

**POSSIBLE IMPLEMENTATION OF ADVANCE PRICING ARRANGEMENTS IN SOUTH  
AFRICA**

Mini dissertation by

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# Contents

LIST OF ABBREVIATIONS.....	4
CHAPTER 1 INTRODUCTION.....	5
BACKGROUND .....	5
RATIONALE FOR THE STUDY .....	6
RESEARCH PROBLEM STATEMENT .....	8
RESEARCH OBJECTIVES .....	8
RESEARCH DESIGN AND METHODOLOGY .....	9
PLANNED STRUCTURE OF THE MINI-DISSERTATION.....	10
CHAPTER 2 THE CONCEPT OF APAs.....	12
2.1. INTRODUCTION.....	12
2.2. THE ARM'S LENGTH PRINCIPLE.....	12
2.3. INTRODUCTION TO APAs .....	14
2.4. SAILIENT FEATURES OF AN APA PROGRAMME .....	17
2.5. APA PROCESS .....	18
2.6. ADVANTAGES OF IMPLEMENTING THE USE OF AN APA.....	19
2.7. SHORTCOMMINGS OF THE USE OF AN APA.....	20
2.8. CONCLUSION .....	20
CHAPTER 3 APA FRAMEWORK IN THE UK.....	21
3.1. INTRODUCTION.....	21
3.2. BACKGROUND AND DEVELOPMENT OF THE APA PROGRAMME .....	21
3.3. BASIS OF TRANSFER PRICING LEGISLATION IN THE UK .....	24
3.4. LEGAL FRAMEWORK OF APAs IN THE UK .....	25
3.5. CONCLUSION .....	31
CHAPTER 4 APA FRAMEWORK IN INDIA .....	32
4.2. BACKGROUND AND DEVELOPMENT OF THE APA PROGRAMME IN INDIA .....	32
4.3. BASIS OF TRANSFER PRICING LEGISLATION IN INDIA.....	35
4.4. LEGAL FRAMEWORKOF APAs IN INDIA .....	36
4.5. CONCLUSION .....	41

CHAPTER 5: IMPLEMENTATION OF AN APA PROGRAMME IN SOUTH AFRICA .....	42
5.1 INTRODUCTION.....	42
5.2 FACTORS TO CONSIDER BEFORE IMPLEMENTING AN APA: INITIAL FEASIBILITY STUDY.....	43
5.3. IMPLEMENTATION OF AN APA FRAMEWORK SOUTH AFRICA .....	48
5.4. INCORPORATING THE APA FRAMEWORK INTO SOUTH AFRICAN LAW .....	54
5.5 CONCLUSION .....	61
CHAPTER 6: CONCLUSION .....	62
6.1 SUMMARY OF FINDINGS .....	62
6.2 CONCLUSION .....	63
6.3. RECOMMENDATIONS FOR FUTURE RESEARCH.....	64
BIBLIOGRAPHY .....	65

## LIST OF ABBREVIATIONS

AE	Associated enterprises
ALP	Arm's Length Principle
APA	Advance Pricing Arrangement / Agreement
BEPS	Base Erosion and Profit Shifting
CBDT	Central Board of Direct Taxes
FAQs	Frequently Asked Questions
FDI	Foreign Direct Investment
HMRC	Her Majesty Revenue and Customs
MAP	Mutual Agreement Procedure
MEMAP	Manual on Effective Mutual Agreement Procedures
MNE	Multinational Enterprises
OECD	Organisation for Economic Co-operation and Development
OECD Guidelines	Organisation for Economic Co-operation and Development, 2017
PN7	SARS Practice Note 7 which came into effect on the 6 August 1999
SARS	South African Revenue Service
SoP/SP	Statement of Practice
the Act	Income Tax Act 58 of 1962
TIOPA 2010	Taxation (International and Other Provisions) Act 2010
TIWB	Tax Inspectors Without Borders
UN Manual	UN Practice Manual (2017)
UNDP	United Nations Development Programme
US	United States

# CHAPTER 1 INTRODUCTION

## BACKGROUND

Arnold & McIntyre define a transfer price as follows:<sup>1</sup>

*‘A transfer price is a price set by a taxpayer when selling to, buying from, or sharing resources with a related person. For example, if ACo manufactures goods in country A and sells them to its foreign affiliate, BCo organised in country B, the price at which that sale takes place is called a transfer price. A transfer price is usually contrasted with market price, which is the price set in the market place for transfer of goods and services between unrelated persons.’*

It is clear from this definition that it would be possible for Multinational Enterprises<sup>2</sup> (“MNEs”) to price intragroup transactions so that profits are taxed in low tax jurisdictions while deductions are taxed in high tax jurisdictions.<sup>3</sup>

Transfer pricing therefore refers to the setting of prices between associated enterprises<sup>4</sup> of the transfer of property or services which is also referred to as a “controlled transaction” which is distinct from an “uncontrolled transaction” which are between companies that are not associated and which such transaction is at arm’s length basis<sup>5</sup>.

In order to regulate the issue of transfer pricing within MNEs most countries to a certain extent follow the Organisation for Economic Co-operation and Development (“OECD”) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereafter referred to as the “OECD guidelines”) which comprehensively covers the arm’s length principle<sup>6</sup> (“ALP”), administrative approaches, and resolving transfer pricing disputes.<sup>7</sup>

There are many challenges in South Africa in arriving at the arm’s length price. These challenges include choosing the appropriate transfer pricing method and avoiding the risk of audits in respect of non-compliance with documentation requirements. In an endeavour to

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<sup>1</sup> Olivier, L. *et al* 2011. International Tax: A South African Perspective, 5<sup>th</sup> edition, Siber Ink, Cape Town 620, primary source: Arnold and McIntyre, *International Tax Primer*, (2002) 55.

<sup>2</sup> A MNE is defined as being part of an MNE group which is a group of associated companies with business establishments in two or more countries.

<sup>3</sup> *Ibid* fn 1.

<sup>4</sup> An associated enterprise is defined as two enterprises are associated enterprises with respect to each other if one of the enterprises meets the conditions of Article 9, sub-paragraphs 1a) or 1b) of the OECD Model Tax Convention with respect to the other enterprise.

<sup>5</sup> United Nations, 2013. United Nations Practice Manual on Transfer Pricing, United Nations, New York) 2.

<sup>6</sup> Refer to section 2.2 for a further discussion of the ALP.

<sup>7</sup> *Ibid* fn 5.

resolve transfer pricing disputes and the challenges of uncertainty, a number of countries have introduced Advance Pricing Arrangements<sup>8</sup> (“APA”) as a means of enhancing effectiveness to their transfer pricing regime.

The OECD defines an APA as:

*“An arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An advance pricing arrangement may be unilateral involving one tax administration and a taxpayer or multilateral involving the agreement of two or more tax administrations.”*

An APA is therefore a written binding contract between a taxpayer and a revenue authority.

There are two types of APAs, namely a unilateral and bilateral APA. A unilateral APA is where the taxpayer institutes an agreement with a tax authority in its jurisdiction. A bilateral APA is used in an effort to curb double taxation of income and is entered into by a taxpayer, tax authority and a foreign tax authority<sup>9</sup>.

An APA is seen, as a valuable mechanism that can be used by taxpayers internationally to obtain transparency and certainty on transfer pricing matters. However, the South African Revenue Service (“SARS”) has not, as yet, had any form of an APA system, and advanced tax rulings relating to transfer pricing matters has been specifically excluded.<sup>10</sup>

Many tax professionals are of the opinion that APAs are not available in South Africa because SARS has no personnel to deal specifically with APAs and the main inhibiting factor is the administrative and technical capacity of SARS to implement and maintain an APA system.

## **RATIONALE FOR THE STUDY**

Rapid advances in technology, transportation and communication have given rise to a large number of MNEs which have flexibility to place their enterprises and activities anywhere in the world.

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<sup>8</sup> The term "arrangement" and "agreement" is used interchangeably.

<sup>9</sup> Oguttu, A, “Resolving Transfer Pricing Disputes: Are ‘Advanced Pricing Agreements’ the Way Forward for South Africa?” (2006) Merc LJ 400.

<sup>10</sup> Section 80(1)(a)(iii), *Tax Administration Act 28 of 2011*.

Globalisation is therefore causing MNEs to play a significant role in the economy of most nations. It is estimated that approximately two-thirds of all business transactions worldwide take place amongst connected parties, and Africa is no exception.<sup>11</sup>

The South African government considers that South Africa should be the gateway into Africa by looking into attractive hubs for investments.<sup>12</sup> The main consideration is that South Africa should protect their domestic tax base without discouraging international trade or Foreign Direct Investment (“FDI”). To this extent transfer pricing has always been a priority for SARS.<sup>13</sup>

Transfer pricing regulations were first introduced to South Africa with effect from 19 July 1995 to counter transfer pricing malpractices which may have adverse tax implications for the South African tax base. Comprehensive legislation regulating transfer pricing is encapsulated in Section 31 of the Income Tax Act<sup>14</sup> (“the Act”) and the South African Revenue Services has issued a practical guide on how to approach transfer pricing in Practice Note 7 (hereafter referred to as SARS “PN 7”) which came into effect on the 6 August 1999.

What is more evident that transfer pricing is high on the agenda for SARS is the recent adoption of the Base Erosion and Profit Shifting (“BEPS”) Action 13,<sup>15</sup> which introduced the three tiered-approach to transfer documentation which entails:

- 1) The Country-by-Country Report;
- 2) Master File; and
- 3) Local File.

This documentation requirement places a compulsory obligation on taxpayers to submit specific documentation should certain intercompany transaction and group revenue thresholds be met.

To this extent, MNEs should manage their risks and expectations and the best possible way to achieve this certainty is by entering into APAs in the jurisdictions in which a MNE would operate.

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<sup>11</sup> PwC, “*Spotlight on Africa’s Transfer Pricing Landscape*” 2012, 5.

<sup>12</sup> *Ibid.*

<sup>13</sup> *Ibid.*

<sup>14</sup> Act 58 of 1962.

<sup>15</sup> Published by the OECD in July 2013.

Obtaining APAs is generally a time consuming and expensive process. However, MNEs may consider the investment worthwhile because the cost and disruption associated with transfer pricing disputes is generally significantly greater. Having an APA regime in South Africa would create this certainty for MNEs and would in return promote FDI in South Africa.

Therefore there is a need to evaluate the APA regime in a South African context and this consequently forms the basis of this dissertation.

## **RESEARCH PROBLEM STATEMENT**

There is a current need, or possible proposal to consider and evaluate the prospects of the implementation of APAs in South Africa. The research question that consequently arises is whether:

- 1) factors to consider when deciding to implement an APA in a developing country;;
- 2) practical implementation: with reference to the UK and Indian APA programme
- 3) whether implementation of an APA programme is possible in South Africa;

## **RESEARCH OBJECTIVES**

In an attempt to address the problem statement posed, the following objectives are formulated to answer the research question:

### **Primary research objective**

The primary-research objective or main purpose of this research is to comparatively explore the regulatory framework of APAs in the UK and India and the implementation thereof from a South African perspective.

