or the relative is a beneficiary;

(b) in relation to a trust, any beneficiary of that trust; and any person who is connected to the beneficiary. Moreover, paragraph (bA) of the definition deems all persons who are connected persons in relation to the trust, to be connected to each other as well;

(c) partners in a local or foreign partnership are connected to each other and any other connected person in relation to any partner of the partnership or foreign partnership;

“(d) in relation to a company:

(i) any other company that would be part of the same group of companies as that company if the 70% threshold, in the definition of group of companies”, for holding equity shares and voting rights in a company was reduced to 50%;

(iv) any person, other than a company that individually or jointly with any connected person in relation to that person, holds, directly or indirectly, at least 20 per cent of:

(aa) the equity shares in the company; or

(bb) the voting rights in the company;

(v) any other company if at least 20 per cent of the equity shares or voting rights in the company are held by that other company, and no holder of shares holds the majority voting rights in the company;
any other company if the other company is managed or controlled by a person who is a connected person, in relation to the first-mentioned company, or another connected person in relation to that person…"

The “connected person” definition also provides that where a person is a connected person in relation to another person, that other person is deemed to be connected to the first mentioned person.

Where section 31 of the Income Tax Act is found to apply to a particular arrangement or transaction (an “affected transaction”) the resident contracting party (or a non-resident with a permanent establishment in South Africa) enjoying a tax benefit from the transaction must calculate its taxable income as if the transaction had been entered into on arm’s length basis.\(^\text{29}\)

The term “tax benefit” is widely defined in section 1 of the Income Tax Act to include “…any avoidance, postponement or reduction of any liability for tax”. This definition may be considered too vague to be helpful in some cases. However, the benefit is easily demonstrated in other cases, such as a supply of goods to a South African purchaser at above arm’s length prices. If the South African purchaser pays more for the goods than it would in an arm’s length transaction and accordingly claims a greater tax deduction than it would have in an arm’s length transaction, it has reduced its taxable income. On this basis, the South African purchaser would have obtained a “tax benefit”.

The onus is on the recipient of the benefit to disclose the arm’s length terms of the deal to SARS, rather than the actual price charged by the parties under the transaction. If the party does not calculate its taxable income on this basis, SARS may adjust the party’s taxable income in order to comply with section 31 of the ITA. This is known as the “primary adjustment”\(^\text{30}\).

There is a further adjustment mechanism in terms of which amount of the benefit derived by the offshore party will be deemed to be:

(i) a dividend, consisting of the distribution of an asset *in specie*\(^{31}\) from the resident contracting party, where the resident is a company;

(ii) a donation (for donations tax purposes only) from the resident contracting party to the non-resident contracting party, where the resident is a natural person or a trust.

This is known as the “secondary adjustment”.\(^{32}\)

A transaction cannot qualify as an “affected transaction” contemplated in section 31 if the contracting parties are not “connected persons”. The term “connected person” thus plays an important role in section 31 and is defined in both sections 1 and 31 of the Income Tax Act. The definition in section 1, explained above, comprehensively defines the legal relationships which connect natural persons, trusts, companies (which is broadly defined to include several forms of juristic persons). Section 31(4) of the Income Tax Act also defines a “connected person”. However, the definition in section 31(4) of the Income Tax Act merely supplements paragraph (d)(v) of the definition of “connected person” in section 1 of the Income Tax Act. to the result is that a company which is a “connected person” in relation to another company because it holds more than 20% of the equity shares and voting rights in that company, regardless of whether a person holds a majority of the shares in the other company.

It is submitted that the “connected person” definition defines legal relationships only, except for paragraph (d)(vA) of the definition,\(^{33}\) in the sense that the definition clearly describes the circumstances in which persons are connected based on legally recognised relationships between parties (i.e. relatives, a trust and a beneficiary, an employer and employee or a shareholder and a company). There is no completely substantive test for control which considers the economics of the relationship between two parties only. Even


\(^{33}\) This part of the definition does refer to the management or control but for limited purposes only.
paragraph (d)(vA) of the definition requires that persons the person who manages and controls a company is connected to the other company, unlike the definition of a in section 66(2)(a)(iv), (v) and (vi) of the Customs Duty Act, which consider substantive control over a party. This appears to be a point of departure from the definition of related parties for customs purposes.

It is also relevant that for customs purposes, two parties with may be connected by a third person who controls a five per cent stake in each of them. In paragraph (d)(iv) of the “connected person” definition in section 1 of the Income Tax Act, on the other hand, the test requires one person to directly or indirectly hold at least 20% of the equity shares or voting rights in the company. Notably, section 66(2)(a)(iv) the Customs Duty Act refers to a person who “owns, controls or holds” shares whereas the “connected person” definition refers to “holds” only. The term “hold” may be defined to include not only ownership, but also possession of a thing.34 However, it does not appear that the term “hold” could include other forms of control as referred to in US customs legislation.35 This means that the test for related parties, in relation to companies, in the C&E Act is wider than the test in the “connected person” definition in section 1 of the Income Tax Act, as a person may exercise control over shares in a company without actually possessing those shares.

It is submitted that these differences may result in opportunities for arbitrage between the definitions of the related parties in the C&E Act and a “connected person” in the Income Tax Act.36

One issue which requires further consideration is the issue of year-end adjustments (also known as compensating adjustments),37 particularly which increase a taxpayer’s deduction from income tax. As mentioned in 2.6.4 above several European states did not regard compensating adjustments as permissible or have a policy for dealing with them. Section

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34 Union Government v De Kock 1918 AD 22, 33.
35 I.e., substantive control whether legally enforceable or not, including control resulting from the action of two or more persons acting in concert or with a common goal or purpose (refer to Ainsworth 2007:30; 26 CFR § 1.482-1(i)(4)).
36 This issue will be discussed further at 3.6.2 below.
37 TP Guidelines 25 – the glossary defines a compensating adjustment as “[a]n adjustment in which the taxpayer reports a transfer price for tax purposes that is, in the taxpayer’s opinion, an arm’s length price for a controlled transaction, even though this price differs from the amount actually charged between the associated enterprises. This adjustment would be made before the tax return is filed.”
31 of the Income Tax Act is silent on the issue of compensating adjustments. Any adjustment which increased a deduction which was claimed by the taxpayer in terms of section 11(a) of the Income Tax Act would not be regarded as expenditure actually incurred as required by that section, and thus not allowed by SARS. This is a concern for taxpayers in many jurisdictions as they are not obliged to accept compensating adjustments, even where the connected party adjusts its transfer price upward in the other jurisdiction, from which it sells the goods. The taxpayer can only request the tax authorities to negotiate adjustments through the mutual agreement procedure. Even when a tax authority makes an adjustment in the return of the seller of the goods in one state ("a corresponding adjustment"), the rights of the purchaser to an adjustment in the other state are limited.  

Further, it appears that SARS regards year-end adjustments as a means of shifting profits, to maintain a low targeted net margin which enables the offshore parent company to retain the residual profits. SARS is of the view that taxpayers often show little regard for the drivers in profits and the functional and risk profile of South African subsidiaries. Often these entities are treated as low risk distributors or manufacturers, without regard to unique dynamics in the South African market, which allow the South African subsidiaries to earn greater profits than related entities in other countries.  

In light of this uncertainty, there is a risk that any year end adjustment by other tax authorities may be disputed by SARS. This risk is even greater when the adjustment is initiated by the taxpayer. Thus, it is submitted that, based on the recommendation of the EU JPTF, it is advisable for taxpayers to:

(i) agree the computation formula for determining year-end adjustments in advance in writing; and

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38 Hattingh, 2010:s36.15 argues that Article 9(2) of the many treaties which are based on the OECD model (incorporated into the Income Tax Act in terms of section 108(2)) require SARS to make corresponding adjustments, at least in an amount SARS considers represents the arm’s length result of the transaction. However, significant risks of double taxation arise as article 9(2) of the OECD model does not oblige the tax authorities in one contracting state to accept the value of the adjustment made by the authorities in the other contracting state. Rather, the tax authorities must make a concerted effort to reach agreement on the value of the adjustment through the mutual agreement procedure, which does not have a deadlock-breaking mechanism.

39 Feinschreiber & Kent, 2014: 32.
40 The recommendation is discussed in 2.6.4 above.
(ii) be able to explain why the forecast results did not materialise, with reference to specific facts and circumstances,

in order to mitigate these risks.

3.5.2 **Practice Note 7 of 1999**

The present version of section 31 of the Act (like the version of section 31 of the Income Tax Act prior to substitution by section 57(1) of the Taxation Laws Amendment Act\(^\text{41}\)) indicate how the resident contracting party should determine what the arm’s length terms and conditions for a transaction are. Thus, SARS published Practice Note 7 on 6 August 1999.\(^\text{42}\)

The practice note is largely outdated due to the significant amendments which were made to section 31 of the Income Tax Act in 2011. However, the practice note does record that while South Africa is not a member of the OECD, the TP Guidelines should be followed in the absence of specific guidance in the practice note.\(^\text{43}\)

In the practice note, SARS further endorses all of the transfer pricing methods in the TP Guidelines as acceptable transfer pricing methods. However, the appropriateness of these

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\(^{41}\) Section 31 of the Income Tax Act was substituted by section 57(1) of the Taxation Laws Amendment Act (24 of 2011) with effect from 1 April 2012.

\(^{42}\) Practice Note 7 constitutes an interpretation of section 31 by SARS which constitutes a “practice generally prevailing” in terms of section 5(1) of the Tax Administration Act (28 of 2011) (hereafter the “TAA”), being “…a practice set out in an official publication regarding the application or interpretation of a tax Act”. In terms of section 99(1)(d)(aa) of the TAA, SARS is prevented from raising an additional assessment where the “amount which should have been assessed to tax under the [additional assessment] was, in accordance with the practice generally prevailing at the date of the [additional assessment], not assessed to tax.

Practice Note 7 also provided an indication of the documentation which taxpayers types and were advised to keep, to be able to demonstrate how their methods and prices satisfy the arm’s length principle Practice Note 7 para 10.1.4. The record keeping guidance in Practice Note 7 were replaced by the record keeping requirements in GN1334 GG40375 dated 28 October 2016 which specifies the information to be included in a taxpayer’s transfer pricing documentation in accordance with section 29 of the TAA. Please see Government Notice 1334 Government Gazette 40375 (28 October 2016) and SARS “Briefing Note: Notice in terms of section 29 of the Tax Administration Act, 2011, requiring the persons specified in the Schedule to keep the records, books of account or documents prescribed in the Schedule.” 2016 Available URL: http://bit.ly/2fC9rkQ. Accessed on 27/11/2016.

\(^{43}\) Practice Note 7 para 3.2.
methods varies depending on the particular situation.\textsuperscript{44} When determining the most appropriate method to apply to a transaction, consideration should be given to:\textsuperscript{45}

(i) The nature of the activities being examined; 
(ii) The availability, quality and reliability of data; 
(iii) The nature and extent of any assumptions; and 
(iv) The degree of comparability between controlled and uncontrolled transactions.

The TP Guidelines provide guidance, in relation to the issue of comparability, generally but also in relation to specific transfer pricing methods.

Key considerations in relation to the comparability of transactions are:

(i) The characteristics of property or services (the importance of the characteristics of the property or services varies depending on the method which is applied – for example it is much more important in the comparable uncontrolled price method which requires a high degree of comparability for a transaction when compared with the transactional net margin method);\textsuperscript{46}

(ii) Functions performed by each party to the transaction (the compensation which parties obtain in an independent transaction is related to the functions performed by each of them; most transfer pricing methods focus on functions performed, risks assumed and assets utilised. The focus is not on the goods or services which are the subject of the transaction);\textsuperscript{47}

\textsuperscript{44} Practice Note 7 para 9.2.4.  
\textsuperscript{45} Practice Note 7 para 9.1.1 to 9.1.3. 
\textsuperscript{46} Practice Note 7 para 8.2.2.  
\textsuperscript{47} Practice Note 7 8.3.1 to 8.3.3.
(iii) Economic circumstances of the markets in which the parties operate (such as the size, location competitiveness and level of the market); and

(iv) Business strategies (these may include innovation, new product development, degree of diversification, risk aversion and market innovation strategies).