### **Secondary research objective**

The primary research objective of this dissertation is supported by completing the following research objectives:

- discussion and concept of transfer pricing and the regime in South Africa;
- discussion of the concept of an APA in context of transfer pricing as well as the processes involved;
- advantages and disadvantages of APAs;
- research into the regulatory framework of APAs in the UK;
- research into the regulatory framework of APAs in the India;
- possibility of the implementation of APAs into the South African legal framework;



- distinguishing between APAs and Advance Tax Rulings;
- make possible recommendations and suggestions on whether SA should implement the APA regime;

## **RESEARCH DESIGN AND METHODOLOGY**

The research that is conducted in this dissertation will be applied comparative research. This applied research is the original or primary investigation undertaken in order to acquire new knowledge. It is, however, directed primarily towards a specific practical objective.<sup>16</sup>

Descriptive research information is collected that will demonstrate relationships that will assist in explaining and describing the current regulatory framework. The objective of explanatory research is to provide details where only small amounts of information exists.<sup>17</sup>

A specific research question has been identified above which will be answered through the collection and study of research. A comparative analysis of other countries (UK and India) will be conducted which will support the descriptive research as there are no published rulings, relevant publications, or interpretations notes in South Africa which focuses on APAs.

In order to obtain data for research, an evaluation of secondary data is evaluated. This data is the data that has been collected and is readily available from other sources.<sup>18</sup> Data includes:

- academic dissertations and thesis;
- books / Government publications;
- internet
- academic journals;
- newsletters / published reports
- theses and reports previously published will be assessed;

A further review will be conducted on the current APA regimes in two countries; namely the UK and India. The countries were selected for the following reasons:

- these countries revenue authorities are very aggressive and robust in transfer pricing;
- most of South Africa tax laws are derived from the UK tax legislation;
- south Africa's economy is very similar to that of India;
- both countries follows the OECD guidelines;
- these countries have developed views and guidance on APAs.

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<sup>16</sup> Wicht (2016) *UP University* p 14.

<sup>17</sup> Wicht (2016) *UP University* p 14.

<sup>18</sup> Wicht (2016) *UP University* p 15.

## **PLANNED STRUCTURE OF THE MINI-DISSERTATION**

The main outcome and objectives of the study will be presented in the format of a mini-dissertation. The planned structure of the mini-dissertation is explained, and briefly summarised below:

### **Chapter 1: Introduction**

Chapter 1 provides an introduction and background to the research and also includes the rationale and objective of the study as well as the research problem, research question and research objectives. The research design and methodology are briefly summarised and a brief description of the chapter structure that is included in the mini-dissertation.

### **Chapter 2: The concept of APAs**

Chapter 2 will provide a detailed explanation of an APA which would include the process involved as well as the advantages and disadvantages of an APA. The chapter will also provide insight into APA in the context of transfer pricing and what an APA aims to achieve. The discussion of this chapter will primarily be based on information provided for by the OECD. The following chapters 3 and 4 will provide insight into the countries that currently have an established APA.

### **Chapter 3: United Kingdom's current APA regulatory framework**

Chapter 3 provides insight into, and a detailed description of the current APA framework in the UK. The main objective of this chapter is to fully comprehend the APA regime in the UK and obtain useful information that could be applicable to South Africa. Gathering information would include, the advantages and disadvantages of APAs, the current APA framework and formal processes, the revenue authority contribution to the system and taxpayers interest in the system.

### **Chapter 4: India's current APA regulatory framework**

Chapter 4 provides insight into, and a detailed description of the current APA framework in India. The main objective of this chapter is to fully comprehend the APA regime in India and obtain useful information that could be applicable to South Africa. Gathering information would include, the advantages and disadvantages of APAs, the current APA framework and formal processes, the revenue authority contribution to the system and taxpayers interest in the system.

## **Chapter 5: A South African perspective**

Chapter 5 will provide insight into the current transfer pricing regime in South Africa and considering the implementation of the APA framework. The implementation would determine how the APA will form part of South Africa's regulatory framework and whether this would be viable option to consider taking into account the research that was considered in Chapters 3 and 4.

## **Chapter 6: Conclusion**

Chapter 6 will summarise and conclude the research. The chapter summarises the findings and conclusions from the other chapters, explains the contributions and limitations of the present study. In addition this chapter makes suggestions for future research.

## CHAPTER 2 THE CONCEPT OF APAs

### 2.1. INTRODUCTION

This chapter provides a detailed explanation of an APA which would include the process involved as well as the advantages and disadvantages of an APA. The concept of the ALP will also be introduced in this chapter as the underlying principle as to what an APA aims to achieve. If the concept of transfer pricing can be seen as an art then the ALP is seen to be that “essential painting” of that art.

The earliest concept of transfer pricing is believed to have occurred during 1920's in the United States (US).<sup>1</sup> Back in 1960's the US seemed to have been at the fore-front of transfer pricing by having transfer pricing regulations in place.<sup>2</sup> The US was also one of the first countries to raise the issue for the need of transfer pricing documentation and transfer pricing compliance amongst taxpayers back in 1988.<sup>3</sup> Then, in 1991 it is believed that the US was the first country to have issued an arm's length standard for intercompany transfer pricing in a binding APA and is one of the earliest known sources of such an APA.<sup>4</sup>

### 2.2. THE ARM'S LENGTH PRINCIPLE

#### 2.2.1. ALP in terms of the OECD

The ALP is the basis of transfer pricing, which is not an exact science but rather a methodology which can be interpreted differently, by different people.<sup>5</sup> Paragraph 1 of Article 9 of the OECD Model Tax Convention considers the arm's length principle as follows:

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

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<sup>1</sup> Mullachella, Z, “Improving the Effectiveness of the International Advance Pricing Agreement Process” (2018) *International Transfer Pricing Journal*, 69.

<sup>2</sup> *Ibid.*

<sup>3</sup> *Ibid.*

<sup>4</sup> *Ibid.*

<sup>5</sup> <http://transferpricing.co.za/category/transfer-pricing/arms-length-principle/> (Date used:10 March 2015).

In simple terms the ALP is the price at which independent enterprises would negotiate if they were bargaining in a competitive market.<sup>6</sup>

### **2.2.2. ALP in a South African context**

South Africa has adopted the ALP which is an international norm to firstly minimise the potential for double taxation,<sup>7</sup> secondly so that each tax jurisdiction will receive their fair share of taxes from an affected transaction,<sup>8</sup> and lastly appropriately deal with other countries which are overly aggressive in their enforcement of their transfer pricing rules.<sup>9</sup>

SARS PN 7 states, at paragraph 7.3:

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

Section 31 of the Income Tax Act<sup>10</sup> does not contain any guidelines on how to arrive at the arm’s length price but SARS PN 7 contains various methods on arriving at the arm’s length price.

SARS’ practice note is not law but merely a practical guideline where both the taxpayer and SARS need to approach each case, having due regard for the unique business and market realities applicable to each individual case.<sup>11</sup>

The arm’s length price does not constitute one single price but a range of prices and the facts of each case will determine where, within that range, a specific arm’s length price will lie.

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<sup>6</sup> Ndirangu, LJ (2015), *A case for introduction of advance pricing agreements provisions in Kenya: Creating certainty in transfer pricing law*, University of Nairobi 39.

<sup>7</sup> SARS’ *Practice Note 7* para 7.4.

<sup>8</sup> Transfer pricing rules for South African domestic intergroup transactions available at: <http://www.gt.co.za/publications/2013/05/e-taxline-may-2013/#link4> (Accessed: 6 July 2015).

<sup>9</sup> Olivier, L. *et al* 2011. *International Tax: A South African Perspective*, 628.

<sup>10</sup> Act 58 of 1962.

<sup>11</sup> SARS PN 7 (1999), 8.

The ALP is viewed by some as inherently flawed because in certain circumstances the ALP might result in an administrative burden for both the taxpayer and SARS. This cumbersome task can still be undertaken several years after the transaction has actually taken place.<sup>12</sup>

Another prominent issue that SARS and the taxpayer face is that there is a lack of adequate information to apply the ALP. The ALP requires both the taxpayer and SARS to evaluate uncontrolled transactions and the business activities of independent enterprises, and then to compare the transactions with and activities of connected persons which demands substantial amount of data.<sup>13</sup>

In order to eliminate these flaws many OECD countries have implemented APAs into their transfer pricing regimes.

### **2.3. INTRODUCTION TO APAs**

There are many challenges in arriving at the arm's length price. These challenges include choosing the appropriate transfer pricing method and avoiding the risk of audits in respect of non-compliance with documentation requirements. In an endeavour to resolve transfer pricing disputes and the challenges of uncertainty, a number of countries have introduced APAs as a means of enhancing effectiveness to their transfer pricing regime.<sup>14</sup> The main purpose of an APA is to provide certainty to both taxpayers and tax administrations by reducing the risk of any future transfer pricing audits or tax disputes.<sup>15</sup>

The OECD defines an APA as:<sup>16</sup>

*“An arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An advance pricing arrangement may be unilateral involving one tax administration and a taxpayer or multilateral involving the agreement of two or more tax administrations.”<sup>17</sup>*

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<sup>12</sup> OECD, 2010. OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD Publications, Paris par 1.9.

<sup>13</sup> *Ibid*, par 1.12.

<sup>14</sup> Oguttu, A, (2006) *MERC* 400.

<sup>15</sup> Mullachella (2018) *International Transfer Pricing Journal* 68.

<sup>16</sup> <http://www.oecd.org/tax/transfer-pricing/38008392.pdf> (Accessed : 15 June 2015).

<sup>17</sup> OECD, 2017. OECD Guidelines 23.

Another definition that can be found in The United Nations Practice Manual (UN Manual) focuses on the cross-border component of the definition of an APA:<sup>18</sup>

*“These APAs are so named because pricing methodologies are agreed in advance in relation to certain types of transactions, often called the “covered transactions”. APAs provide greater certainty for the taxpayer on the taxation of certain cross-border transactions and are considered by the taxpayers as the safest way to avoid double taxation, especially where they are bilateral or multilateral. Many countries have introduced APA procedures in their domestic laws though these may have different legal forms. For example, in certain countries an APA may be a legally binding engagement between taxpayers and tax authorities, while in other countries it may be a more informal arrangement between the tax authorities and the taxpayer.”<sup>19</sup>*

An APA is therefore a written binding / non-binding contract between a taxpayer and a tax administration to determine some agreed criteria in transactions that are under review, including the price, method, comparability analysis, duration and assumptions as well as to mitigate any potential transfer pricing audits or disputes.<sup>20</sup> Ultimately the purpose of the APA is to provide certainty for both the government and taxpayers.<sup>21</sup>

There are two types of APAs, namely a unilateral and bilateral agreement.

### **2. 3.1. Unilateral APA**

A unilateral APA is whereby a taxpayer institutes an agreement with a tax authority in its jurisdiction. In this instance the tax administration and the taxpayer in a particular jurisdiction establish an arrangement without the involvement of other interested tax administrations. However, the shortcoming of a unilateral APA is that it may affect the tax liability of an associated enterprises in other tax jurisdictions.<sup>22</sup> Where unilateral APAs are concluded, the Competent Authorities of other interested jurisdictions should be informed about the procedure as early as possible to determine whether they are willing and able to consider a bilateral arrangement under the mutual agreement procedure.

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<sup>18</sup> United Nations, 2017. United Nations Practice Manual on Transfer Pricing, United Nations, New York, 52.

<sup>19</sup> Own emphasis added

<sup>20</sup> Mullachella (2018) *International Transfer Pricing Journal* 69.

<sup>21</sup> *Ibid.*

<sup>22</sup> OECD, 2017. OECD Guidelines par 4.140.

### **2.3.2. Bilateral / Multilateral APAs**

A bilateral / Multilateral APA (i.e. an arrangement in which two or more countries concur) is used in an effort to curb double taxation of income and is entered into by a taxpayer, a tax authority and a foreign tax authority.<sup>23</sup>

The bilateral (or multilateral) approach would most likely ensure that the arrangements will reduce the risk of double taxation, which will be favourable to the tax administrations that are involved and provide better certainty to the taxpayers involved.<sup>24</sup>

These types of APAs are more commonly referred to as MAP APAs which is discussed below.

#### **2.3.2.1. The use of APA under the Double Taxation Agreement and Mutual Agreement Procedure**

It is possible that during a transfer pricing audit in a particular tax jurisdiction the tax administration in that particular country would simply impose a taxable income based on their findings. The issue with this is that the particular MNE would have paid tax on the very same income in another tax jurisdiction which will ultimately result in double taxation.

In such an instance article 25 of the OECD Model Tax Convention on Income and on Capital lays down the procedure of a mutual agreement procedure (MAP). The purpose of the article is to resolve disputes leading to inconsistent taxation under the Convention.<sup>25</sup>

The MAP is a well-established means through which tax administrations consult to resolve disputes regarding the application of double tax conventions.<sup>26</sup> Most double tax agreements include a MAP article, which provide for the Competent Authorities<sup>27</sup> of the two countries to consult each in the event of double-taxation.

A taxpayer may request a bilateral APA with respect to specified cross-border transactions, which is conducted via the MAP article of a tax convention. Once concluded, bilateral APAs provide an increased level of tax certainty in both tax jurisdictions, thereby considerably lessening the likelihood of double taxation.<sup>28</sup>

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<sup>23</sup> Oguttu, A, (2006) *MERC* 400.

<sup>24</sup> *Ibid.*

<sup>25</sup> Olivier, L. *et al* 2011. *International Tax: A South African Perspective* 473.

<sup>26</sup> OECD, 2017. *OECD Guidelines* 180.

<sup>27</sup> Article 3 OECD Model Tax Convention on Income and on Capital states the Competent Authority of a particular country.

<sup>28</sup> OECD, 2007. *Manual on Effective Mutual Agreement Procedures*, OECD, Paris 43.



Where an APA programme is available the use of a bilateral APA is encouraged. The OECD Guidelines further supports this view in the following extract:<sup>29</sup>

*“Between those countries that use APAs, greater uniformity in APA practices could be beneficial to both tax administrations and taxpayers. Accordingly, the tax administrations of such countries may wish to consider working agreements with the Competent Authorities for the undertaking of APAs. These agreements may set forth general guidelines and understandings for the reaching of mutual agreement in cases where a taxpayer has requested an APA involving transfer pricing issues”*

## **2.4. SAILIENT FEATURES OF AN APA PROGRAMME**

As mentioned above the main purpose or key feature of an APA programme is to provide certainty to tax administrations and taxpayers. Regulations relating to an APA programme are usually adopted by the country’s tax administration and most of this guidance is derived from the OECD Guidelines and incorporated into the domestic regulations of a country.<sup>30</sup>

The salient features of an APA programme are listed below:<sup>31</sup>

- regulations should be accessible, informative and fair;
- the team that is involved in the APA programme should be technically skilled and should act in an impartial and independent manner. The team should focus on the double non-taxation issues as opposed to the collection of revenue;
- APA programme is costly and time consuming;
- each country has their specific requirements for APAs. The features are mostly aligned with each of the applicants’ domestic laws;
- taxpayer’s eligibility, availability of corresponding adjustments and dispute resolution mechanisms in terms of a taxpayer’s access to treaty;and
- there are four steps in the process of conducting an APA, from preliminary discussion until the conclusion.

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<sup>29</sup> OECD, 2017. OECD Guidelines 225.

<sup>30</sup> Mullachella (2018) *International Transfer Pricing Journal* 70.

<sup>31</sup> *Ibid.*

## 2.5. APA PROCESS

As mentioned above each country will have its own regulations and processes in relation to an APA request. The typical APA process for taxpayer's includes the following phases, which are discussed further below:<sup>32</sup>

- APA strategy and transfer pricing analysis;
- pre-filing conference;
- formal APA request;
- evaluation and negotiation; and
- administration and renewal.

As the APA moves forward, the interaction evolves from a general discussion of the taxpayer's industry and business to the specific transactions to drafting and administering the agreement.

Transfer pricing analysis: the TP analysis performed for an APA generally requires the same effort and level of detail and precision as is required to produce TP documentation.

Pre-filing conference: a taxpayer should request a pre-filing conference with the relevant tax authority/authorities to present relevant facts before formally requesting an APA. The pre-filing is an informal way for the taxpayer to explore the suitability of an APA and the amount of information required by the tax authority in considering the request.

Formal APA request: a successful pre-filing conference should provide the taxpayer with a good understanding of the tax authority's comments to the proposed APA and any areas of uncertainty that needs to be established. With this information, the taxpayer can begin drafting its formal APA request.

Evaluation and negotiation: upon filing a substantially complete APA request to the tax authorities, they begin assembling their teams to process the request. The tax authorities may request meetings and additional information or supporting documentation from the taxpayer before entering into an agreement.

APA administration and renewal: after an APA is finalised, the taxpayer files an annual report that demonstrates compliance with the terms and conditions of the APA. In addition, the taxpayer must maintain books and records to enable the tax authority to examine the taxpayer's compliance with the APA.

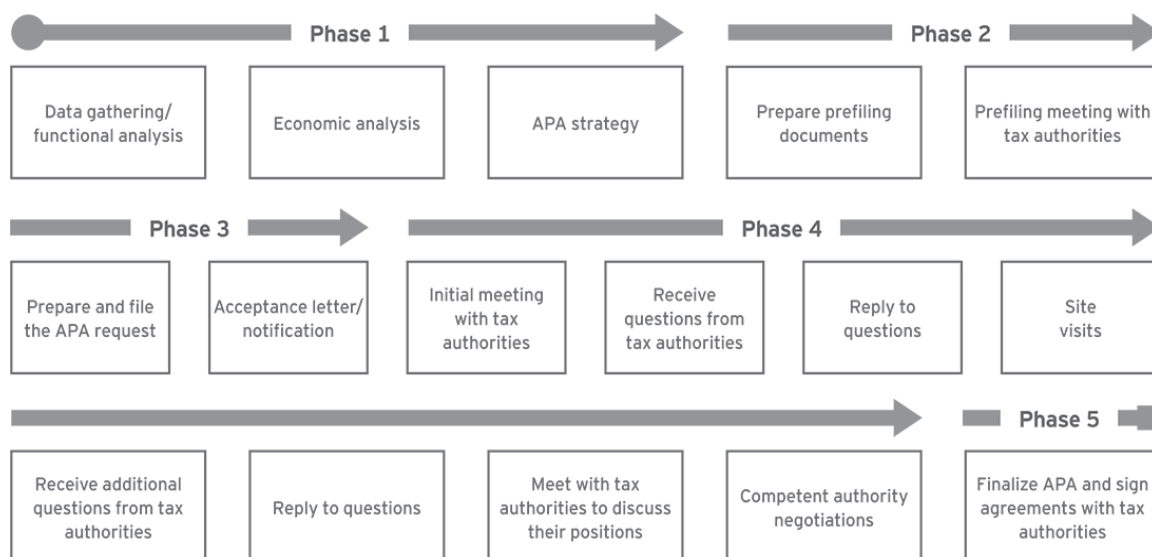
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<sup>32</sup> EY "APA Process for Taxpayers" available at: <http://www.ey.com/GL/en/Services/Tax/International-Tax/Guide-to-advance-pricing-agreements-APA---APA-process-for-taxpayers> (Accessed: 25 May 2015).

A tax authority may revoke or cancel the taxpayer's APA due to fraud, or lack of good faith in compliance with the terms or conditions of an APA.

Should the need arise for the amendments be made to the current APA a taxpayer may request an APA renewal by following the same procedures that apply to the initial APA.<sup>33</sup>

Below is a diagrammatic representation of the APA process:<sup>34</sup>



**Figure 1: Diagrammatic representation of a typical APA process**

The following paragraphs will address the advantages as well as the shortcomings on the use of APAs.

## 2.6. ADVANTAGES OF IMPLEMENTING THE USE OF AN APA<sup>35</sup>

- ensures transfer pricing certainty where tax rules are clear so that MNEs can anticipate the tax consequences of the transactions that they enter into;
- avoids taxpayers incurring penalties for not complying with certain requirements;
- the procedure at arriving at the arm's length price is accelerated;
- prevents long and expensive drawn-out audits, queries and controversies which often results in expensive transfer pricing disputes;
- less manpower is required by tax authorities in negotiating and monitoring compliance to APAs than conducting a fully-fledged transfer pricing audit;and
- APAs can help tax authorities understand the intricate details of the transaction by creating transparency.

<sup>33</sup> *Ibid.*

<sup>34</sup> *Ibid.*

<sup>35</sup> *bid.*

## **2.7. SHORTCOMINGS OF THE USE OF AN APA<sup>36</sup>**

- although APAs are internationally recognised it does not resolve all transfer pricing issues;
- APAs are cumbersome and takes too long to complete and thus creates inefficiencies and high costs;
- unless given statutory power, like in the UK, the agreement itself is beyond the control of the courts;
- an APA may result in tax considerations rather than business reasons thus losing flexibility in making business decisions; and
- APAs are complex and requires expertise and employment of specialised personnel.

## **2.8. CONCLUSION**

It is clear from the above is that an APA aims to achieve certainty amongst taxpayers on the arm's length pricing and policy that are set amongst associated enterprises. The use of APAs can be beneficial to both taxpayers and tax administration and involves more co-operation and communication by both the taxpayer and tax administrations.