The practice note provides that, as a general rule, the most reliable transfer pricing method is the one which produces the most accurate result and requires the least number of adjustments. The practice note does not indicate when the transfer prices must be established, before the year of assessment (the “price setting approach” or after the year of assessment, the “outcomes based approach”). In the absence of any guidance in the practice note, the TP Guidelines apply. The TP Guidelines do not express a preference for the price setting approach or the outcomes based approach. Thus, either the price setting approach or the outcome based approach may be applied and the application of the particular approach should be justified.

The outcomes based approach will often require year-end adjustments in order to bring the taxpayer’s financial results in line with the transfer pricing analysis. Neither section 31 of the Income Tax Act nor Practice Note 7 provide any form of guidance on the acceptability of year-end adjustments. Section 31 of the Income Tax Act is broadly formulated and thus, could support such adjustments. However, this broad formulation could also result in a year-end adjustment being an “affected transaction”.

For example, if a party enters into a transaction:

(i) with a connected person, who is a non-resident;

(ii) on terms and conditions which would have existed between independent parties; and

(iii) which results in a tax benefit,

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48 Practice Note 7 8.4.
49 Practice Note 7 9.1.1 to 9.1.3.
50 Practice Note 7 9.1.6.
section 31 of the Income Tax Act will apply and that party would be required to file its return as if the transaction had been entered into on arm’s length terms and conditions. It would be permissible under section 31 of the Income Tax Act to make a year-end adjustment in its accounts to ensure that the results of the transaction are arm’s length.

It has been argued that a clause in an agreement which requires a party to make a payment to a connected person based on, amongst other things, its operating margin is not a term or condition which would exist in a transaction entered into between independent parties. A party which increases its operating margin in a year and thus, increases its profits would not necessarily want to pay a portion of those profits to its supplier. However, it is submitted that a payment made to achieve an arm’s length result, in relation to transactions which have already been undertaken between the parties, could not logically result in an “affected transaction”.

These potentially contradictory outcomes may be resolved with reference to the recent reports of the OECD on base erosion and profit shifting. In particular, the report amends Section D of Chapter 1 of the TP Guidelines in relation to functional analysis, particularly, the allocation of risks ex ante by parties. This amendment is convenient in light of the applicability of the TP Guidelines to section 31 of the Income Tax Act, by virtue of Practice Note 7.

The amendments provide that where parties agree to allocate risks associated with uncertain future business outcomes upfront they will be entitled to the unanticipated profits or to bear the unanticipated losses which result from those risks.52

This is in accordance with the acceptance of the price setting approach in transfer pricing analyses. The amendments also indicate that so long as the ex-ante pricing arrangement is based on information which was reasonably foreseeable at the time the price was determined should not be subject to challenge by tax authorities based on ex post evidence unless there is something more to suggest that the transaction was not arm’s

There seems to be more recent support for this approach by Schoeneborn and Hanken and Dorward. This also seems to be a less risky means of establishing the transfer price for goods sold to a South African subsidiary, in light of the concerns raised by SARS regarding the use of year-end adjustments to maintain low targeted operating margins.

All of the above suggests that adherence to a strict reference to a predetermined, comparable operating margin in the transactional net margin method is not always the most desirable outcome. Thus, if at the end of a financial year, a party’s results diverge from the results projected at the beginning of a year, consideration should be given to why the divergence exists and whether an adjustment is really required, because the result may actually reflect an arm’s length result.

3.6 COMMENTS ON THE INTERSECTION OF CUSTOMS VALUATION AND TRANSFER PRICING LEGISLATION

3.6.1 General

So far, in it has been established from the review in this Chapter that:

(i) the principles in the C&E Act generally reflect the principles in the GVC; and

(ii) the principles in section 31 and suggested practices in Practice Note 7 generally reflect the principles in the TP Guidelines.

Thus, it is submitted that it can be assumed that the difficulties relating to harmonisation and the prospects for harmonisation of customs valuation rules under the GVC and transfer pricing under the TP Guidelines, which were identified in Chapter 2, apply equally in relation to the South African legislation and practice.

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55 Feinschreiber & Kent, 2014: 32.
56 Please see 2.7 above.
While there are opportunities for harmonisation of customs valuation and transfer pricing as discussed in Chapter 2 above, particularly in relation to the proposals of the WCO, it appears from SARS' stated policy that the information provided in transfer pricing documentation is not sufficient evidence that the relationship between the importer and supplier did not influence the price actually paid or payable that there is a limitation of the usefulness of information in transfer pricing documentation in the circumstances of the sale test. It is submitted that this approach by SARS could constitute a significant barrier to harmonisation of customs valuation and transfer pricing in South Africa.

3.6.2 Definition of relationships for income tax and customs

One distinction between customs valuation and transfer pricing rules which requires further analysis is the difference between the definition of related parties in the C&E Act and connected persons in the Income Tax Act. These definitions are important because parties will only be required to deal at arm's length if they are related for the purpose of section 66(2)(a) of the C&E Act, or connected persons in terms of the definition of “connected person” in section 1 of the Income Tax Act.57

Upon examination of the potential relationships between companies there appear to be a number of differences in the relationships referred to the C&E Act and those referred to the definition of a “connected person” in section 1 of the Income Tax Act.

In the definition of “connected person” in section 1 of the Income Tax Act, subparagraphs (d)(i) to (v) all require the direct or indirect holding of shares in one or both companies involved in a transaction.

An example of this requirement is found in paragraphs (d)(v) and (d)(iv) of the definition of “connected person” in section 1 of the Income Tax Act, where a company is connected to:

“(d)(v) any other company if at least 20 per cent of the equity shares or voting rights in the company are held by that other company;

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57 This is not analysed at an international level, in Chapter 2 above, as there is no uniformity amongst countries in the definition of related or associated parties in relation to income tax. Please see 2.2 above.
(d)(vi) any person, other than a company … that individually or jointly with any connected person in relation to that person, **holds, directly or indirectly**, at least 20 per cent of

(aa) the equity shares in the company; or

(bb) the voting rights in the company…”

In both definitions there is a minimum threshold of a 20 per cent shareholding.

The broader definition of connected persons, in relation to “a company” is found in paragraph (d)(vA) of the definition of “connected person” in section 1 of the Income Tax Act:

“any other company if such other company is managed or controlled by -

(aa) any person who or which is a connected person in relation to such company; or

(bb) any person who or which is a connected person in relation to a person contemplated in item (aa)…”

In this definition there is clearly scope to apply a substantive test of management or control in relation to the “other company” and the other person who controls or manages it. This definition thus appears to contain a substantive element of management and control. Nonetheless this other person must still be a “connected person” in relation to the first-mentioned company, or a “connected person” in relation to the other person. Thus, this definition it ultimately relies on the other components of the definition of a “connected person”.

The definition of related parties, in a business relationship, in section 66(2)(a)(iv) of the C&E Act does not face the same difficulty. Two companies will be related if they are both

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directly and indirectly controlled by the same person or if a person holds or controls more than 5 per cent of the shares in each of them.

This could result in a situation where:

(i) a company which purchased goods from another company having a common shareholder, who holds a five per cent stake in both companies only, would be related to that other company for customs purposes. However, the shareholder does not hold a 20 per cent stake in either company and thus, could not be the “connected person” referred to in paragraph (d)(vA)(aa) or (bb) of the definition of a “connected person” in section 1 of the Income Tax Act; or

(ii) a third party may in substance control two companies without holding shares or voting rights in either (for example, through the presence of a domineering director). For customs purposes the two companies would be related. However, for income tax purposes the companies would not be connected as the third party does not hold shares or voting in either of them.

An arbitrage between the definition of “connected person” and the relationships on this basis could allow for a scenario where the goods are imported using the lowest possible arm’s length “transaction value” or a computed value which is agreed with SARS while the compensation paid to the supplier could be increased through the payment of management or other fees to the supplier (which are non-dutiable) which would not need to be arm’s length as the importer and supplier would not be subject to section 31 of the Income Tax Act.

Nevertheless, the “connected person” definition is comprehensive, particularly in relation to structures in which a trust is interposed as, in terms of paragraph (bA) of the definition of “connected persons” all persons who are connected persons in relation to a trust are deemed to be connected to each other. Thus, for example a beneficiary of a trust would be a connected person to any company which is also a connected person in relation to the trust.

58 IN67 24; ITC1741 65 SATC 106, 114
3.7 CONCLUSIONS

Sections 3.2.2, 3.5.1 and 3.6.2 considered how the C&E Act and Income Tax Act define related or connected parties (taking account of the GVC and TP Guidelines). It was established that:

(i) in relation to related parties for the purposes of the C&E Act, section 66(2)(a) allows for a wide definition of “control” over two companies by a common shareholder, or another person; and

(ii) the “connected person” definition in section 1, read with section 31(4), of the Income Tax Act is largely a formalistic test based on the existence of certain legal relationships. This definition is much narrower than the C&E Act definition of relationships and may be exploited by importers, leading to divergences between transfer prices and customs values by importers who are related for customs purposes but not subject to transfer pricing rules.

Section 3.2 and 3.3 analysed the C&E Act and compared it against the GVC to establish whether there were any conflicts between them. It was established that the C&E Act generally reflects the principles in the GVC, except that section 129(1)(b) of the Customs Duty Act is a novel provision in South African customs law which will allow SARS to reject to the transaction value of any goods which were not sold under fully competitive conditions which has the potential to create uncertainty, contrary to the object of the GVC.

It was also established that the test for whether a royalty or license fee is dutiable is a broad test which considers the dynamics of the relationship between the importer and the person receiving the payment and whether the sale would have been concluded but for the payment, as a matter of fact, taking account of the relationship between the parties.

Section 3.2 also sought to establish whether there were any practices of SARS which are relevant to the application of the domestic customs valuation and transfer pricing rules which may affect the case study in Chapter 4 and how these compare to, or contrast with,
international practice. It was found that SARS’ practice in relation to customs valuation is to require related parties to answer a valuation questionnaire to demonstrate that their relationship did not affect the price of the goods, as part of its powers to determine the customs value of goods under section 65(4) of the C&E Act. SARS will not consider the information in transfer pricing documentation as evidence that the price actually paid or payable was not affected by the relationship between the parties. If the importer cannot satisfy the circumstances of the sale test, it will only be permitted to provide substitute values, to the extent that SARS has previously allowed the importer to utilise that substitute value in the valuation of identical or similar goods.

Section 3.5 analysed the transfer pricing rules in the Income Tax Act, taking account of what was established in Chapter 2 in relation to TP Guidelines and whether there are any conflicts with the TP Guidelines. It was established that:

(i) Section 31 of the Income Tax Act requires a taxpayer to calculate its tax liability in relation to transactions with a “connected person” on an arm’s length basis;

(ii) Practice Note 7 largely reflects the principles of the TP Guidelines and allows taxpayers to use the TP Guidelines when determining whether a transaction was carried out on an arm’s length basis, but is based on a much earlier version of the TP Guidelines; and

(iii) However, Practice Note 7 does not resolve the question of whether one of the outcomes based approach or price setting approach is more desirable. It is submitted that the price setting approach may be desirable in many cases as it allows for parties to be adequately compensated, or bear the transactional losses for the risks that they actually bear. It is also arguable that the outcomes-based approach which requires year-end adjustments may not produce arm’s length results as an importer would want to retain any additional profits made in a year for itself, rather than pay the additional profit over to its supplier.

This section also sought to establish whether there were any practices of SARS which are relevant to the application of the transfer pricing rules in the Income Tax Act which may
affect the case study in Chapter 4 and how these practices compare to, or contrast with, international practice. It appears that SARS regards year-end adjustments as a means of shifting residual profits offshore. Moreover, SARS is of the view that these taxpayers’ transfer pricing analyses often show little regard for the drivers in profits and the functional and risk profile of South African subsidiaries and regard to unique dynamics in the South African market.