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<sup>36</sup> *bid.*

## CHAPTER 3 APA FRAMEWORK IN THE UK

### 3.1. INTRODUCTION

The rationale for using the UK as a country for this research is on the premise that South Africa, like many other countries, based certain of their efforts to establish and implement domestic taxation rules and regulations on the experience of the UK. In the past, South Africa has mirrored the UK in developing and enacting many income tax provisions.<sup>1</sup>

In addition, UK transfer pricing rules have been incorporated for many years and South Africa can leverage on this experience in an attempt to implement best practices.

### 3.2. BACKGROUND AND DEVELOPMENT OF THE APA PROGRAMME

#### 3.2.1. BCKGROUND TO APAs IN THE UK

An APA is the only way that a UK taxpayer can agree on a transfer pricing method with Her Majesty Revenue and Customs (HMRC).<sup>2</sup>The HMRC has, within a statutory framework, an APA programme which has been in place since 1999.<sup>3</sup> Before this period, APAs were agreed under the MAP article of the relevant treaty.

The applicable legislation for the UK's APA process, was formerly found in Section 85 of the Finance Act 1999, which has subsequently been rewritten as part of the UK's Tax Law Rewrite Project and is currently codified in sections 218-230 of the Taxation (International and Other Provisions) Act 2010 (TIOPA 2010). Practical guidance of APAs was made available by HMRC Statement of Practice (SP) SP3/1999, which has now been superseded by SP 2/2010.<sup>4</sup>

Before the revised SP came into force in December 2010 only unilateral APAs were available in the UK. The UK's APA legislation now provides for both unilateral (an agreement between the UK taxpayer and HMRC) as well as bilateral (agreements involving one or more other tax authorities) APAs.<sup>5</sup>

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<sup>1</sup> <https://bit.ly/2PH2JkR> (Accessed 18 November 2018)

<sup>2</sup> D hay, *et al*, (2011) *International Transfer Pricing Journal*, 312.

<sup>3</sup> Avoseh (2014) University of Glasgow, 30.

<sup>4</sup> *Ibid*.

<sup>5</sup> D hay, *et al*, (2011) *International Transfer Pricing Journal*, 312.

### 3.2.2. THE DEVELOPMENT OF THE APA PROGRAMME

Historically, the UK has strongly favoured bilateral APAs as, in its view, only bilateral agreements could eliminate the risk of double taxation.<sup>6</sup> The reason being is that when the APA programme commenced in the UK there was indeed to a lack of domestic legislation and the UK could only make advance agreements under the MAP provisions with other treaty partners.<sup>7</sup>

This position has been relaxed and HMRC is now increasingly open to unilateral APAs.<sup>8</sup> There are three instances where HMRC will now consider entering into a unilateral APA with a UK taxpayer.<sup>9</sup>

–Firstly, where the transfer pricing arrangements involving the UK taxpayer are an integral part of transfer pricing arrangements that involve a large number of other countries. For example, where the UK is at the centre or part of a regional structure, that means it would be difficult to isolate the UK transaction or to treat one other country as the tested party;

– Secondly, where there was little to be gained from a bilateral or multilateral agreement. This may well be the case, for example, where the transaction is such that its visibility in the other country is very limited or where a ruling already exists in that country;

–Thirdly, where the other party is resident in a country without a formal APA programme, although HMRC may well be keen to try to seek agreement to the UK APA position through an exchange between the Competent Authorities.

Furthermore, since the inception of the APA programme in the UK the HMRC subtly lowered its “complexity threshold”. Because the APA programme is free to taxpayers in the UK, in order to reduce the work load burden the HMRC restricted entry to the programme to cases where the transfer pricing was complex.<sup>10</sup>

Under SP 2/2010, HMRC will admit an APA application into the programme where the transfer pricing is not complex but the taxpayer’s risk assessment would be “high risk” without an APA or, where the transfer pricing method is highly tailored to the taxpayer’s own circumstances.

Any of the following may apply for an APA in the United Kingdom:<sup>11</sup> a UK business, including a partnership, to which the transfer pricing provisions in Part 4, TIOPA 2010 apply; a non-

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<sup>6</sup> D Hay, *et al*, (2011) *International Transfer Pricing Journal*, 313.

<sup>7</sup> *Ibid.*

<sup>8</sup> *Ibid.*

<sup>9</sup> *Ibid.*

<sup>10</sup> D Hay, *et al*, (2011) *International Transfer Pricing Journal*, 313.

<sup>11</sup> Cooper, J, *et al*, (2018) “Transfer Pricing in the United Kingdom”

resident trading in the United Kingdom through a permanent establishment; and a UK resident trading through a permanent establishment outside the United Kingdom.

An APA in the UK is in place for a maximum period of 5 years. Taxpayers may apply for a shorter period, however by doing so reduces the period for which certainty is achieved.

Furthermore, it seems that HMRC has shown flexibility in applying the agreed APA methodology to years before the initial APA period, referred to as the “roll-back period.” Some taxpayers have used this approach as a way of resolving tax audits for prior years as the more cooperative nature of the APA negotiations has sometimes proved more successful in reaching common ground in comparison to an adversarial atmosphere during an audit.<sup>12</sup>

The table below shows relevant statistics of HMRC’s APA program. During the year 2017/18, HMRC received 16 applications; turned down 6; and agreed to the terms of 27 APAs.<sup>13</sup>

	<b>2012/13</b>	<b>2013/14</b>	<b>2014/15</b>	<b>2015/16</b>	<b>2016/17</b>	<b>2017/18</b>
Applications made during year	45	43	66	47	32	16
Applications turned down	0	0	2	3	5	6
APAs agreed during year	27	29	37	22	19	27
Average time to reach agreement (months):	26	27.8	18.00	33.0	32.8	37.1
50% agreed within (months):	15	19.7	15.6	32.3	34.7	35.1

*Table 1:UK APA statistics*

HMRC suggests that an APA case will take approximately 18-21 months to complete.<sup>14</sup> The average time to reach agreement for an APA has varied over the years in the UK. The most significant being for the 2016/17 and 2017/18 years.

<sup>12</sup> DFK, “EU and G20 Transfer Pricing Handbook” 2018, 196.

<sup>13</sup> <https://bit.ly/2DkjSsS> (Accessed 15 November 2018).

<sup>14</sup> Cooper, J, et al, (2018) “Transfer Pricing in the United Kingdom”

The below figure represents the number of APA as well as the average age for APA cases to be finalised.<sup>15</sup>

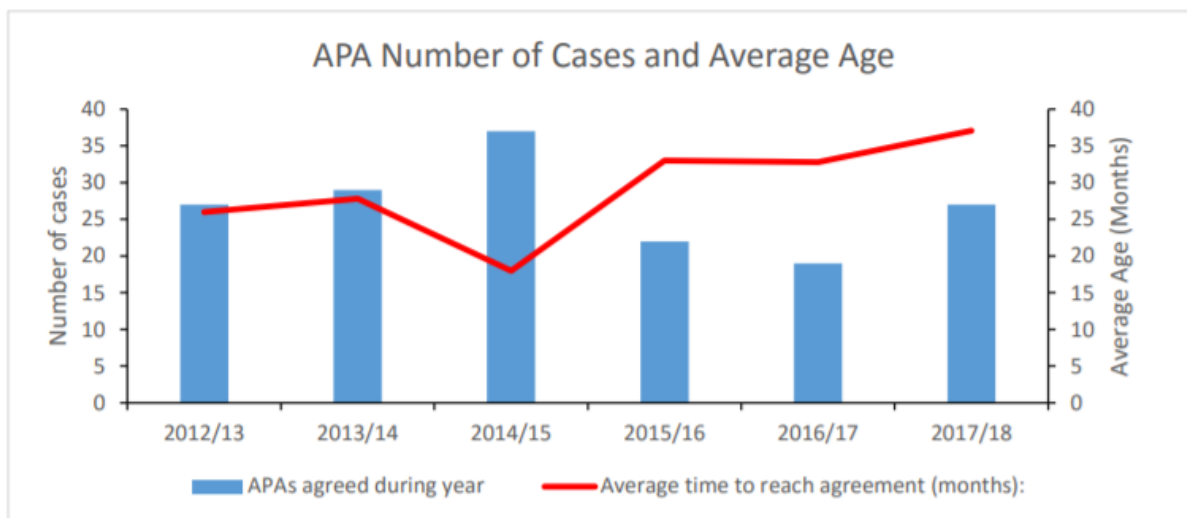


Figure 2: UK APA statistics

### 3.3. BASIS OF TRANSFER PRICING LEGISLATION IN THE UK

The UK has incorporated the OECD Guidelines into its domestic law and the legislative framework is supplemented by formal guidance issued by HMRC.<sup>16</sup> The UK transfer pricing legislation must be used to ensure consistency with the ALP in Article 9 of the OECD Model Tax Convention on Income and on Capital.<sup>17</sup>

The UK's transfer pricing legislation is based on the ALP which can be found in part 4 of TIOPA. The basic transfer pricing rule is found in chapter 1 of part 4 of TIOPA and requires that where there is "provision" between two "affected persons", "the arm's length provision" is substituted for "the actual provision" if: the actual provision is different from the "arm's length provision"; and the difference gives rise to a tax advantage for one or both persons.

The term "the arm's length provision" is defined to mean "the provision which would have been made as between independent enterprises". For interpretation, part 4 of TIOPA refers directly to article 9 of the OECD Model Tax Convention on Income and on Capital as well as the OECD Guidelines which is the premise for the arm's length principle.

<sup>15</sup> <https://bit.ly/2DkjSsS> (Accessed 15 November 2018).

<sup>16</sup> Cooper, J, et al, (2018) "Transfer Pricing in the United Kingdom".

<sup>17</sup> Cooper, J, et al, (2018) "Transfer Pricing in the United Kingdom".



The vast majority of HMRC's guidance in relation to transfer pricing (including APAs) is found in the Inspectors Manual<sup>18</sup> (HMRC Manuals), but HMRC have also issued Statements of Practice.

HMRC manuals are not law, are not binding on taxpayers and cannot be relied upon in court, but if a taxpayer takes a position in a return that is contrary to that set out in one of the manuals, there may be implications if such differences is not disclosed.

### **3.4. LEGAL FRAMEWORK OF APAs IN THE UK**

#### **3.4.1. APPLICABLE LEGISLATION**

As discussed above the HMRC commenced with the APA programme in 1999, with the main purpose to assist businesses in determining the most appropriate methodology to derive the arm's length outcome for complex transfer pricing issues and prevent disputes arising that may otherwise result in a MAP being necessary later.<sup>19</sup> This in turn will provide more certainty to HMRC and the taxpayers alike. To this extent HMRC has a practical manual (SP 2/2010) in place on how to manage the processes.

The SP by HMRC is a general guide in relation to APAs and the interpretation of the APA legislation can be found in sections 218-230 of the TIOPA. The SP is intended to provide guidance about how HMRC interprets the APA legislation and applies it in practice. The SP is updated in order to incorporate best practices identified. The recent update of the SP was made in November 2016.<sup>20</sup> In addition there are HMRC manuals available on HMRC's website that provides further guidance on APAs.

#### **3.4.2. APA APPLICATION PROCESS TO HMRC**

HMRC's Business International Division is responsible for all APA applications which consists of teams of APA specialists. The APA specialists are part of a Competent Authority team that is led by a programme manager which covers both APA and MAP cases. This team is staffed with experienced transfer pricing specialists who have many years of case-working experience. Several members of this team also have many years' experience of working specifically on APAs or MAPs.<sup>21</sup>

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<sup>18</sup> The majority of the guidance on transfer pricing is found in the International Manual (which is available on the internet at <http://www.hmrc.gov.uk/manuals/intmanual/index.htm>) and is very detailed.

<sup>19</sup> Statement of Practice 2 / 2010 (2018).

<sup>20</sup> <https://bit.ly/2DkjSsS> (Accessed 15 November 2018).

<sup>21</sup> D Hay, *et al*, (2011) *International Transfer Pricing Journal*, 312.

An APA leader is assigned to take responsibility of every APA case and will be responsible for HMRC's involvement from the first meetings to drafting the final agreements. The APA leader will work with members of the taxpayer's case team within HMRC and will use HMRC economists and other specialists as deemed necessary to help negotiate an agreed position with the other tax authority (if bilateral) and with the taxpayer.<sup>22</sup>

Every APA request will be considered on the basis of its merits, but generally HMRC will take the following factors in to account, whether:

- the transfer pricing issues are complex rather than straightforward. To HMRC "complex" means; *"there is real doubt as to how the arm's length standard should be applied. Conversely, where market comparables can be readily identified for the transaction(s) in point, in accordance with the OECD Transfer Pricing Guidelines, HMRC is likely to regard such a situation as 'straightforward'. HMRC will be willing to consider an innovative proposal providing that there isn't a more appropriate and straightforward method, it's compliant with OECD Guidelines, and not one that HMRC considers it or its Treaty Partners would regard as being overtly tax aggressive"*;
- without an APA there is a high likelihood of double taxation; and
- HMRC consider that it is a good use of taxpayer and governmental resources.

What follows in the following paragraphs is the typical process a taxpayer would follow in seeking to agree its transfer prices with HMRC through an APA.

### **Step 1: the initial contact (expression of interest)<sup>23</sup>**

Before presenting a formal application HMRC strongly recommends that a taxpayer that is interested in applying for an APA contacts HMRC to informally discuss certain issues. The expression of interest would include:<sup>24</sup> a description of the proposed transfer pricing method; the likely documentation requirements; what is required from the taxpayer; what supporting documentation / additional information the taxpayer needs to provide, the nature of the transfer pricing issues intended to be covered by an APA; details of the tax residence of the parties involved and the importance to the wider business of the transactions intended to be covered; and lastly an indication of the nature of any current transfer pricing enquiries, Competent Authority claims, and any other relevant issues that the business is aware of in the context of the suggested APA.

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<sup>22</sup> *Ibid.*

<sup>23</sup> DFK, "EU and G20 Transfer Pricing Handbook" 2018, 196.

<sup>24</sup> INTM42205 (2018).

The expression of interest is in place to ensure that resources of the business is not to be wasted on an unsuitable application, and ensures that the detailed work that is to be undertaken by the business in finalising its application is focused on relevant issues. It also gives HMRC an opportunity to outline a realistic anticipated timetable for agreeing an APA based on past experience, or to discuss other practical 'process' issues with the business.<sup>25</sup>

HMRC regards the expression of interest as a vital step in the process, and it would be exceptional for them to turn down a request for a meeting.<sup>26</sup> At the meeting HMRC will take the opportunity to ask detailed questions about the application and the purpose behind the application to determine whether that the APA application would be accepted.<sup>27</sup>

In the event that HMRC considers that an APA application to be unsuccessful, HMRC will provide the taxpayer with the reasons for declining the application, and will allow the taxpayer the opportunity to make further representations. However there is no right of admission into the APA programme.<sup>28</sup>

## **Step 2: formal submission**

At the inception of HMRC SP 2/2010 there were no standard requirements when making the formal application. HMRC was very flexible on this, and took a pragmatic view of the format and content. In a bilateral case, HMRC will usually agree to the submission of the same material in the same format as required by the other treaty partner.<sup>29</sup>

Subsequently, HMRC has published a revised SP2/2010 and has issued an annexure detailing information that is required when submitting a formal APA to HMRC.<sup>30</sup>

However despite having formal application requirements HMRC may, in practice, agree to be amenable with such requirements where the circumstances of the particular case mean that a different approach will make for a better process. In a bilateral case, HMRC is often able to agree to work from the same format application as is mandated by the other administration's procedures.<sup>31</sup> These are issues best discussed with HMRC at the expression of interest stage. The application should ideally be made before the start of the first chargeable period proposed to be covered by the APA, but HMRC may exercise discretion over this, for

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<sup>25</sup> INTM42205 (2018).

<sup>26</sup> D Hay, *et al*, (2011) *International Transfer Pricing Journal*, 313.

<sup>27</sup> INTM42205 (2018).

<sup>28</sup> *Ibid*.

<sup>29</sup> D Hay, *et al*, (2011) *International Transfer Pricing Journal*, 313.

<sup>30</sup> INTM422070 (2018).

<sup>31</sup> Statement of Practice 2 / 2010 (2018).

instance, when a bilateral APA is sought and the other administration is prepared to allow the business more time to lodge its' application.<sup>32</sup>

In the case of a bilateral APA the taxpayer will be expected to ensure that all information provided in the application to one administration is made available at the same time to the other administration involved.<sup>33</sup>

APA information is subject to the same rules of confidentiality as any other information about taxpayers. Information exchanged with treaty partners, will be protected from disclosure by the terms of the Exchange of Information Article in the relevant DTA. Therefore HMRC will not disclose the details of a bilateral APA reached with a jurisdiction that's not a member state of the EU (in compliance with EU Directive on Administrative Cooperation in the field of taxation, 2015/2376). It will however disclose the relevant details of the formal application.

#### **Step 4: evaluation**

The examination of the application is to be a cooperative process in which the transfer pricing issues are discussed as openly as possible and the taxpayer willingly provides the required information or provides further explanations to HMRC.<sup>34</sup> This is a key feature of HMRC's approach and it is crucial that there be openness and trust between the taxpayer and HMRC.<sup>35</sup> Lack of co-operation in these respects could possibly result in HMRC declining to give any further consideration to the application.<sup>36</sup>

As mentioned above, as in the case at the formal submission stage, the taxpayer should ensure that in the case of a bilateral APA the taxpayer should make available the same information and documentation to both treaty partners at the same time.<sup>37</sup> HMRC will in turn keep the taxpayer informed of the progress of its discussions with the other treaty partner.<sup>38</sup> HMRC and the other tax authority will normally both prepare a position paper setting out their views of the transfer pricing, and will exchange these papers and may meet to discuss cases.<sup>39</sup>

The UK has regular meetings with a number of other tax authorities including the US, Japan, Canada, France and Germany, at which they will typically discuss a number of cases and seek to reach a consensus amongst themselves.<sup>40</sup> In some instances HMRC and the other treaty

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<sup>32</sup> INTM422070 (2018).

<sup>33</sup> INTM422070 (2018).

<sup>34</sup> INTM422080 (2018).

<sup>35</sup> D hay, *et al*, (2011) *International Transfer Pricing Journal*, 313.

<sup>36</sup> INTM422080 (2018).

<sup>37</sup> D hay, *et al*, (2011) *International Transfer Pricing Journal*, 313.

<sup>38</sup> INTM422080 (2018).

<sup>39</sup> D hay, *et al*, (2011) *International Transfer Pricing Journal*, 314.

<sup>40</sup> *Ibid*.

partner may convene a meeting with the taxpayer to try to reach a shared understanding of the commercial background and the detail of the taxpayer's proposals.<sup>41</sup> These joint meetings are often welcomed by all sides as an opportunity for the taxpayer to make a presentation of the same facts to both tax authorities and to answer questions from both tax authorities.<sup>42</sup>

### **Step 5: agreement**

The APA made between the taxpayer and HMRC (unilateral APA) is a binding undertaking on the treatment of the specified transfer pricing issues for a specific period of time.<sup>43</sup>

The agreement between HMRC and the taxpayer will be made subject to its terms being observed. The terms will include, *inter alia*:<sup>44</sup>

- a commitment from the taxpayer to demonstrate adherence to the agreed method for dealing with the transfer pricing issues during the term of the APA in the form of a regular compliance report (an 'Annual Report')<sup>45</sup> as required by Section 228 TIOPA 2010; and
- the identification of critical assumptions which has an impact on reliability of the method and which, if subject to change, may render the agreement invalid. This will generally include an assumption that the relevant transfer pricing law and OECD Guidelines remain materially the same.

In the case of a bilateral APA, there will also be an agreement between the two tax authorities under the MAP provision which will be reflected in the agreement with the taxpayer.<sup>46</sup> In such instances, there will generally be three agreements. The first agreement is between the taxpayer and the HMRC, the second agreement is between the taxpayer and the other tax authority and the third agreement is between the two Competent Authorities.<sup>47</sup>

While the taxpayer does not have access to Competent Authority agreement, it is usually possible for the details of the transfer pricing methodology agreed between the two Competent Authorities (which is its key element) to be described in a separate document that is made available to the taxpayer.<sup>48</sup>

Annexure 2 of SP 2/2010 provides further information of a typical APA template.

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<sup>41</sup> D Hay, *et al*, (2011) *International Transfer Pricing Journal*, 313.

<sup>42</sup> *Ibid.*

<sup>43</sup> *Ibid.*

<sup>44</sup> Statement of Practice 2 / 2010 (2018).

<sup>45</sup> Annual Report under section 3.3.1.

<sup>46</sup> D Hay, *et al*, (2011) *International Transfer Pricing Journal*, 313.

<sup>47</sup> *Ibid.*

<sup>48</sup> *Ibid.*

Usually the person responsible for signing the agreement on behalf of the taxpayer would be the person responsible for signing a tax return, subject to that person having authority within the multinational group to commit the group to the terms of the APA.<sup>49</sup>

It is expected that HMRC aims to complete the APA process within 18 to 21 months from the date of the formal submission.<sup>50</sup> This timeline is dependent on the complexity of the case and, in the case of bilateral or multilateral applications, may be dependent on the working practice of the administration(s) in the other country or countries. It is also, of course, dependent on co-operation from the applicant.<sup>51</sup>

HMRC may view the significant delay on the part of the taxpayer as indicative of a lack of co-operation or a loss of interest in agreeing an APA and may then proceed to terminate the APA process.<sup>52</sup>

### **3.4.3. POST APA AGREEMENT**

As mentioned above an APA is usually in place for a period of 5 years. During the duration that the APA is in force there are certain rights and obligations of the taxpayer as well as powers that are vested with HMRC.