It also appears that SARS is unlikely to regard compensating adjustments as giving rise to a deduction for income tax purposes. Any such deduction would have to be based on the other provisions of the Income Tax Act, such as section 11(a) of the Income Tax Act (i.e., expenditure actually incurred by the taxpayer). Thus, there is a significant risk that such adjustments would be disallowed, as a taxpayer’s deduction from income under section 11(a) of the Income Tax Act requires the taxpayer to actually incur expenditure.

Sections 3.2 to 3.5 C&E Act then considered how the customs valuation rules in the C&E Act and transfer pricing rules in the Income Tax Act interact (taking account of what was established in Chapter 2 in relation to the GVC and TP Guidelines and whether there are any conflicts between domestic and international rules). It was concluded that many of the issues and opportunities relating to harmonisation in Chapter 2 apply equally in relation to the Income Tax Act and C&E Act. However, the prospects for harmonisation of transfer pricing and customs valuation rules are poor in light of SARS’ view that the information provided in transfer pricing documentation is not sufficient evidence that the relationship between the importer and supplier did not influence the price actually paid or payable.
4 CHAPTER 4: CASE STUDY AND ANALYSIS

In Chapter 3 we established the South African law relating to customs valuations and transfer pricing (particularly as they relate to year-end adjustments). The purpose of the case study in this chapter is to evaluate the rules in the C&E Act and Income Tax Act to determine whether harmonisation of customs valuation and transfer pricing is practically possible. In other words, the evaluation of the case study should indicate whether the legislation produces consistent customs valuation and transfer prices, or if the results are anomalous or uncertain and will create risks for importers, particularly when the importer makes a year-end adjustment.

4.1 FACTS OF THE CASE STUDY

In a case study based on the author’s experience:

(i) Company A is a South African incorporated company that is a wholly owned subsidiary of Company B, an entity, established in a foreign jurisdiction;

(ii) Company B is the sole shareholder of entities in several other jurisdictions and is in turn wholly owned by Company C, an entity established in another foreign jurisdiction;

(iii) Company C manufactures niche goods which it sells to Company A;

(iv) Company A markets and distributes the goods under license from Company C. In terms of the distribution agreement between Company A and Company C, Company C agrees to sell goods to Company A at prices established according to the Company C’s global transfer pricing policy. It is further agreed the parties will mandate experts to establish a targeted profitability range based on the profitability of comparable businesses with similar functions, assets and risks (adjusted for differences in the risk profile of the businesses) in compliance with local transfer pricing regulations. At the end of a financial year, Company A and Company C will
review the results of transactions concluded between them, in light of a number of the above factors and determine whether one party should make a payment to the other party to bring its results in line with the targeted profitability margin (hereafter referred to as the “Review Requirement”);

(v) Company A makes an adjustment to its accounts after the end of the financial year to bring its financial results from the distribution transactions (i.e. the supply of goods by Company C to Company A) in line with the transfer pricing study, as there was a deviation from the targeted profitability range. This is done by reflecting additional liability to Company C;

(vi) Company C grants Company A a non-exclusive, non-transferable license to use Company C’s trademarks in association with the distribution of goods in South Africa. As consideration for the license Company A pays a royalty, based on its sales turnover, to Company C. The amount of the royalty is finally determined after the end of the financial year when Company’s sales turnover is quantified and an amount is reflected as owing to Company C in the annual financial statements;

(vii) Company A imports the goods supplied by Company C using a VDN, in respect of a value determination previously made by SARS; and

(viii) Company C does not have a global export price list because of the fact that it only sells goods to its subsidiaries and determines the prices of its goods based on its transfer pricing documentation.

The transfer pricing documentation:

(i) Analyses the distribution and royalty transactions entered into between Company A and Company C, for South African transfer pricing purposes;

(ii) In relation to the distribution transaction;
a. The transactional net margin method is determined to be the most appropriate method for determining the arm's length range in the analysis, as Company A does not add manufacturing value or significant intangible value to the goods purchased from Company C. Therefore, under normal circumstances, Company A can be expected to earn the same relative level of operating profit as would be expected in an arm's length distribution operation. Specifically, the chosen financial comparison would be the operating margin;

b. The comparable uncontrolled price method is not used as Company A does not purchase goods from third parties and sales from Company C to third party distributors in other jurisdictions are subject to, different contractual terms and economic conditions;

c. The resale price method is not used for the same reason that the third party distributors in other jurisdictions are subject to, different contractual terms and economic conditions and because the resale price method involves a gross margin analysis which requires comparison against information which is not publicly available;

d. The cost plus method is not used as the segmentation of Company C’s financials to exclude the distribution of goods in other markets and income from the exploitation of intellectual property would produce unreliable results;

e. The profit split method is not used as there is no intangible property owned by Company A which adds value to its distribution function;

f. Comparable companies were identified based on functional similarity. The list of comparable companies was narrowed by excluding companies with significant research and development spending and those without sufficient financial data over a period of three years and at least one year of operating profits during this period;
g. As part of the functional analysis, several criteria were considered to determine if the comparable companies perform distribution activities comparable to those performed by Company A. To be comparable, the company had to indicate that it distributes similar goods and does not perform manufacturing activities or other dissimilar activities. The companies were rejected if they owned any non-routine intangible assets because the ownership of such intangible assets would give rise to an additional return that is not related to the functions and risks of Company A. An appropriate operating margin was established for Company A by comparing the operating margins of the remaining comparable companies based on their publically available financial information. Note however, that none of the comparable distributors operated in South Africa;

h. However, due to a change in product related risks assumed by Company A in the current financial year, the transactional net margin is calculated to include a specific margin relating to the additional expenses resulting from the new risks assumed by Company A and a premium amount is added to the specific margin to reflect the commensurate risks and returns relating to this additional assumption of risk by Company A; and

i. Company A’s actual margin varies from the margin determined in the transfer pricing analysis.

(iii) As regards the licensing of Company C’s trademarks, the comparable uncontrolled price method was selected for the analysis as there was sufficient data regarding third party licensing agreements after considering the following factors:

a. The characteristics of property are substantially similar in controlled and uncontrolled transactions as the property licensed involves trademarks and the licensor retains ownership over the trademarks;

b. In both the controlled and uncontrolled transactions, the licensee is responsible for the exploitation of the licensed rights within its territory and thus, the functional profiles of the licensees are substantially similar;
c. There were no significant differences in contractual terms of the controlled and uncontrolled licensing agreements;

d. Geographic differences did not have a material effect on price; and

e. There were no significant differences in business strategies of the controlled and uncontrolled licensees;

f. None of the other methods would provide a more reliable result than the comparable uncontrolled price method.

(iv) The report identified comparable agreements (from publically available databases) based on net sales and concerning the licensing of trademarks and determined an arm’s length royalty based on these comparable agreements.

4.2 APPLYING TRANSFER PRICING RULES TO THE CASE STUDY

4.2.1 Introduction

For the purposes of section 31 of the Income Tax Act there may be an “affected transaction” involving Company A and Company C as:

(i) Company C, a non-resident, supplies its goods to Company A, a resident and Company C licenses trademarks to Company A against payment of a royalty;

(ii) Company C and Company A are connected persons in relation to one another as Company C is a “controlling group company” which indirectly holds all of the shares in Company A, which is a “controlled group company” and are thus part of a “group of
companies”\(^1\) as contemplated paragraph (d)(i) of the definition of “connected persons”.

For the supply of goods by Company C to Company A, or the licensing of trademarks by Company C to Company A to be an “affected transaction”, the terms of the supply of goods to Company A or the licensing of the trademarks to Company A must be different from the terms which would have existed had Company C and Company A had been dealing at arm’s length.

4.2.2 **Distribution transaction**

As Company C sells its goods to Company A at prices established according to Company C’s global transfer pricing policy it seems unlikely that the price paid for the goods would not reflect an arm’s length price. However, this assumes that the transfer pricing analysis complies with Practice Note 7 and the TP Guidelines. It is submitted that the transfer pricing analysis meets the key formal requirements of Practice Note 7 in that it has performed the functional analysis of Company A and Company C, the comparability analysis and justified the selection of the transfer pricing method. Thus, any challenge to the findings in the transfer pricing documentation would be substantive, i.e. the comparability analysis was flawed.

Such a challenge may be possible because transfer pricing practices carried on by Company A and Company C are of the kind which concern SARS. Specifically SARS’ concerns may be that:

\(^1\) A “group of companies” as defined in section 1 of the Income Tax Act exists when one company (the “controlling group company”) directly or indirectly holds ordinary shares in at least one other company (hereinafter referred to as the “controlled group company”), if that -

(i) at least 70 per cent of the ordinary shares in each controlled group company are directly held by the controlling group company; and

(ii) the controlling group company directly holds at least 70 per cent of the shares in at least one controlled group company.
(i) Company A is a distributor and its transfer pricing analysis requires adherence to an operating margin (for determining the price of goods) which is tested against distributors of similar goods, operating outside of South Africa; and

(ii) Company A and C make use of year-end adjustments to bring the results of the distribution transactions in line with the transfer pricing analysis.

As Company A is responsible for its own marketing in South Africa and has discretion to price its goods according to market forces, its earnings could be sensitive to unique features of the South African market for its goods, which is the concern raised by SARS in relation to transfer pricing analyses which compare South African distributors against foreign distributions. However, Company A is compensated for some of the additional risks that it bears, but again this compensation is also fixed. Thus, Company A's transfer prices may attract additional scrutiny from SARS or even be disputed by SARS.

Then there is also the ongoing difficulty of determining the price for the goods which Company C sells to Company A. The prices paid for the goods are estimated based on prior financial year's transfer pricing analysis and Company A’s financial projections. Confirmation that the transactions were carried out on arm’s length terms and conditions can only be established at the end of the current financial year, when the outcomes based approach to transfer pricing is applied.\(^2\) In this case, there is a variation between Company A’s financial results and the arm’s length operating margin determined in the current year's transfer pricing analysis. As Company A's operating margin was too high, Company A can:

(i) make year-end adjustments in its accounts to bring its results in line with the transfer pricing analysis, increasing the cost of the goods acquired from Company C and file its income tax return on this basis (this adjustment would be the result of the recordal of an amount owing by Company A to Company C); or

(ii) forego any year-end adjustments in its accounts but file its income tax returns as if it had transacted on an arm’s length basis, i.e. reflect a higher cost for the goods acquired from Company C in its return (i.e. a compensating adjustment).

\(^2\) TP Guidelines 79.
If Company A has filed its return reflecting an increased price for the goods, without an underlying payment (in other words it merely made a compensating adjustment), there has been no expenditure for the purposes of section 11(1)(a) of the Income Tax Act and the deduction of the additional amount will be disallowed.

In this case study Company A incurs the additional liability to Company C and claims a deduction from its income and makes a year-end transfer pricing adjustment. Arguably, this sort of year-end adjustment does not reflect arm’s length behaviour. An independent distributor whose operating costs decreased in one year due to external factors would not make a payment to a supplier in order to reduce its operating margin. Based on the arguments set out above by Schoeneborn3 there may also be grounds to argue that the additional payment to Company C is not arm’s length as Company A would, in arm’s length circumstances, want to retain the additional profits for its own benefit. However, it is submitted that Company A should not fall foul of section 31 of the Income Tax Act, merely because it has made a year-end adjustment. Outcomes based testing and year-end adjustments are permissible under the TP Guidelines and thus, will be no affected transaction if Company A made appropriate year-end adjustments to its accounts because there is no “tax benefit” to Company A, as required by section 31(2) of the Income Tax Act as Company A will pay the amount of tax that it would have, had it transacted with Company C on an arm’s length terms and conditions.

Moreover, if Company A’s transfer pricing document indicates that the payment to Company C is required to bring its operating margin into an arm’s length range, Company A would be acting in accordance with section 31 of the Income Tax Act and Practice Note 7 in making such payment.

Another issue which may be raised by SARS is that, as noted above, many of the comparable companies were located in foreign jurisdictions and thus, it is arguable that the transfer pricing should have taken account of this fact by making adjustments to account

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3 Schoeneborn argues that year-end transfer pricing adjustments, which result in payments between the related parties to bring their financial results in-line with their transfer pricing study, do not represent typical arm’s length behaviour between independent third parties, as independent parties acting at arm’s length would not share their profits they earned following the transactions between them. Schoeneborn, 2015:153 Please see 2.6.4 above.
for unique South African market conditions. It would be up to SARS to provide some basis to suggest that unique South African market forces exist in the particular industry in which Company A operates. The validity of SARS’ concerns and the existence of these economic forces are no considered further as they raise issues beyond the scope of this dissertation and would require economic analysis. The issue is merely raised in order to indicate that Company A’s transfer prices may be challenged by SARS.