*Submission of Annual Report:* Once an APA is finalised in the UK there is still a requirement from the taxpayer is to submit an Annual Report with the annual tax return. The purpose of the Annual Report is to confirm whether the business has complied with the terms and conditions of the APA.<sup>53</sup>

*Revoke or Nullify an APA:* After the finalisation of an APA the HMRC can revoke the APA agreement if the HMRC is of the opinion that the taxpayer did comply with the terms and conditions of the agreement, or where the identified critical assumptions cease to be valid. In practice, when considering nullifying, revoking or cancelling a bilateral APA HMRC will consult with the business and with the Competent Authority of the treaty partner involved.<sup>54</sup> HMRC can nullify an APA in instances where false or misleading information was supplied fraudulently, or negligently, in connection with an application for, or in the process of monitoring, an APA. In such cases penalties may be applied, and the APA might be nullified.<sup>55</sup>

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<sup>49</sup> Statement of Practice 2 / 2010 (2018).

<sup>50</sup> *Ibid.*

<sup>51</sup> *Ibid.*

<sup>52</sup> INTM422090 (2018).

<sup>53</sup> Statement of Practice 2 / 2010 (2018).

<sup>54</sup> Statement of Practice 2 / 2010 (2018).

<sup>55</sup> Statement of Practice 2 / 2010 (2018).

*Revising and renewing APAs:* In addition, after the completion of the APA process a taxpayer can request for a renewal or amendment of the current APA. In some cases the APA may provide for an amendment of its terms in specific circumstances; for example, a particular agreement may provide that where there has been a change which makes the agreed methodology difficult to apply, but which doesn't go as far as to invalidate a critical assumption, the agreement may be modified with the consent of the parties to resolve that difficulty. In such instances the APA may be revised in accordance with section 225, TIOPA 2010 after consultations between the business and HMRC and, in the case of bilateral agreements, the Competent Authority of the other country involved.<sup>56</sup> Where the facts and circumstances haven't changed, the business may request renewal of an APA for an additional extended period. Ideally the notice to extend the APA should be submitted not later than 6 months before the expiration of the APA. HMRC will consider interest in a renewal in light of current international thinking and HMRC's practice at the time.<sup>57</sup>

### **3.5. CONCLUSION**

With transfer pricing high on the agenda for most taxpayers, the key benefit for a taxpayer is gaining certainty over its transfer pricing arrangements. With the increasing focus on reducing uncertainties and tax risk, there is currently a significant interest in APAs in the UK.

Tax authorities worldwide are becoming more engaged in transfer pricing enquiries and audits, it seems that the number of cross-border disputes would inevitably rise.

Taxpayers are taking the initiative and seeking APAs to reduce the risks of audit and double taxation, and to achieve certainty of tax treatment going forward. In the UK the process has been operational for some time and by leveraging of best practices which can support a seamless and efficient APA programme with a dedicated team of professional skilled transfer pricing specialists.

It is evident that the HMRC is responding very positively to these needs and allowing more cases into the programme.

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<sup>56</sup> *Ibid.*

<sup>57</sup> *Ibid.*

## **CHAPTER 4 APA FRAMEWORK IN INDIA**

### **4.1. INTRODUCTION**

The rationale for using India as a country for this research is based on the fact that India like South Africa is categorised as a developing country. The introduction of transfer pricing into legislation and providing practical guidance on transfer pricing was more or less the same time that South Africa introduced their practical guidance on transfer pricing rules. This chapter will demonstrate the extent to which the transfer pricing regime India has progressed over the years compared to South Africa. In addition, as further discussed below the APA programme in India commenced as taxpayers needed certainty on transfer pricing as the Indian Tax Authority became very aggressive in selecting and dealing with transfer pricing audits.<sup>1</sup> It would seem that in practice SARS is selecting more taxpayers for transfer pricing audits. Finally, India and South Africa's transfer pricing regime is adopted with reference to the OECD guidelines.

### **4.2. BACKGROUND AND DEVELOPMENT OF THE APA PROGRAMME IN INDIA**

#### **4.2.1. BACKGROUND OF APAs IN INDIA**

The APA programme in India was launched in 2012. The relevant legislation applicable to the APA programme can be found in the Finance Act, 2012 through the insertion of sections 92CC and 92CD in the Income Tax Act, 1961. The commencement of the APA programme allows the Central Board of Direct Taxes (CBDT) to enter into APAs with taxpayers for a maximum period of 5 years in respect of international transactions between Associated Enterprises (AEs) to determine the ALP or to specify the manner in which the ALP is to be determined.<sup>2</sup>

By way of public notification no. 36/2012 [F. No. 133/5/2012-SO(TPL)]/SO 2005 (E), dated 30 August, 2012, the APA Scheme [Rules 10F to 10T] was incorporated into the Income Tax Rules to formalise the validity of the APA programme. Thus, the Indian APA programme, actually became functional and operational from 30 August, 2012. The rules lay down the detailed procedures for the feasibility study ; pre-filing consultation; payments of fees; filing of APA application; processing of APA application; withdrawal of APA application; terms and

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<sup>1</sup> See section 4.4.1 below.

<sup>2</sup> CBDT (2018) 1.



conditions of APA; filing of Annual Compliance Report; Compliance Audit; revision, cancellation and renewal of APA; etc.<sup>3</sup>

APAs under the programme can be multilateral or bilateral (involving CBDT and the tax authorities of one or more countries) or unilateral (involving the CBDT only).<sup>4</sup> Over the last 6 years, almost 1,000 applications have been filed in India. The majority of these applications (about 85%) are for unilateral APAs between the Indian taxpayer and the CBDT.<sup>5</sup>

The rationale behind the introduction of the Indian APA programme was seen to be the “silver lining” to the, already then aggressive transfer pricing audit regime in India, and may indeed be a game changer in the Indian transfer pricing landscape. It aimed to reduce much litigation time and expense of taxpayers and tax authorities.<sup>6</sup>

#### **4.2.2. THE DEVELOPMENT OF THE PROGRAMME**

To provide clarity and awareness to taxpayers on a number of issues concerning the APA programme, the CBDT issued a booklet containing guidance on the APA programme and answers to Frequently Asked Questions (FAQs) as part of its Taxpayers’ Information series. The purpose of this booklet is to provide useful insight on the development and enhancement of the APA programme.<sup>7</sup>

The Indian APA rules are on a par with the APA rules followed in most developed countries.<sup>8</sup> As a developing country, this can be seen as a positive step which takes the standard of the Indian transfer pricing programme to the next level. The APA programme is available to a person who has undertaken an international transaction, or is contemplating one. The APA will be entered into by the CBDT with the taxpayer, after its approval by the central government.

In the first year and subsequent later years, the APA programme clearly showcased the competence, fairness and unbiased approach of the Indian revenue department. The progress and success of the programme is clearly shown in the below table:<sup>9</sup>

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<sup>3</sup> CBDT (2018) 1.

<sup>4</sup> CBDT (2018) 1.

<sup>5</sup> CBDT (2018) 1.

<sup>6</sup> Phatarphekar, KR, *et al*, (2014) *International Transfer Pricing Journal*, 172.

<sup>7</sup> CBDT (2018), 1.

<sup>8</sup> Phatarphekar, KR, *et al*, (2014) *International Transfer Pricing Journal*, 172.

<sup>9</sup> CBDT (2018), 4.

Financial Year (F.Y)	Unilateral APA Applications	Bilateral APA Applications	Total
2012-13	117	29	146
2013-14	206	26	232
2014-15	192	14	206
2015-16	113	19	132
2016-17	78	23	101
2017-18	115	53	168
<b>Total</b>	<b>821</b>	<b>164</b>	<b>985</b>

Table 2: India's APA statistics 2017/18

Further, it seems that in India there is a preference of unilateral APAs as opposed to bilateral/multilateral APAs. However for the 2012/13 – 2016/17 there has been a decline in unilateral APAs (with the exception of the 2017/18 period) and an incline in bilateral APAs during the 2014/14-2017/18 period. The below figures illustratively depicts this trend:<sup>10</sup>

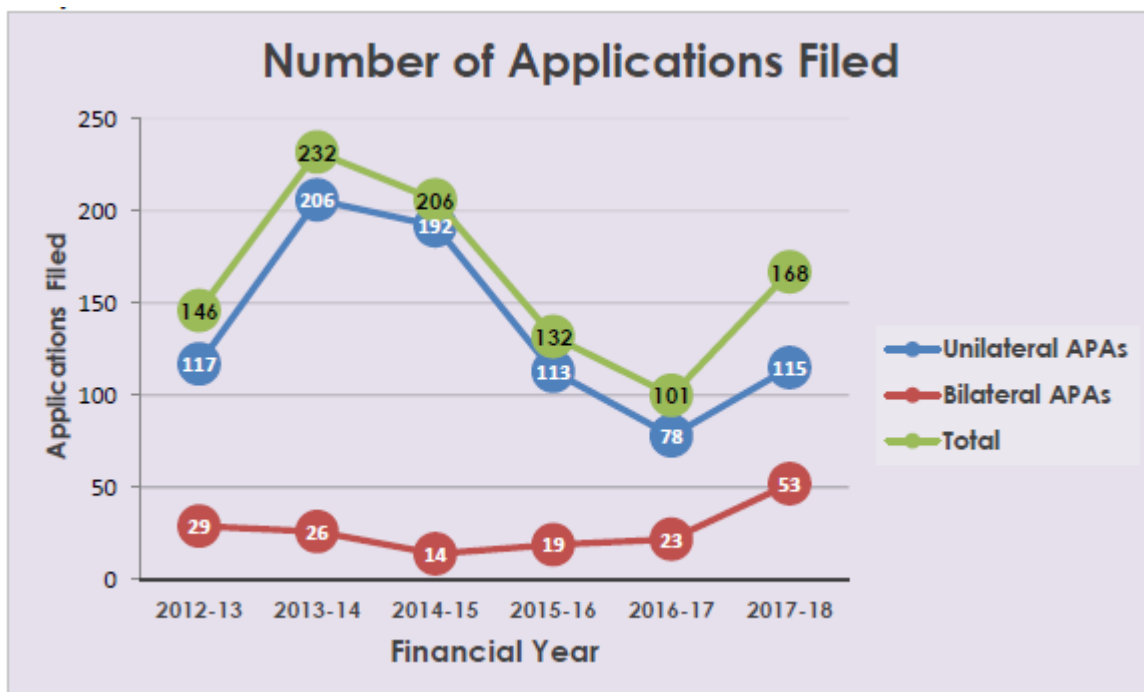


Figure 3: India's APA statistics (unilateral vs bilateral APAs)

<sup>10</sup> CBDT (2018), 4.

The majority of APAs signed related to service activity followed by manufacturing and trading. From an industry sector perspective the most APAs signed related to Information Technology followed by Banking & Finance. The most APAs filed pertain to the provision of software development and IT enabled services, followed by intra-group payments and trading of goods. India has signed APAs with 118 countries out of which the majority of APAs are entered into with the US followed by the UK, Singapore and China.

### **4.3. BASIS OF TRANSFER PRICING LEGISLATION IN INDIA**

India's follows the OECD Guidelines as a foundation of its transfer pricing regulations.<sup>11</sup> The Indian transfer pricing provisions have been in existence for about 17 years and were first introduced by the Finance Act, 2001 as a separate means of reporting and assessing cross-border transactions between connected parties with the effective date of 1 April 2001.<sup>12</sup> The relevant provisions are included in sections 92 to 92F and sections 94A of the Income Tax Act 1961 and rules 10A to 10THD of the Indian Income Tax Rules.

In addition, with effect from 1 April 2013, the transfer pricing provisions were extended by the inclusion of Section 92BA to cover specific domestic related transactions between two resident taxpayers.

In summary India's transfer pricing regulations are applicable to the all enterprises that enter into an "International Transaction"<sup>13</sup> with an "Associated Enterprise"<sup>14</sup>.<sup>15</sup> Therefore in essence, generally it applies to all cross-border transactions entered into between associated enterprises. The main aim is to arrive at the comparable price as available to any unrelated party in open market conditions and is known as the ALP. Currently the APA is not applicable to domestic transactions between two resident connected persons.<sup>16</sup>

Transfer Pricing Regulations in India follow the internationally accepted principles for determination of ALP and essentially being aligned to the OECD Transfer Pricing Guidelines where the underlying principle is the arm's length principle with some principles adopted from the United Nations Practical Manual on Transfer Pricing for Developing Countries.<sup>17</sup>

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<sup>11</sup> <https://bit.ly/2QPlxdR> (Accessed 16 November 2018).

<sup>12</sup> RSM, "*Transfer pricing regulations in India – In harmony with the world*" 2015, 19.

<sup>13</sup> The term "International transaction" includes transactions between the related parties (called "associated enterprises" under the Income Tax Act, 1961).

<sup>14</sup> As defined in section 92A under the Income Tax Act, 1961.

<sup>15</sup> Domestic transactions applicable from years of assessment 2013/14.

<sup>16</sup> PwC, "*Advance pricing agreements – frequently asked questions*" (2014), 3.

<sup>17</sup> Muljee, TGB (2017) University of the Witwatersrand, 32.

## **4.4. LEGAL FRAMEWORK OF APAs IN INDIA**

### **4.4.1. APPLICABLE LEGISLATION**

Over time, the transfer pricing audit landscape in India has evolved quite substantially, such that India has emerged as one of the most aggressive transfer pricing countries. The country is one of the top five nations with respect to pending transfer pricing disputes.<sup>18</sup> This in turn gave rise to concerns in relation to India's image amongst the world's economies in relation to investment into the country.<sup>19</sup>

In an attempt to reduce the amount of tax litigation in transfer pricing in India, the APA provisions sections 92CC and 92CD were introduced in July 2012 and became effective on 30 August 2012, with the main purpose to reduce the number of disputes and to provide taxpayers with tax certainty on the determination of the arm's length price.<sup>20</sup>

### **4.4.2. APA APPLICATION PROCESS TO CBDT**

The APA scheme provides for identification of "critical assumptions". According to the OECD guidelines these assumptions accurately reflects the arm's length pricing of future transactions. Such assumptions are 'critical' when the actual conditions existing at the time the transactions could differ from those that were assumed to have existed when the APA was concluded, to the extent that the reliability of the arm's length pricing is undermined. The Indian APA scheme does not provide any detailed guidance on this aspect hence assumptions made during the negotiation of the APA should be considered.<sup>21</sup>

Generally, the APA team would comprise of a team leader who is an expert in international tax and transfer pricing assisted by an economist and other industry experts as and when needed. The APA team for bilateral and multilateral APA would also include the Competent Authority office.<sup>22</sup>

The Indian APA rules requires a dedicated APA team which will consist of an income tax authority and experts from economics, statistics, law and other necessary fields. For unilateral APAs, the Director General of Income Tax (International Tax and Transfer Pricing) (DGIT) would be responsible, who will be supported by the Commissioner of Income Tax (APA).<sup>23</sup> For

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<sup>18</sup> Laksmikumaran & Sridharan Attorneys, Indian Transfer Pricing Landscape & Advance Pricing Agreements" 2014, 17.

<sup>19</sup> Bilaney, SK, (2017) *International Transfer Pricing Journal*, 69.

<sup>20</sup> Muljee, TGB (2017) University of the Witwatersrand, 41.

<sup>21</sup> Laksmikumaran & Sridharan Attorneys, Indian Transfer Pricing Landscape & Advance Pricing Agreements" 2014, 19.

<sup>22</sup> PwC, "Advance pricing agreements – frequently asked questions" (2014), 3.

<sup>23</sup> PwC, "Advance pricing agreements – frequently asked questions" (2014), 3.

bilateral or multilateral APAs, the Competent Authority of India would be responsible, supported by the Director APA. Further, there are teams reporting to the Commissioner (APA) in three major cities of Delhi, Mumbai and Bangalore to help facilitate the process.<sup>24</sup>

The APA is entered into by the taxpayer and the CBDT and would include: the international transactions to be covered in the agreement, the agreed transfer pricing methodology, the determination of the arm's length price, the definition of any relevant terms, critical assumptions and any conditions to the APA that are not provided in the Income Tax Act 1961 or the rules pertaining to APAs.<sup>25</sup>

The process to be followed for an advance pricing agreement is provided in rule 10H, rule 10-I and rules 10-O to 10S of the rules. What follows in the following paragraphs is the typical process a taxpayer would follow in seeking to agree its transfer prices with CBDT through an APA.

### **Step 1: feasibility study**

A feasibility study needs to be undertaken to analyse a taxpayer's transaction or group of transactions that will be covered in the proposed APA.<sup>26</sup> In its simplest terms, the feasibility study should encapsulate the objective, type of transaction(s) to be covered, cost-benefit (economic) analysis and the risks assumed.<sup>27</sup>

### **Step 2 – pre-filing consultation (Rule 10H)**

The APA programme requires that a taxpayer desiring to enter into an APA shall undertake a pre-filing consultation. The Applicant needs to file an application with the DGIT in a prescribed form.<sup>28</sup> In case the Applicant is seeking a bilateral or multilateral APA, the Competent Authority in India or its representative would also be involved in the pre-filing consultation.<sup>29</sup> The pre-filing consultations at this stage can be done anonymously.<sup>30</sup>

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<sup>24</sup> PwC, "Advance pricing agreements – frequently asked questions" (2014), 3.

<sup>25</sup> Phatarphekar, KR, *et al*, (2014) *International Transfer Pricing Journal*, 173.

<sup>26</sup> RSM, "Transfer pricing regulations in India – In harmony with the world" 2015, 139.

<sup>27</sup> RSM, "Transfer pricing regulations in India – In harmony with the world" 2015, 139.

<sup>28</sup> Form. No. 3 CED.

<sup>29</sup> Laksmikumaran & Sridharan Attorneys, Indian Transfer Pricing Landscape & Advance Pricing Agreements" 2014, 19.

<sup>30</sup> Phatarphekar, KR, *et al*, (2014) *International Transfer Pricing Journal*, 173.

The objective of the pre-filing consultation is to determine the scope of the agreement, identify any transfer pricing issues, determine the suitability of the international transaction and to discuss broad terms of the agreement. The pre-filing stage does not oblige either tax authority or the taxpayer to enter into or proceed with entering into an APA.<sup>31</sup> However, The APA scheme does not contain any safeguards against the sharing of information between the various divisions of the income tax authorities in the event that the taxpayer opts not to proceed with the application.

### Step 3: filing an APA application

After the pre-filing consultation, and if the taxpayer wishes to proceed further, the taxpayer can then file an application for an APA in the prescribed manner and form.<sup>32</sup> At this stage the tax authority requires additional information such as discussions on un-assessed tax years (Indian and foreign) and related outstanding tax, legal, and other pertinent issues.

The application should be accompanied by a prescribed fee, which is based on the amount of international transaction proposed to be, or entered into. The prescribed fee, which ranges from INR 1 million to INR 2 million. The below table summarises the applicable fees:<sup>33</sup>

Amount of international transaction entered into or proposed to be undertaken in respect of which APA is proposed	Fee (INR)	Fee (ZAR) <sup>34</sup>
International transactions up to INR 1 billion	1,000,000	196, 718
International transactions up to INR 2 billion	1, 500, 000	295, 077
International transactions greater than INR 2 billion	2, 000, 000	393, 436

Table 3: summary of the APA filing fee in India.

### Step 3: preliminary processing of the APA application (Rule 10K)

After filing the APA application is reviewed to ensure basic compliance. If a defect is noticed in the application (including if a relevant document is not attached) or if the application is not in line with the understanding that was reached in pre-filing consultation then either the DGIT or the Competent Authority in India can serve a deficiency letter on the applicant asking it to rectify the defect or to amend the application.<sup>35</sup>

<sup>31</sup> Laksmikumaran & Sridharan Attorneys, Indian Transfer Pricing Landscape & Advance Pricing Agreements” 2014, 19.

<sup>32</sup> Laksmikumaran & Sridharan Attorneys, Indian Transfer Pricing Landscape & Advance Pricing Agreements” 2014, 20.

<sup>33</sup> <https://bit.ly/2DtrJnZ> (Accessed 16 November 2018).

<sup>34</sup> Exchange rate at 17 November 2018, available at: <https://bit.ly/26acJCd>, INR 1 = ZAR 0.19672

<sup>35</sup> Laksmikumaran & Sridharan Attorneys, Indian Transfer Pricing Landscape & Advance Pricing Agreements” 2014, 20.

The deficiency letter, if applicable, must be served on the applicant within one month from the date of filing of the application. The applicant can rectify the defect/modify the application within 15 days of the date of service of deficiency letter or such extended time as may be requested subject to a maximum of 30 days from the date of service of the deficiency letter.

If the DGIT or the Competent Authority in India are not satisfied that the deficiency has been rectified by the Applicant, they can pass an order to remove the APA application in its entirety. However, the applicant would be given an opportunity to be heard before such an order is passed.