Nevertheless, it is submitted that the assumption of a price setting approach requires some consideration as it will reduce the possibility for year-end adjustments and may also resolve SARS’ concerns regarding transfer pricing in distributor relationships as the price setting approach appears to be more sensitive to the effect of market forces on the distributor’s business and there is no strict adherence to a targeted profitability margin by Company A and Company C.

4.2.3 Licensing agreement

The payment of the royalty by Company A to Company C may also constitute an “affected transaction”. However, the amount of the royalty is established as an arm’s length rate.

In this case study the transfer pricing analysis undertaken for Company A and Company C appears compliant with Practice Note 7 and the TP Guidelines because the analysis was performed:

(i) Using the most appropriate transfer pricing method and justifying the choice of method in the transaction documentation;

(ii) By comparing the transactions undertaken between Company A and Company C with transactions undertaken by entities with similar functions, assets and risks; and

(iii) Where differences between the transactions undertaken by Company A and Company C and third parties did exist, those differences were not material.
Moreover, the likelihood of any year-end adjustments is low as the royalties in the comparable agreements are based on fixed rates which remain the same over several years. Thus, there is unlikely to be a deviation in the rate of the royalty paid by Company A to Company C is unlikely.

4.3 APPLYING CUSTOMS VALUATION RULES TO THE CASE STUDY

4.3.1 Introduction

Company A and Company C are related parties for the purposes of section 66(2)(a)(v) of the C&E Act as Company C is a controlling shareholder in relation to Company A.

If Company A had only recently begun importing goods into South Africa, Company A would be required to declare that it is related to Company C when it imports the goods. It will likely be allowed to import the goods purchased from Company C at the value declared in its customs documentation. However, SARS will require Company A to complete a valuation questionnaire in a post clearance investigation. In submitting its responses to the valuation questionnaire to SARS, Company A will be required to show that its relationship with Company C did not influence the price actually paid or payable for the goods and to declare whether it pays any royalties and licence fees, which are related to the imported goods, as a condition of the sale of those goods.4

4.3.2 Circumstances surrounding the sale test

There would be several difficulties for Company A in demonstrating to SARS that the price actually paid or payable for the goods was not influenced by its relationship with Company C. Company A is not able to provide Company C’s export price list as it does not have one, because Company C’s sales prices are determined with reference to its transfer pricing documentation (i.e. there is no fixed price for the goods and the price may vary from year to year). The transfer pricing documentation prepared for Company A and

4 SARS Customs External Directive: Method 1 Valuation of Imports 36, 40.

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Company C is unlikely to be accepted by SARS, based on its current policy.\(^5\) On examination of the transfer pricing documentation there is little evidence which may assist the Company A as the transfer pricing documentation simply analyses the operating margins of third party firms operating in similar industries to determine what an arm’s length operating margin is. However, it is submitted that the transfer pricing documentation should be given further consideration if it contains relevant information which can be supplemented by Company A.

Relevant information may include the company’s operating margin. The operating margin is arguably an arm’s length amount which can be extrapolated to determine Company A’s compensation for the distribution of the goods. If the profit amount is added to an amount representing Company A’s:

(i) General expenses;

(ii) Transportation, insurance and loading and handling costs before and after the goods have been imported into South Africa;

(iii) Customs duties; and

(iv) Value-added tax,

are deducted from the unit price the remaining amount should reflect an arm’s length value for the product under the deductive value method. To achieve this, Company A will obviously have to disclose its general expenses as well as specific additions to the transaction value to SARS.

The difficulty which Company A would still face is that the comparison in the transfer pricing documentation does not consider Company A’s margin per product line. This is problematic because of the price manipulation concerns outlined in Chapter 2.\(^6\) This could possibly be overcome with segregation of Company A’s profits per product line to

\(^5\) Refer to 3.2.3 above. See also SARS Customs External Directive: Valuation of Imports 36.

\(^6\) Please see 2.6.1 above.
demonstrate some consistency in the margins across product lines or the duties paid across product lines. Such consistency would indicate that the parties are not manipulating prices to lower the Company A's liability for customs duty.\(^7\)

This analysis, if undertaken correctly by Company A, should provide SARS with some evidence that the price actually paid or payable to Company C for the goods was not influenced Company A's relationship with Company C. However, the resultant value could only be utilised in the circumstances surrounding the sale test. The value will not be accepted by SARS as a "test value" for the purposes of section 66(3)(b) of the C&E Act as the value has not been accepted by SARS in a prior import transaction. This is a significant difficulty for an importer who has only recently begun importing goods into South Africa, or has not previously had its customs valuations verified by SARS, thus requiring it to produce a customs valuation.

Once the valuation questionnaire has been completed by Company A, SARS must consider the information therein. If SARS is satisfied with the transaction value of the goods and the additions to the transaction value SARS will provide Company with a VDN, which Company A must include in the customs documentation for all imports from Company C in future and Company A will be allowed to continue declaring the same transaction value and additions to SARS.

In considering the valuation questionnaire, SARS is required to consider the information provided by Company A (referred to above in relation to Company A's profits per transaction (extrapolated from its operating margin), general expenses and other specified costs in relation to the deductive value method). Even though the information provided by Company A may demonstrate that the value declared reflects an arm's length value it is submitted that presently SARS is unlikely to accept this information as the operating margin is derived from Company A’s transfer pricing documentation.

Moreover, as SARS has not previously accepted a value determined in accordance with the methods in sections 66(4) to (9) of the C&E Act, or the C&E Act, it will not accept a test value based on the deductive value method which approximates the value declared by

\(^7\) Methenitis and Wrappe 2008, 23.
Company A. Thus, SARS may want to determine its own value for the goods. If SARS does this, it will provide Company A with a VDN and Company A will be required to:

(i) value all historical transactions involving the purchase of the same goods from Company C, for a period of two years, using SARS determined value and pass vouchers of correction for these transactions; and

(ii) value all future purchases of the same goods from Company C using the value declared by SARS and must provide the VDN in each customs declaration.

However, in the present circumstances Company A has already obtained a VDN from SARS based on the transaction value of the imported goods (ie the price actually paid by Company A for the goods).

Pursuant to the Review Requirement Company A made a year-end adjustment to bring its financial results from the sale of goods from Company C to Company A in line with its transfer pricing analysis.

It is submitted that there are strong reasons for finding that the payment by Company A to Company C as a result of the year-end adjustment forms part of the transaction value of the goods. This is because the Review Requirement (which resulted in the year-end adjustment) follows from a transfer pricing analysis and is contained in the same distribution agreement which provides that Company C will sell goods to Company A at prices established according to the group transfer pricing policy. Thus, there is a strong connection between the year-end adjustment and the transaction value of the goods.

At the very least, any year-end adjustment may be an indication that the value of the imported goods declared by Company for customs purposes did not reflect an arm’s length value. On the other hand, a compensating adjustment would not result in any increase for the price actually paid or payable for the goods, but could also be an indication that the value of the imported goods declared by Company for customs purposes did not reflect an arm’s length value.
The customs risk for Company A will therefore depend on what was declared to SARS in the valuation questionnaire and any subsequent change in circumstances. For example, if Company A did not disclose the year-end adjustments in the valuation questionnaire as being included in price actually paid or payable for the goods because it was able to satisfy SARS that the declared value of the goods on importation was an arm’s length value by providing other information, or additional information to SARS, then Company A may have made a false declaration to SARS.

The risk for Company A in these circumstances, involving a false declaration, is that the value determination could be amended retrospectively, as far back as the date on which Company A first imported goods into South Africa, even if the determination was made more than two years after the goods were imported into South Africa. In these circumstances SARS may also seek to impose penalties. In a worst case scenario, taking account of the findings relating to the transfer price of the goods in 4.2.2 above, the “double taxation” contemplated in Chapter 1 could occur if SARS challenges the year-end adjustment under section 31 of the Income Tax Act and pursues Company A for additional customs duties, based on existence of year-end adjustments.

This risk could be overcome if SARS actually approved the method used to determine the transaction value of the goods and that the value may be subject to year-end adjustments. In other words SARS would have to accept the transfer price of the goods and the formula year-end adjustments as agreed between Company A and Company C (ie the Review Requirement). However, based on SARS’ views on transfer pricing documentation, it appears that SARS would generally not accept such a proposal in the value determination.

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8 As mentioned in 3.2.3 above, section 65(4)(b) of the C&E Act allows SARS to make new value determination from the time that the goods were first imported into South Africa, based on a false declaration.

9 Administrative penalties may be imposed in terms of section 91 of the C&E Act. It is up to the importer to elect to be subjected to an administrative penalty in order to avoid criminal prosecution for a contravention of the C&E Act (see section 91(3) of the C&E Act). In terms of section 91(1) of the C&E Act an importer who has contravened, or failed to comply with, a provision of the C&E Act, agrees to abide by SARS’ decision and makes payment of an amount not exceeding the maximum fine that may be imposed under the relevant provision. SARS may then summarily determine the final amount of the penalty and order all or part of the forfeiture of the amount deposited with SARS.

10 Please see 1.1 above.
process. At least, if SARS accepts the transaction value of the goods on this basis, there may be grounds for Company A to claim a refund of customs duty if SARS challenges the transfer price of the goods in terms of section 31 of the Income Tax Act. However, this is not a complete solution as the refund will be limited goods imported in the last two years\textsuperscript{11} and Company A will likely have to make applications for refunds for each bill of entry\textsuperscript{12} or pass vouchers of correction for each transaction, likely with agreement from SARS\textsuperscript{13}.

On the other hand, if the year-end adjustments were declared to SARS in the valuation questionnaire and SARS rejected the transaction value of the goods and proceeded to determine that the goods should be valued based on one of the methods in sections 66(4) to (9) of the C&E Act, rather than the price actually paid or payable for the goods then Company A will be compliant with the C&E Act in using the value determined by SARS when it imports the goods.

Again, this could result in some level of “double taxation” as there is a risk that Company A may pay customs duties based on a higher customs value for the imported goods while paying income tax based on lower transfer prices for the same goods.

4.3.3 Payment of a royalty by Company A to Company C

As Company A:

(i) Pays Company C a royalty in connection with the use of trademarks owned by Company C;

(ii) Distributes the goods purchased from Company C without any alterations; and

(iii) Markets the goods under Company C’s trademark,

\textsuperscript{11} Please see the limitation on the period for refunds in terms of section 76 of the C&E Act.
\textsuperscript{12} Please see section 76(3) of the C&E Act.
\textsuperscript{13} Please see section 40(3)(a)(i) read with section 76(2)(f) of the C&E Act.
SARS will most likely regard the royalty as dutiable. Thus, the onus will be on Company A to add an amount to the value of the imported goods, which represents the royalty. However, it is difficult for Company A to apportion its royalty payment to a transaction in advance as the royalty is based on Company A’s sales turnover in that year and is thus variable, depending on the price at which Company A sells the goods, Company A's volume of sales.

The apportionment of the royalty payment to a transaction is also affected by the amount of stock Company A has on hand at the end of the financial year, any stock obsolescence, or the return of stock by customers in the course of a year. Furthermore, the amount of the royalty is subject to a transfer pricing analysis at the end of each tax year. If it were found that the royalty was excessive, i.e. it does not reflect an arm's length royalty, and Company A made an adjustment to bring the royalty in line with the transfer pricing analysis it is likely that the amount included in in the calculation of the dutiable value of the goods purchased from Company A in respect of royalties was too high. However, Company A will not be able to claim a refund of customs duties from SARS. Conversely, if the royalty amount is too low, then there is a risk that Company A underpaid customs duties and thus risks the imposition of significant penalties.

It is submitted that, at best, Company A can only estimate how these variables will affect the final royalty payment. There will be some difficulty for Company A in calculating the dutiable value of goods at the time they are imported. Company A can only estimate the amount in respect of the royalty which should be added to the transaction value of the goods which it purchases from Company C, unless it makes a provisional declaration which it later confirms or amends, or approaches SARS for a value determination in which SARS will determine how the royalties must be included the in the dutiable value of the imported goods.\(^{14}\)

Despite these potential difficulties, Company A’s predicament can be resolved by approaching SARS for a value determination in terms of section 65(4) of the C&E Act. SARS will make a determination of the amount representing royalties which should be added to the transaction value of the imported goods. As with the distribution transaction,

\(^{14}\) These issues will be dealt with further in Chapter 5. Please see 5.3 below.
any change in the amount of the royalty, due to the Review Requirement in the distribution agreement would have to be notified to SARS and a new value determination would have to be made.

It should also be noted that no issues arose regarding the amount of the royalty, or in other words whether it was arm’s length. This is because section 67(1)(c) of the C&E Act does not require the amount of the royalty to be determined based on arm’s length principles.

4.4 CONCLUSIONS

The purpose chapter was to evaluate the rules in the C&E Act and Income Tax Act to determine whether harmonisation of customs valuation and transfer pricing is practically possible.

From the application of the transfer pricing rules in section 31 of the Income Tax Act, it has been established that the distribution transactions between Company A and Company C are largely compliant with section 31 of the Income Tax Act and Practice Note 7. However, as noted in 3.5.1 SARS appears to be concerned that use of year-end adjustments based on a targeted profitability margin is a means of shifting profits from South Africa. SARS may challenge the transfer pricing analysis and consequent year-end adjustments on the basis that the transfer pricing analysis did not take account of local market conditions. The use of year-end adjustments may result in increased scrutiny from SARS, but is still preferable to compensating adjustments without an underlying payment as any adjustment to the price of goods acquired by Company A from Company C will not be allowed as it would not have been incurred in the production of income as required by section 11(a) of the Income Tax Act. That said, companies should consider using the price setting approach to transfer pricing as this may lead to fewer year-end adjustments and thus, address SARS’ concerns.

No issues arose in the transfer pricing analysis in relation to the royalty paid by Company A to Company C and the inclusion of the royalty in the dutiable value of the imported goods. This was not unexpected because the amount of the royalty is not required to be arm’s length for customs purposes.
In relation to the application of the customs valuation rules in the C&E Act it was established that:

(i) Company A as the importer of the goods will be required to show, in post-import verification, value determination process, that the price actually paid or payable for the goods was not influenced by the circumstances surrounding the sale of the goods because it is related to Company C;

(ii) Company A will not be able to use the information in its transfer pricing documentation to satisfy SARS that it has been dealing at arm’s length with Company C in the value determination process. This is because the analysis for the distribution transaction used the transactional net margin method, which provides a net margin for all distribution activities is too general and is not segregated per product line; and

(iii) Company A will not be able to incorporate the information in its transfer pricing documentation directly into one of the customs valuation methods, for the purposes of determining a substitute value. SARS will not allow Company A to rely on a substitute value based on one of the customs valuation methods, which it has not accepted in a previous import transaction.

These findings were mostly expected in light of the law and practice applicable to customs valuations described in 3.2.2 to 3.2.4 above. However, it was still surprising to find that so little information in the transfer pricing analysis could be used for customs valuation purposes, which would justify SARS’s generalised view on the usability of this information in the circumstances surrounding the sale test. However, this does necessarily justify its approach to the problem.

On the key issue of whether year-end adjustments to the price of goods for transfer pricing purposes, may have an effect on the customs value of the same goods, it was found that:

(i) There are strong reasons for finding that the payment by Company A to Company C as a result of the year-end adjustment forms part of the transaction value of the
imported goods and results in the underpayment of customs duties, or at least the year-end adjustment may be an indication that the declared value of the goods was not an arm’s length price for the imported goods;

(ii) The customs risk for Company A will therefore depend on what was declared to SARS in the valuation questionnaire and any subsequent change in circumstances. In a worst case scenario, the “double taxation” contemplated in Chapter 1\(^\text{15}\) could occur if SARS challenges the year-end adjustment under section 31 of the Income Tax Act and pursues Company A for additional customs duties, based on existence of year-end adjustments;

(iii) This risk could be overcome if SARS actually approved the method used to determine the transaction value of the goods and that the value may be subject to year-end adjustments. However, based on SARS’ views on transfer pricing documentation, it appears that SARS would generally not accept such a proposal in the value determination process. At least, if SARS accepted the transaction value of the goods on this basis, there may be grounds for Company A to claim a refund of customs duty if SARS challenges the transfer price of the goods in terms of section 31 of the Income Tax Act. However, this is not a complete solution as the refund will be limited goods imported in the last two years\(^\text{16}\) and vouchers of correction will have to be passed for each transaction by agreement, likely with agreement from SARS.\(^\text{17}\)

(iv) On the other hand, if the year-end adjustments were declared to SARS in the valuation questionnaire and SARS rejected the transaction value of the goods and proceeded to determine that the goods should be valued based on one of the methods in sections 66(4) to (9) of the C&E Act, rather than the price actually paid or payable for the goods then Company A will be compliant with the C&E Act in using the value determined by SARS when it imports the goods.

(v) Again, this could result in some level of “double taxation” as there is a risk that Company A may pay customs duties based on a higher customs value for the

\(^{15}\) Please see 1.1 above.
\(^{16}\) Please see the limitation on the period for refunds in terms of section 76 of the C&E Act.
\(^{17}\) Please see section 40(3)(a)(i) read with section 76(2)(f) of the C&E Act.
imported goods while paying income tax based on lower transfer prices for the same goods.

As mentioned in 1.3 above, there is some debate on the extent to which a transfer pricing adjustment can affect the customs valuation of goods. It is true that a compensating adjustment can be viewed as a legal fiction. However, when the year-end adjustment involves an actual payment or a creation of a loan account between the parties then the question of whether the year-end adjustment has customs valuation implications will depend on the value of the goods that was declared to SARS.

It is evident that there is some risk for Company C if it makes year-end adjustments to the transfer price of goods acquired from Company A but has declared a different transaction value for the goods to SARS in the value determination process. First is the risk of “double taxation” and second is the risk of penalties where Company A is found to have made a false declaration.

Also on the issue of customs valuation rules, the royalty paid by Company A to Company C is based on its net sales of imported goods throughout the year, and is only finalised at the end of the year. It is thus difficult to accurately calculate the dutiable value of the goods in the import transaction. However, it was found that difficulty is ameliorated by Company A approaching SARS for a value determination in respect of the imported goods, as SARS will determine the amount, representing royalties, to be added to the transaction value of the imported goods.
5 CHAPTER 5: REDUCING CUSTOMS AND INCOME TAX RISKS RESULTING FROM YEAR-END ADJUSTMENTS

5.1 INTRODUCTION

In this chapter, the various means of managing the risks faced by Company A in Chapter 4 will be critically considered.

From the analysis in Chapter 4 we have established that Company A faces some risk for income tax purposes pursuant to the transactions entered into with Company C, depending on the information which was provided to SARS during the value determination process.¹ The payment of the lump sum amount by Company A to Company C pursuant to the distribution agreement may lead to increased scrutiny by SARS. Nevertheless, it is submitted that the probability of a successful challenge by SARS is low as the transfer pricing analysis appears compliant with section 31 of the Income Tax Act and Practice Note 7. The only shortcoming in the transfer pricing documentation is that the comparable distributors did not operate in South Africa and no adjustments were made to reflect this fact. In other words, unique features of the South African market are not reflected in the comparison and no adjustments are made to correct this potential deficiency. However, SARS would have to provide some evidence to show that this would have an impact on the transfer price of the goods and this is a matter for economic analysis.

It has also been established from the analysis in Chapter 4 that Company A faces a higher risk of non-compliance from a customs perspective and faces a risk of “double taxation”. There is a particular risk that, because Company A has made a year-end adjustment in respect of the goods, Company A may have under declared the transaction value of goods (i.e. the price actually paid for the goods), which is established according to its transfer pricing documentation. Obtaining a value-determination from SARS may be of some assistance to Company A but this will depend on what is declared to SARS in the valuation questionnaire and the value which is determined or approved by SARS. Moreover, it

¹ Please refer to 4.2.2 above.
appears unlikely that SARS would accept that the transaction value of the imported goods should be established in accordance with Company A’s group transfer pricing policy.

From the literature reviewed in Chapter 2, there are several potential mechanisms which could be used to manage these risks, including:

(i) The inclusion of information relevant to customs valuations in transfer pricing documentation;

(ii) Negotiation of an advance pricing agreement, from an income tax perspective and a corresponding value determination, from a customs perspective;

(iii) The declaration of provisional values for customs purposes, supported by a price adjustment clause in the distribution agreement;

(iv) Minimizing the use of year-end adjustments for income tax purposes by applying the price-setting approach to transfer pricing and making prospective adjustments to transfer prices during the year.

In any of the above instances, if an importer is going to attempt to harmonise its approach to customs valuations and transfer pricing, the first step for the importer is to include additional information in its transfer pricing documentation which will be relevant to customs authorities, in their analysis of the customs valuation of the imported goods acquired from a related party. This information includes:

(i) Segregated transfer pricing data (i.e. costs and profit margins) for each product imported;

(ii) Benchmarking the profits of the manufacturer of the imported goods against the profits of similar manufacturers or benchmarking of the importer’s profits based on the importer’s functions and the relevant industry, depending on the transfer pricing and customs valuation methods applied; and

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2 Please see 2.6 above.
(iii) The transfer pricing documentation specifies the adjustments to be made and detailed information and calculations are retained by the importer.

However, as mentioned above SARS has stated that that information provided in an importer’s transfer pricing documentation is not sufficient evidence in the “circumstances surrounding the sale” test. It is evident from the findings regarding the lack of relevant information in Chapter 4 why SARS as adopted this position. However, if the above information is included the importer’s transfer pricing documentation there is reason to reject the information out of hand. Thus, it is submitted that SARS should restate its policy on the acceptability of transfer pricing documentation for customs valuation purposes. The restatement of the policy should reflect the interpretation of article 1.2 of the GVC as adopted at the WCO level in Commentary 23.1, which states that customs authorities must consider the information provided in an importer’s transfer pricing documentation on a case-by-case basis.

5.2 ADVANCE PRICING AGREEMENTS AND VALUE DETERMINATIONS

For transfer pricing purposes, advance pricing agreements are not available to taxpayers. The advance ruling process in Chapter 7 of the Tax Administration Act, 2011 does not provide for advance pricing agreements. Section 80(1)(a)(iii) of the Tax Administration Act, allows SARS to reject any application which requires the determination of the pricing of goods or services supplied by, or rendered to, a connected person to an applicant. SARS has indicated as long ago as 2000 that in the long term it will consider introducing advance pricing agreements, once it has developed sufficient capacity to administer them. However, no such program has materialised.

Even if an APA program were to be implemented, this would not necessarily result in SARS accepting the information provided by the taxpayer during the negotiation of an APA in a concurrent application for a value determination. There are several reasons for this:

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3 SARS Customs External Directive: Method 1 Valuation of Imports 40-41.
4 Jovanovich, 2015: 142-143.
5 SARS Comments on Representations to the PCOF on the Revenue Laws Amendment Bill, 2000 (24 October 2000) 11.

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(i) The information provided in transfer pricing documentation is generally not sufficient for customs valuation purposes and SARS’ stated policy is that it does not accept such information as evidence in the “circumstances surrounding the sale” test; and

(ii) SARS’ current customs systems, which do not allow for bulk VOCs and reconciliations, which would arise as a result of agreed transfer pricing adjustments in terms of an APA.

In any event, the use of APAs has varied between jurisdictions but is generally regarded as low. In the United States, applications for an APA between 2000 and 2007 ranged between 20 and 50 applications per year. Whereas in India, the APA regime was well used at its inception. The reasons for the mixed reception of APA programs is that while the APA process brings some certainty, it is generally lengthy and in many cases, expensive. Moreover, taxpayers may be reluctant to disclose the details of their business operations to tax authorities in order to avoid highlighting potential tax issues which may have been passed over in a normal audit.

Moreover for an APA to be effective, it should be a bilateral or multilateral APA. Taxpayers who obtain a unilateral APA are at risk of double taxation, where a tax authority makes a transfer pricing adjustment while another foreign tax authority may not be willing to make an equivalent corresponding adjustment, as it did not participate in the APA process. The involvement of multiple tax authorities adds complexity to the process as the taxpayer and tax authorities are required to negotiate with each other.

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7 SARS Customs External Directive: Method 1 Valuation of Imports 40-41.
8 Michaletos, 2013: 45.
9 Snowden, 2010: 9.
11 Sikanar, 2013: 1 reports that at the inception of the Indian APA program approximately 150 firms applied for APAs.
12 Givati, 2009: 173 states that the median waiting period in the United States in 2006 was 28 months; Snowden, 2010: 9; Gandhi, Parameswaran & Menon, 2011: 35 indicate that the period for a bilateral APA varies between 18 months and three years.
14 Kerschner & Stiaxny, 2013: 590.
On the other hand, for customs valuation purposes, a value determination may be obtained from SARS. SARS will in any event require an importer transacting with a “related party” to complete a valuation questionnaire. The value determination process will assist the importer in quantifying the dutiable value of the imported goods (particularly in relation to the amount of additions to the transaction value of the goods, such as royalties) and thus, complying with the C&E Act. However, based on the findings in the case study above, the importer is at risk of making a false declaration if it makes year-end adjustments in respect of new imports and even if it does include the details of year-end adjustments in the valuation questionnaire the importer may have to approach SARS for new determinations frequently in the event that the total purchase consideration payable (inclusive of year-end adjustments) changes in a particular year, based on the importer’s transfer pricing documentation. There is also the risk that SARS will determine a customs value for the imported goods which is different from what is proposed by the importer.

If SARS were to change its policy on the use of transfer pricing documentation in customs valuations it may be possible for an importer to obtain a value determination which accords with transfer prices it has determined for income tax purposes on an annual basis. This would be a significant step towards harmonisation of customs valuation and transfer pricing regimes. SARS would also need to confirm that is will accept the transfer pricing method used to establish the price of the imported goods, and not an actual value, which is subject to change.

5.3 DECLARATION OF PROVISIONAL VALUES AND RECONCILIATIONS

As indicated in Chapter 2, the United States Customs and Border Protection has had a reconciliation program in place for many years which allows an importer to make a customs declaration based on the best available information to the importer and flag (i.e. highlight) that entry or several entries, individually or in aggregate, for reconciliation within a certain period. 

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15 Please see 4.2.2 above.
16 Please see 2.6.2.
Such a reconciliation would provide a possible solution to Company A’s difficulty in determining the amount representing royalties paid to Company C which must be included in the dutiable value of the goods purchased from Company C. Using a reconciliation program Company A could flag all import transactions involving goods acquired from Company C for reconciliation. Once the royalty amount is determined at the end of the financial year, the amount can be apportioned to all of the marked import transactions, individually or in aggregate.

However, an equivalent system for provisional declarations does not appear to exist in South Africa. Moreover, in relation to the calculation of additions to the dutiable value of the imported goods, the system would have limited practical usefulness if the importer (i.e. Company A) has obtained a value determination from SARS, which includes the royalty paid to the supplier (i.e. Company C).

SARS allows importers to make a provisional payment in order to obtain the release of imported goods, and at the time of release the importer is not able to declare the correct tariff heading or the correct value for customs duty. It is not clear whether an importer is allowed to make a provisional payment where it is not able to declare the correct customs value merely because certain data relevant to the transaction is unknown but SARS’ list of examples where the procedure may be used is not exhaustive.18 A further difficulty is that SARS notes that the period within which the importer’s liability for customs duty must be finalised should rarely be more than three months.19 SARS does provide some guidance that provisional values can be declared in relation to the determination of royalties or licence fees which are subject to the passing of a VOC within a specified period but no period is specified. It is submitted that a period of three months is not practical in a number of the circumstances set out above where a final value may only be determined more than 12 months after the goods were imported. Thus, SARS should provide some clarity on the period for which the determination of the customs value of goods can be finally determined.

18 SARS Customs External Policy: Provisional Payments (3 June 2013) 3-4 (hereafter referred to as “Customs External Policy: Provisional Payments”).
19 Customs External Policy: Provisional Payments 4.
Article 13 of GVC allows the importer to delay the final determination of the customs value of goods under any circumstances, while still allowing the importer to import the goods subject to the provision of adequate security.\textsuperscript{20} The application of this article is not limited to a specific set of circumstances. As the GVC is incorporated into the C&E Act, SARS must ensure that its practice is consistent with article 13 of the GVC.

In addition to allowing adjustments to the dutiable value of goods to take account of royalties which have yet to be determined, the United States reconciliation program can be used to amend the transaction value of imported goods pursuant to a year-end adjustment. However, the United States Customs and Border Protection require that importer’s transfer pricing policy specifies how the transfer price is to be determined and what adjustments must be made to the transfer price.\textsuperscript{21}

The same information on how a price must be determined can be incorporated into a distribution or supply agreement in the form of a price review clause in order to support the importer’s declared customs value. A price review clause is desirable, particularly where it contains a formula which is used to determine the price of the goods. If such a clause is not present and it transpires that the importer has paid too much to the seller of the goods, the refund may be regarded as a discount or rebate which may not be taken into account in determining the customs value of the goods retrospectively. A refund of duties paid is normally only available where the duties were not legally owing at the time that the goods were imported and even then, where the change in the amount legally owed is the result of deliberate action by the parties then customs authorities may still refuse to refund the duties paid.\textsuperscript{22}

On the other hand, if the price paid by the importer for the goods is reduced by virtue of a review clause that final price will represent the transaction value of the goods as the final determination of the customs value of the goods has been delayed. Thus, any reduction in the price of the goods will not take the form of a rebate. Delaying the final determination of the value of the goods imported because the importer does not have all necessary

\textsuperscript{21} Please see 2.6.2 above.  
\textsuperscript{22} Lasinski-Sulecki, 2013: 179-180.
information available at the time the goods are imported ensures that importers in these circumstances are declaring the correct customs values.\textsuperscript{23}

Thus, it would be advisable for SARS to provide adequate guidance on whether it is permissible for importers to declare a provisional customs value because the final value of the goods is subject to determination in terms of a price review clause. However, given SARS’ practice of rejecting information which is provided in a transfer pricing analysis it is unlikely that SARS would be agreeable to price review clauses which are based on the application of transfer pricing methods.

It is submitted that if SARS can take these steps the system for provisional declarations will be more attractive to importers. However, no reconciliation program equivalent to that used by the United States Customs and Border Protection exists in South Africa. This means that there is an additional administrative burden on the importer, who is required to pass VOC’s for each provisional declaration. This may limit the usefulness of provisional declarations.

Despite this limitation provisional declarations, in theory, have some benefit from a compliance perspective as they eliminate the risk of the taxpayer understating the customs value of imported goods by eliminating the importer’s need to estimate additions to the customs value such as royalties and the final value of the imported goods. This would assist importers in avoiding penalties and, potentially, criminal prosecution.\textsuperscript{24} In practice however, the use of a provisional declaration by an importer will be limited where it has obtained a value determination from SARS (whether of its own accord or in the course of an investigation by SARS). This is likely where the importer and the supplier are related for the purposes of section 66(2)(a) of the C&E Act.\textsuperscript{25}

\textsuperscript{24} Please see sections 84 of the C&E Act. A person who makes a false statement in connection with any matter dealt with in the C&E Act, or who submits a declaration or document containing any such statement is, unless he proves that he was ignorant of the falsity of such statement and that such ignorance was not due to negligence on his part, be guilty of an offence and liable on conviction to a fine not exceeding R40 000 or treble the value of the goods to which such statement, declaration or document relates, whichever is the greater, or to imprisonment for a period not exceeding ten years, or to both such fine and such imprisonment, and the goods in respect of which such false statement was made or such false declaration or document was used shall be liable to forfeiture.
\textsuperscript{25} Please see 3.2.3 above.
From an income tax perspective it is also advisable to have a price review clause in the event of a year-end adjustment. This is because the taxpayer is only allowed to claim a deduction from income tax in terms of section 11(a) Income Tax Act in respect of expenditure actually incurred. An importer would not be able to rely on section 31 of the Income Tax Act to increase its expenditure in respect of the acquisition of the goods or its inventory cost if it makes a compensating adjustment only.

By incorporating a price review clause in the distribution the taxpayer will be able to increase the price actually paid for the goods and claim a deduction from income tax in terms of sections 11(a) of the Income Tax Act, as the case may be.

5.4 AGGREGATED ADJUSTMENTS FOR CUSTOMS PURPOSES

As indicated by Michaletos, the C&E Act does not allow for the filing of bulk vouchers of correction. Thus, where an adjustment is required for customs purposes, pursuant to a transfer pricing adjustment or the amendment of other information previously declared to SARS, such as the royalties paid by the importer to the seller of the goods, each previous declaration must be amended by way of a VOC. Michaletos suggested in 2013, while the Customs Duty Act was being drafted, that the use of bulk VOCs should be permitted under the new legislative dispensation. 26 However, the Customs Duty Act and the rules thereto do not allow for bulk VOCs.

As indicated earlier in 5.3, these aggregated adjustments via bulk VOCs would also facilitate the reconciliation process in respect of provisional declarations for customs purposes. Thus, SARS should consider introducing a bulk VOCs or a similar mechanism to allow for lump sum or aggregate adjustments to customs declarations.

Moreover, the proposal for lump sum adjustments must be considered in conjunction with a voluntary disclosure programme, where the importer has made a final customs declaration. We have already established that the use of provisional declarations should assist the importer in avoiding any penalties under the C&E Act. Where the importer has made a final declaration which under values the imported goods the importer risks the

26 Michaletos, 2013: 45.
imposition of significant penalties under section 84 of the C&E Act. There is little incentive for the importer to amend the declaration later unless it has some guarantee that it will be prosecuted criminally or subjected to significant penalties. Under the C&E Act, there is no option to make voluntary disclosure against relief from the imposition of penalties.

Thus, lump-sum adjustments are only useful in relation to the finalisation of provisional declarations.

5.5 MINIMISING RETROSPECTIVE TRANSFER PRICING ADJUSTMENTS

In Chapter 2 above, several authors recommend the proactive monitoring of budgeted and actual financial performance of the importer during the financial year. Where the importer’s budgeted and actual financial results diverge, the importer may make prospective adjustments to the price of the imported goods, for customs and income tax purposes, instead of adjusting the price of the imported goods prospectively. This is desirable from a customs perspective as these adjustments are less likely to attract additional scrutiny for customs authorities and avoid any argument that the taxpayer has under declared the customs value of imported goods during the course of the year. However, where the importer obtained a value determination from SARS based on a particular price for the goods (based on its transfer prices prevailing at the time) and this price is amended due to a prospective adjustment Company A would probably have to approach SARS for a new value determination.

It was also noted in Chapter 2 that the price setting approach has been criticised as being more burdensome for taxpayers in comparison to the outcomes based approach. This is because the price setting approach requires the taxpayer to analyse its transfer prices constantly. The use of the price setting approach without careful monitoring of the taxpayer’s actual and budgeted financial results throughout the year may result in large variances between the actual and budgeted results. This in turn may result in increased scrutiny from tax authorities, even if the variances are justifiable. It is also not certain

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27 Please see 2.6.4 above.
29 An, Gambardella & Ritchie, 2010: 1036.
30 Please see 2.6.4 above.
31 Please see 2.6.4 above.
whether the importer would have to approach SARS for a new value determination
(assuming it has a VDN), unless SARS has accepted the transfer pricing method put
forward by the importer, and accordingly, the method the importer uses to determine its
transfer prices.

On the other hand, and despite OECD’s lack of preference between the price setting
approach or the outcomes based approach, there does appear to be more concern on the
part of tax authorities and academics that the outcomes based approach to transfer pricing
does not reflect the behaviour of parties acting at arm’s length.32

It is submitted that, notwithstanding the difficulties outlined above, the use of the price
setting approach to transfer pricing, proactive monitoring of results and prospective
transfer pricing adjustments is a readily available means of managing transfer pricing and
customs valuation risks.

5.6 CONCLUSIONS

This chapter sought to critically analyse proposals identified in Chapter 233 for the effective
management of Company A’s risks. It was established that as a primary step SARS should
provide guidance to importers on provisional declarations. SARS should also reconsider
the use of transfer pricing documentation in customs valuations and provide guidance on
the information which should be incorporated into the importer’s transfer pricing
documentation.

In relation to APAs, it was established that no APA programme exists in South Africa and in
any event APAs would not necessarily resolve the difficulties facing Company A and
importers who are similarly situated. APA programmes have had a mixed reception in
states due to the costs involved, the hesitancy of taxpayers to open their businesses up to
increased scrutiny from tax authorities during the APA process. The efficacy of an APA is
also questionable when it involves only one state.

32 Please see 2.6.4 above.
33 Please see 2.6.
It was concluded, in relation to provisional declarations, that they have limited practical use as an importer is still required to amend individual provisional declarations when reconciling the declarations once the importer has sufficient information available to it to accurately declare the customs value of the goods. Accordingly, SARS should consider implementing an electronic reconciliation program which allows for individual or aggregated reconciliation of the dutiable value of imported goods.

While, provisional declarations have some benefit for importers as they reduce the risk of the importer understating the customs value of imported goods and incurring significant penalties and possibly facing criminal sanctions. In practice however, the importer is likely to obtain a value determination from SARS, which negates the need for a provisional declaration.

Following on from provisional declarations, the issue of aggregated value adjustments to prior import transaction was considered. Presently it is not possible for importers to make such adjustments. SARS should consider introducing an option for such aggregated adjustments by way of a bulk VOC in order to reduce the administrative burden for importers who are required to amend the declared customs values in prior transactions due to a year end adjustment which results in a retrospective change in an importers transfer prices.

Moreover, the proposal for lump sum adjustments should be considered in conjunction with a voluntary disclosure programme, where the importer has made a final customs declaration.

Hand-in-hand with the issue of provisional declarations is the use of a price review clause in a distribution agreement, which is essential to year-end adjustments. It was established that the incorporation of a price review clause into the distribution agreement is advisable for transfer pricing purposes and for customs valuation purposes, as the amount of the adjustment will form part of the transaction value of the goods. The price review clause also ensures that the importer can claim a refund duties paid provisionally in the event of a downward year-end adjustment.
However, due to the absence of:

(i) an APA programme in South Africa;

(ii) an electronic customs reconciliation programme for importers and the lack of certainty regarding the time periods applicable in provisional declarations and the use of provisional declarations to take account of year-end adjustments; and

(iii) bulk VOCs for customs purposes,

it appears that the use of a price setting approach for transfer pricing purposes and careful monitoring of the taxpayer’s actual and budgeted financial results, with prospective adjustments to transfer prices may be the simplest and most effective way to manage the transfer pricing and customs valuations risks. However, even this measure has its limitations. Where the importer obtained a value determination from SARS based on a particular price for the goods (based on its transfer prices) and this price is amended due to a prospective adjustment Company A would probably have to approach SARS for a new value determination.

It should also be mentioned in the conclusion that provisional customs declarations have the potential to become an effective means of managing customs and transfer pricing risks (in relation year-end adjustments). However, SARS should provide guidance for importers, confirming that the SARS will accept a transfer pricing method as a means for determining the transaction value of imported goods in the value determination process, rather than establish a particular value for the imported goods.
CHAPTER 6: CONCLUSIONS

6.1 INTERSECTION OF THE CUSTOMS VALUATION RULES UNDER THE C&E ACT AND THE TRANSFER PRICING RULES UNDER THE INCOME TAX ACT

The first objective of this dissertation, set out in Chapter 1,¹ was to critically analyse the transfer pricing rules under the Income Tax Act and customs valuation rules under C&E Act and to also consider how these rules impact importers making year-end adjustments. However, there is limited literature on the intersection of customs valuation and transfer pricing rules, particularly in relation to the South African legislation (ie the Income Tax Act and the C&E Act).

Thus, Chapter 2 considered how the customs valuation and transfer pricing rules intersect, in international literature, in order to provide a basis for the consideration of the customs valuation and transfer pricing rules under the Income Tax Act and C&E Act in Chapter 3.

Chapter 2 first considered the means by which customs valuation and transfer pricing rules establish that parties are related was considered in order to determine whether they bear any similarities or differences, which may impact on harmonisation of customs valuation and transfer pricing rules.

It was established that the related party rules used in customs valuations, which have been adopted by WTO member states, appear to be largely formalistic. On the other hand there are no uniform rules on relationships for income tax purposes and thus, the rules may have formalistic or substantive economic elements. It is also possible the transfer pricing rules may be applied to certain transactions between unrelated persons. As a result, it is possible for parties to be related for customs purposes but not transfer pricing purposes, or vice versa.

Chapter 2 then compared and contrasted the valuation methods for customs and transfer pricing and related rules in order to determine whether harmonisation of these rules, which

¹ Please see 1.5 above.
was a recurring issue in the literature, is possible in theory. It was established from existing literature that the transfer pricing and customs valuation methods are similar but not completely compatible. There are also wider generalised differences which exist in relation to the time at which transfer prices and customs values are compared, the use of multiple years’ data in transfer pricing compared to the limited time period for comparison for customs purposes, the aggregation of transactions for transfer pricing opposed to the transaction-by-transaction approach to customs valuations and the treatment of intangible and assists. Nevertheless the transfer pricing and customs valuation methods do share some fundamental similarities which potentially allow for harmonisation of transfer pricing and customs valuation rules where an importer is required to demonstrate that its relationship with a supplier did not influence the transaction value of the imported goods;

Despite these difficulties, the interaction between tax and customs authorities at joint WCO and OECD summits on harmonisation of transfer pricing and customs valuation rules resulted in a conclusion that the most feasible means of harmonisation of these rules lies in the application of article 1.2 of the GVC. Several other recommendations were made to address the challenges which importers face the conflicting aspects of transfer pricing and customs valuation rules including incorporating information relevant customs authorities in transfer pricing documentation and advance pricing agreements, minimising transfer pricing adjustments, aggregated customs duty adjustments, using provisional customs declarations and price review clauses (in distribution agreements).

Following on from the conclusions of the joint WCO and OECD summits the final part of Chapter 2 considered the practical difficulties of harmonisation and the approaches taken by the authorities and taxpayers to achieving harmonisation of these regimes. It was established that it is important for the importer’s transfer pricing documentation to provide a segregated analysis of each produce line acquired and distributed by the importer and also specifies a formula on which transfer pricing adjustments will be made. The same information should be provided when negotiating an APA with tax authorities when the importer intends to involve customs authorities in the negotiation of the APA, a means which also been considered to facilitate the harmonisation of customs valuation and transfer pricing rules.
Moreover, if the importer can provide the information referred to above then it may be possible for an importer to declare a provisional value, which it can reconcile at a later stage in the event of a transfer pricing adjustment, thereby enabling the importer to declare the correct transaction value to the customs authority. This means that the importer avoids any penalties associated with the under-declaring the customs value of the goods and also avoids the overpayment of customs duties in the event that the customs value of the goods is adjusted downward at the end of the fiscal year;

It was also established that year-end transfer pricing adjustments may be an indication that the importer did not declare the correct customs value to the customs authority at the time of importation. Therefore an importer should also monitor its budgeted and actual results closely throughout the year and make pro-active adjustments to transfer prices. This approach may also be desirable from a transfer pricing perspective.

Further, it appears that there are a number of jurisdictions which are resistant to upward transfer pricing adjustments or have not formulated a policy to deal with such adjustments and as Hanken and Dorward have demonstrated, the most logical and reasonable time at which a taxpayer can establish its transfer prices for goods is at the beginning of the taxpayer’s fiscal year, based on benchmarking studies in prior years (thus, favouring the price setting approach).

Chapter 3, based on the findings relating to the underlying rules in the GATT and GVC considered how the C&E Act and Income Tax Act define related or connected parties. Chapter 3 also critically analysed the customs valuation rules in the C&E Act and the transfer pricing rules in the Income Tax Act in order to establish how they interact (taking account of what was established in Chapter 2 in relation to the GVC and TP Guidelines). Finally, Chapter 3 undertook a further review of South African literature to establish whether there were any practices of SARS which are relevant to the application of the domestic customs valuation and transfer pricing rules which may affect the case study in Chapter 4 and how these compare to, or contrast with, international practices.

Thus, Chapter 3 established that:
(i) in relation to related parties for the purposes of the C&E Act, section 66(2)(a) allows for a wide definition of “control” over two companies by a common shareholder, or another person; and

(ii) the “connected person” definition in section 1, read with section 31(4), of the Income Tax Act is largely a formalistic test based on the existence of certain legal relationships. This definition is much narrower than the C&E Act definition of relationships and may be exploited by importers, leading to divergences between transfer prices and customs values by importers who are related for customs purposes but not subject to transfer pricing rules.

Chapter 3 then established that the C&E Act generally reflects the principles in the GVC, except that section 129(1)(b) of the Customs Duty Act is a novel provision in South African customs law which will allow SARS to reject the transaction value of any goods which were not sold under fully competitive conditions which has the potential to create uncertainty, contrary to the object of the GVC.

It was further established that the test for whether a royalty or license fee is dutiable is a broad test which considers the dynamics of the relationship between the importer and the person receiving the payment and whether the sale would have been concluded but for the payment, as a matter of fact, taking account of the relationship between the parties.

Finally, in relation to customs valuations it was concluded in Chapter 3 that SARS’ practice in relation to customs valuation is to require related parties to answer a valuation questionnaire to demonstrate that their relationship did not affect the price of the price of the goods, as part of its powers to determine the customs value of goods under section 65(4) of the C&E Act. SARS will not consider the information in transfer pricing documentation as evidence that the price actually paid or payable was not affected by the relationship between the parties. If the importer cannot satisfy the circumstances of the sale test, it will only be permitted to provide substitute values, to the extent that SARS has previously allowed the importer to utilise that substitute value in the valuation of identical or similar goods.
In relation to the transfer pricing rules in the Income Tax Act Chapter 3 established that:

(i) Section 31 of the Income Tax Act requires a taxpayer to calculate its tax liability in relation to transactions with a “connected person” on an arm’s length basis;

(ii) Practice Note 7 largely reflects the principles of the TP Guidelines and allows taxpayers to use the TP Guidelines when determining whether a transaction was carried out on an arm’s length basis, but is based on a much earlier version of the TP Guidelines; and

(iii) However, Practice Note 7 does not resolve the question of whether one of the outcomes based approach or price setting approach is more desirable. It is submitted that the price setting approach may be desirable in many cases as it allows for parties to be adequately compensated, or bear the transactional losses for the risks that they actually bear. It is also arguable that the outcomes-based approach which requires year-end adjustments may not produce arm’s length results as an importer would want to retain any additional profits made in a year for itself, rather than pay the additional profit over to its supplier.

It was also established that SARS may regard year-end adjustments as a means of shifting residual profits offshore. Moreover, SARS is of the view that these taxpayers’ transfer pricing analyses often show little regard for the drivers in profits and the functional and risk profile of South African subsidiaries and regard to unique dynamics in the South African market.

It also appears that SARS will not regard compensating adjustments as giving rise to a deduction for income tax purposes. Any such deduction would have to be based on the other provisions of the Income Tax Act, such as section 11(a) of the Income Tax Act (ie expenditure actually incurred by the taxpayer). Thus, there is a significant risk that such adjustments would be disallowed, as a taxpayer’s deduction from income under section 11(a) of the Income Tax Act requires the taxpayer to actually incur expenditure.
Chapter 3 then considered the intersection of the customs valuation rules in the C&E Act and transfer pricing rules in the Income Tax Act interact (taking account of what was established in Chapter 2 in relation to the GVC and TP Guidelines) it was concluded that many of the difficulties and opportunities relating to harmonisation, which were identified in Chapter 2, apply equally in relation to the Income Tax Act and C&E Act. However, the prospects for harmonisation of transfer pricing and customs valuation rules are poor in light of SARS’ view that the information provided in transfer pricing documentation is not sufficient evidence that the relationship between the importer and supplier did not influence the price actually paid or payable.

6.2 EVALUATION OF THE CUSTOMS VALUATION RULES UNDER THE C&E ACT AND TRANSFER PRICING RULES UNDER THE INCOME TAX ACT

The second objective of this mini-dissertation was to evaluate the customs valuation rules under the C&E Act and the transfer pricing rules under the Income Tax Act by way of a case study. The evaluation was intended to determine whether harmonisation of the customs valuation rules under the C&E Act and transfer pricing rules under the Income Tax Act is practically feasible. The evaluation was also intended to identify any risks for importers, making year-end adjustments.

From the case study it was established that, in relation to the transfer pricing rules in section 31 of the Income Tax Act, the distribution transactions under review were largely compliant with section 31 of the Income Tax Act and Practice Note 7. However, SARS is concerned that use year-end adjustments based on a targeted profitability margin is a means of shifting profits from South Africa. Thus, SARS may want to challenge the transfer pricing analysis and consequent year-end adjustments on the basis that the transfer pricing analysis did not take account of local market conditions. Thus, the use of year-end adjustments may result in increased scrutiny from SARS, but the adjustments are still preferable to compensating adjustments without an underlying payment as any adjustment to the price of goods acquired by the importer would not be allowed as a deduction from the importer’s income as it would not have been incurred in the production of income as required by section 11(a) of the Income Tax Act. That said, companies
should consider using the price setting approach to transfer pricing as this may lead to fewer year-end adjustments and thus, address SARS’ concerns.

No issues arose in the transfer pricing analysis in relation to the royalty transaction under review and the inclusion of the royalty in the dutiable value of the imported goods. This was not unexpected because the amount of the royalty is not required to be arm’s length for customs purposes.

In relation to the application of the customs valuation rules in the C&E Act it was established that the importer of the goods will be required to show, in the value determination process that the price actually paid or payable for the goods was not influenced by the circumstances surrounding the sale of the goods because it was related to the seller. The importer will also not be able to use the information in its transfer pricing documentation to satisfy SARS that it has been dealing at arm’s length with the seller in the value determination process. This is because the analysis for the distribution transaction used the transactional net margin method, which provides a net margin for all distribution activities is too general and is not segregated per product line. Further, it was established that the importer will not be able to incorporate the information in its transfer pricing documentation directly into one of the customs valuation methods, for the purposes of determining a substitute value. SARS will not allow the importer to rely on a substitute value based on one of the customs valuation methods, which it has not accepted in a previous import transaction.

These findings were mostly expected in light of the law and practice applicable to customs valuations described in Chapter 3 above. It was still surprising to find that so little information in the transfer pricing analysis could be used for customs valuation purposes, which would justify SARS’s generalised view on the usability of this information in the circumstances surrounding the sale test. However, this does necessarily justify SARS’ approach to the problem in simply rejecting the use of transfer pricing documentation in the value determination process.

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Please see 3.2.2 to 3.2.4 above.
On the key issue of whether year-end adjustments to the price of goods for transfer pricing purposes, may have an effect on the customs value of the same goods, it was found that:

(i) There are strong reasons for finding that the payment by Company A to Company C as a result of the year-end adjustment forms part of the transaction value of the imported goods and results in the underpayment of customs duties, or at least the year-end adjustment may be an indication that the declared value of the goods was not an arm’s length price for the imported goods;

(ii) The customs risk for Company A will therefore depend on what was declared to SARS in the valuation questionnaire and any subsequent change in circumstances. In a worst case scenario, the “double taxation” contemplated in Chapter 13 could occur if SARS challenges the year-end adjustment under section 31 of the Income Tax Act and pursues Company A for additional customs duties, based on existence of year-end adjustments.

(iii) This risk could be overcome if SARS actually approved the method used to determine the transaction value of the goods and that the value may be subject to year-end adjustments. However, based on SARS’ views on transfer pricing documentation, it appears that SARS would generally not accept such a proposal in the value determination process. At least, if SARS accepted the transaction value of the goods on this basis, there may be grounds for Company A to claim a refund of customs duty if SARS challenges the transfer price of the goods in terms of section 31 of the Income Tax Act. However, this is not a complete solution as the refund will be limited goods imported in the last two years and vouchers of correction will have to be passed for each transaction by agreement, likely with agreement from SARS.

(iv) On the other hand, if the year-end adjustments were declared to SARS in the valuation questionnaire and SARS rejected the transaction value of the goods and proceeded to determine that the goods should be valued based on one of the

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3 Please see 1.1 above.
4 Please see the limitation on the period for refunds in terms of section 76 of the C&E Act.
5 Please see section 40(3)(a)(i) read with section 76(2)(f) of the C&E Act.
methods in sections 66(4) to (9) of the C&E Act, rather than the price actually paid or payable for the goods then Company A will be compliant with the C&E Act in using the value determined by SARS when it imports the goods.

(v) Again, this could result in some level of “double taxation” as there is a risk that Company A may pay customs duties based on a higher customs value for the imported goods while paying income tax based on lower transfer prices for the same goods.

As mentioned in Chapter 1\(^6\) above, there is some debate on the extent to which a transfer pricing adjustment can affect the customs valuation of goods. It is true that a compensating adjustment can be viewed as a legal fiction. However, when the year-end adjustment involves an actual payment or a creation of a loan account between the parties then the question of whether the year-end adjustment has customs valuation implications will depend on the value of the goods that was declared to SARS.

It is evident that there is some risk for Company C if it makes year-end adjustments to the transfer price of goods acquired from Company A but has declared a different transaction value for the goods to SARS in the value determination process. First is the risk of “double taxation” and second is the risk of penalties where Company A is found to have made a false declaration.

Also on the issue of customs valuation rules, the royalty paid by Company A to Company C is based on its net sales of imported goods throughout the year, and is only finalised at the end of the year. It is thus difficult to accurately calculate the dutiable value of the goods in the import transaction. However, it was found that difficulty is ameliorated by the importer approaching SARS for a value determination in respect of the imported goods, as SARS will determine the amount, representing royalties, to be added to the transaction value of the imported goods.

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\(^6\) Please see 1.3 above.
6.3 ANALYSIS OF THE VARIOUS MEANS OF MANAGING CUSTOMS VALUATION AND TRANSFER PRICING RISKS

The third objective of this mini-dissertation was to critically analyse the various means of managing customs valuation and transfer pricing risks which were proposed in Chapter 2\(^7\) for the effective management of Company A’s risks.

It was established that as a primary step SARS should provide guidance to importers on provisional declarations. SARS should also reconsider the use of transfer pricing documentation in customs valuations and provide guidance on the information which should be incorporated into the importer’s transfer pricing documentation.

In relation to APAs, it was established that no APA programme exists in South Africa and in any event APAs would not necessarily resolve the difficulties facing Company A and importers who are similarly situated. APA programmes have had a mixed reception in states due to the costs involved, the hesitancy of taxpayers to open their businesses up to increased scrutiny from tax authorities during the APA process. The efficacy of an APA is also questionable when it involves only one state.

It was concluded, in relation to provisional declarations, that they have limited practical use as an importer is still required to amend individual provisional declarations when reconciling the declarations once the importer has sufficient information available to it to accurately declare the customs value of the goods. Accordingly, SARS should consider implementing an electronic reconciliation program which allows for individual or aggregated reconciliation of the dutiable value of imported goods.

While, provisional declarations have some benefit for importers as they reduce the risk of the importer understating the customs value of imported goods, incurring significant penalties and possibly facing criminal sanctions. In practice however, the importer is likely to obtain a value determination from SARS, which negates the need for a provisional declaration.

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\(^7\) Please see 2.6.
Following on from provisional declarations, the issue of aggregated value adjustments to prior import transaction was considered. Presently it is not possible for importers to make such adjustments. SARS should consider introducing an option for such aggregated adjustments by way of a bulk VOC in order to reduce the administrative burden for importers who are required to amend the declared customs values in prior transactions due to a year end adjustment which results in a retrospective change in an importers transfer prices.

Moreover, the proposal for lump sum adjustments should be considered in conjunction with a voluntary disclosure programme, where the importer has made a final customs declaration.

Hand-in-hand with the issue of provisional declarations is the use of a price review clause in a distribution agreement, which is essential to year-end adjustments. It was established that the incorporation of a price review clause into the distribution agreement is advisable for transfer pricing purposes and for customs valuation purposes, as the amount of the adjustment will form part of the transaction value of the goods. The price review clause also ensures that the importer can claim a refund duties paid provisionally in the event of a downward year-end adjustment.

However, due to the absence of:

(i) an APA programme in South Africa;

(ii) an electronic customs reconciliation programme for importers and the lack of certainty regarding the time periods applicable in provisional declarations and the use of provisional declarations to take account of year-end adjustments; and

(iii) bulk VOCs for customs purposes,

it appears that the use of a price setting approach for transfer pricing purposes and careful monitoring of the taxpayer’s actual and budgeted financial results, with prospective adjustments to transfer prices may be the simplest and most effective way to manage the
transfer pricing and customs valuations risks. However, even this measure has its limitations. Where the importer obtained a value determination from SARS based on a particular price for the goods (based on its transfer prices) and this price is amended due to a prospective adjustment Company A would probably have to approach SARS for a new value determination.

It should also be mentioned in the conclusion that provisional customs declarations have the potential to become an effective means of managing customs and transfer pricing risks (in relation year-end adjustments). However, SARS should provide guidance for importers, confirming that the SARS will accept a transfer pricing method as a means for determining the transaction value of imported goods in the value determination process, rather than establish a particular value for the imported goods.

6.4 LIMITATIONS OF THIS MINI-DISSERTATION

This mini dissertation has two limitations.

First, the mini-dissertation was partly limited by the scope of the case study. The case study did not present an extensive facts on how Company A established the customs value of the goods it imported. This resulted in the findings on the value determination process, in Chapter 4, being contingent on what was declared to SARS. Unfortunately the information available regarding the declaration made by Company A to SARS in the value determination process was too old and too vague to be useful.

Second, the findings in Chapters 3 and 4 regarding SARS’ practices were based on publically available information contained in journal articles and directives published by SARS. No direct input was obtained from SARS officials.

6.5 RECOMMENDATIONS

In light of the findings set out in this Chapter it is recommended that:

8 Please see 4.3.2.
(i) SARS restates its policy on the use of transfer pricing documentation in the value
determination process to take account of the WCO’s Commentary 23.1;

(ii) SARS considers introducing an electronic customs reconciliation programme similar
to that used by the United States Customs and Border Protection as part of the
customs modernisation programme for importers, with a clearly defined period for
reconciliation of provisional declarations;

(iii) SARS considers introducing rules for the use of bulk VOCs to correct customs
declarations to ease the administrative burden for importers who are required to
reconcile or correct customs declarations after making year-end adjustments.

Areas for further research could include the use of the price setting approach and
outcomes based approach to transfer pricing analysis. Currently, as stated above, the TP
Guidelines do not express a preference for one of the approaches and there has been
some criticism of both approaches.\(^9\) There may be some scope for quantitative analysis of
the preferences of taxpayers on the use of the price setting approach and outcomes based
approach to transfer pricing, or further critical analysis of these approaches to transfer
pricing.

\(^9\) Please see 2.6.4 above.
7  BIBLIOGRAPHY

7.1  BOOKS


7.2  CASES

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7.3  JOURNAL ARTICLES


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Michaletos, J “More holistic planning around custom valuation and transfer pricing: focus” TAXtalk issue no. 43 (2013) 44-45.


7.4 LEGISLATION

26 Code of Federal Regulations § 1.482-1(i)(4)
Customs and Excise Act (91 of 1964).


Customs Duty Act (30 of 2014).


Tax Administration Act (28 of 2011).

7.5 INTERNATIONAL INSTRUMENTS


7.6 OTHER MATERIALS


Government Notice 1334 Government Gazette 40375 (28 October 2016)