#### **Step 4: processing the APA application**

The Tax authorities/Competent Authority can propose meetings, request for additional documents for more information or even visit the premises of the applicant.<sup>36</sup> Site visits are planned in consultation with the taxpayer and are meant to gather facts (to obtain better practical insights into the function, asset and risk analysis)<sup>37</sup> to better understand the business model and are not meant to be investigative in nature.<sup>38</sup>

In case of a unilateral APA, the APA team will send the draft report to the DGIT. In case of a bilateral or multilateral APA, the authorities in the other country(ies), after making due enquiry, will forward a draft report to the APA team in India who will send the draft report to the DGIT, who in turn will send it to the Competent Authority in India.

#### **Step 5: Drafting of an APA and execution post approval**

This phase involves the exchange of comments on the draft APA, the finalisation of the APA, and giving effect to the initial years covered under the APA term that have already elapsed.<sup>39</sup> The DGIT or the Indian Competent Authority and the Applicant would then prepare a proposed mutually agreed draft of the agreement. This agreement will be entered into between the CBDT and the applicant after the approval from the central government.<sup>40</sup>

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<sup>36</sup> Laksmikumaran & Sridharan Attorneys, Indian Transfer Pricing Landscape & Advance Pricing Agreements” 2014, 21.

<sup>37</sup> Phatarphekar, KR, *et al*, (2014) *International Transfer Pricing Journal*, 174.

<sup>38</sup> Laksmikumaran & Sridharan Attorneys, Indian Transfer Pricing Landscape & Advance Pricing Agreements” 2014, 21.

<sup>39</sup> PwC, “*Advance pricing agreements – frequently asked questions*” (2014), 4.

<sup>40</sup> *Ibid*.

#### 4.4.3. POST APA AGREEMENT

Revision of tax returns and tax assessment: The APA scheme in India is not a time bound process, hence, it is likely that by the time an APA is entered into, one or more tax years has elapsed or perhaps selected for a tax audit. An APA is effective for a period of up to five consecutive years.<sup>41</sup> Initially the roll-back period was not applicable when the APA programme commenced. Subsequently, the rollback of APAs enables taxpayers to apply the transfer prices agreed upon in an APA to be rolled back for a period not exceeding four previous years, subject to certain conditions.<sup>42</sup> In such an instance the scheme provides that the taxpayer shall file a revised return of its income for the elapsed years within three months from the end of the month in which the APA was finalised. The tax assessment of such revised return is to be carried out within one year from the end of the financial year in which such revised return was furnished.<sup>43</sup>

Filing of compliance report: The taxpayer is required to furnish an annual compliance report to the DGIT for each year covered in the agreement, within thirty days of the due date of filing the revised income tax return for that year, or within ninety days of entering into an agreement, whichever is later. Failure to file this report or filing a report containing material errors can result in cancellation of the APA. Before the cancellation of the APA the taxpayer will however be given an opportunity to provide reasons for the non-compliance.<sup>44</sup>

Audit of the compliance report: The revised return filed after execution of the APA does not undergo a regular transfer pricing audit (for transactions covered by an APA). For covered transactions, the Transfer Pricing Officer would audit the compliance report to form an opinion on the taxpayers compliance with the terms agreed in the APA which needs to be completed within 6 months from the end of the month in which the compliance report is received by the Transfer Pricing Office from the DGIT.<sup>45</sup>

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<sup>41</sup> <https://bit.ly/2DpTbTL> (Accessed 16 November 2018).

<sup>42</sup> <https://bit.ly/2DpTbTL> (Accessed 16 November 2018).

<sup>43</sup> Laksmikumaran & Sridharan Attorneys, Indian Transfer Pricing Landscape & Advance Pricing Agreements” 2014, 22.

<sup>44</sup> Laksmikumaran & Sridharan Attorneys, Indian Transfer Pricing Landscape & Advance Pricing Agreements” 2014, 22.

<sup>45</sup>



## 4.5. CONCLUSION

There is no time limit prescribed in the APA scheme for concluding an APA. While one appreciates that another government may be involved in the process (i.e. the Competent Authorities of the home country of the foreign associated enterprise), prescribing a limit will provide comfort that the process is aimed to be completed within a reasonable time.

Since the introduction of India's APA programme, the programme received a very positive response and much certainty to taxpayers. An APA is effective for a period of up to five consecutive years.<sup>46</sup>

Therefore, an APA in India can now provide certainty for a period of up to nine years. In the first five years since the inception of the APA programme there has been over 900 APA applications received and over 200 APAs have already been concluded.<sup>47</sup> This signifies both the popularity of the APA programme among taxpayers, and the commitment of the government to the programme.<sup>48</sup>

Concluded APAs to date have included resolutions on a wide range of international transactions, such as, import and export of goods, technical services, marketing support services, software development, engineering design services, administrative/business support services, contract research and development, sales and marketing services, HR consultancy service, clinical research services, receipt of licence fees, etc.<sup>49</sup>

Until recently, India had a policy of not accepting bilateral APA and MAP applications in the absence of Article 9(2) in tax treaties. Recently, it has been decided that transfer pricing MAP and bilateral APA applications will be accepted, regardless of the presence or otherwise of Article 9(2) (or its relevant equivalent article) in double taxation avoidance agreements (DTAs). This could possibly further impetus to the APA and MAP programme in India.

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<sup>46</sup> <https://bit.ly/2DpTbTL> (Accessed 16 November 2018).

<sup>47</sup> <https://bit.ly/2DpTbTL> (Accessed 16 November 2018).

<sup>48</sup> <https://bit.ly/2DpTbTL> (Accessed 16 November 2018).

<sup>49</sup> <https://bit.ly/2DpTbTL> (Accessed 16 November 2018).

## **CHAPTER 5: IMPLEMENTATION OF AN APA PROGRAMME IN SOUTH AFRICA**

### **5.1 INTRODUCTION**

Before considering to introduce an APA programme it is important to determine whether or not it will be practically possible to implement the programme and whether in fact the programme will be sustainable. Based on the research conducted in Chapter 3 and Chapter 4, the success of the commencement of an APA is highly dependent on the government of each respective country and the relevant tax authorities to enforce and sustain the programme.

From a South African perspective the government of South Africa and SARS are the key role players to begin the initiative. When, and if South Africa wishes to introduce the programme, due consideration should be given to the timing of the introduction of the programme as well as if such a programme meets the governments' policy objectives. It is also important to consider an APA programme that would be most suitable to South Africa as a developing country.

Firstly, this chapter will explore the various factors that should be taken into account when South Africa considers introducing an APA programme, i.e. whether the programme will be feasible. These factors will be based on the similarities observed between the UK and Indian APA programme.<sup>1</sup>

Secondly, this chapter will consider a proposed framework that would be most ideal for South Africa should it decide to adopt the APA programme.

Lastly, from a legal perspective whether it is indeed possible to incorporate a unilateral and bilateral/multilateral APAs into the current legislation in South Africa.

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<sup>1</sup> Which is based on the research performed in Chapter 3 and Chapter 4.

## 5.2 FACTORS TO CONSIDER BEFORE IMPLEMENTING AN APA: INITIAL FEASIBILITY STUDY

This section will explore some factors that could be taken into account when South Africa considers to introduce an APA. These factors will be based on the similarities observed between the UK and Indian APA programme which is based on the research performed in Chapter 3 and Chapter 4 as well as published reports that are available and unique to a developing country.

### 5.2.1. FORUMS AVAILABLE

Based on the research performed above it can be concluded that APAs can be very complicated and advice and assistance should be sought by organisations that have assisted tax authorities previously, or have some background in the implementation of APAs. There are various initiatives and programmes available that would be most useful. Some of these organisations/forums are briefly discussed below.

***Tax and Development Programme (OECD):*** developing countries are frequently reporting the need to implement measures that are designed to protect their tax base. Whilst at the same time create certainty, transparent and predictable investment climate through the introduction of rules that are effective in addressing base erosion and profit shifting (BEPS). The Tax and Development Programme delivers support initiatives for developing countries seeking to implement or strengthen their regimes to address transfer pricing and other BEPS-related issues. The duration of the programmes are usually two to three years. These programmes are demand-led and provide solutions to the different needs that developing country tax administrations have in the area of transfer pricing and other BEPS matters. Most of the programmes are delivered in co-operation with international agencies such as the African Tax Administration Forum (ATAF), the European Commission and the World Bank Group.<sup>2</sup>

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<sup>2</sup> <https://bit.ly/2A3r5> (Accessed 18 November 2018).

**Tax Inspectors without Borders (TIWB):** The OECD and the United Nations Development Programme (UNDP) have joined forces to extend the global reach of TIWB and to build-up operations. The partnership was launched at the Third Financing for Development conference in Addis Ababa on 13 July 2015 and was welcomed by stakeholders from business, civil society, OECD and developing country governments attending the conference. The initiative was widely hailed as capable of assisting developing countries mobilise much-needed domestic revenues in support of the post-2015 sustainable development agenda. The TIWB Initiative facilitates targeted, tax audit assistance programmes in developing countries across the globe.<sup>3</sup>

**Africa Tax Administration Forum (ATAF):** ATAF, an African network, aims to improve tax systems in Africa through exchanges, knowledge dissemination, capacity development and active contribution to the regional and global tax agenda. Improved tax systems will increase accountability of the state to its citizens, enhance domestic resource mobilisation thus fostering inclusive economic growth.<sup>4</sup>

**United Nations:** the UN Committee of Experts on International Cooperation in Tax Matters reflects the diversity of the UN membership and places a particular focus on development and developing countries. In all its activities, the Committee gives special attention to developing countries and countries with economies in transition. The Committee is a subsidiary body of the Economic and Social Council and falls within the Financing for Development division of the Department for Economic and Social Affairs.<sup>5</sup>

## 5.2.2. TAXPAYER CERTAINTY

Undoubtedly the main theme of this research, and purpose of the APA programme is to provide taxpayer certainty with regard to their pricing of the cross-border transactions.

An APA provides comfort to a taxpayer that it will not be subject to a costly audit, with an uncertain outcome, in relation to the relevant transaction(s) that fall within the APA, and over the period of the APA. As discussed above this off course remains as long as the conditions of the APA remain fulfilled.<sup>6</sup> Bilateral/multilateral APAs extend that comfort to the treatment of the relevant transactions(s) in more than one country, and also provide for protection against economic double taxation.<sup>7</sup>

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<sup>3</sup> <https://bit.ly/2A3r5> (Accessed 18 November 2018).

<sup>4</sup> <https://bit.ly/2DvvidH> (Accessed 18 November 2018)

<sup>5</sup> <https://pwc.to/2PzLrWL> (Accessed 18 November 2018).

<sup>6</sup> Tax and Development, "Advance Pricing Arrangements: Approaches to Legislation" 2012, 3.

<sup>7</sup> Tax and Development, "Advance Pricing Arrangements: Approaches to Legislation" 2012, 3.

It is important to note that APAs should not be used to provide preferential or advantageous treatment to individual taxpayers as part of a “tax incentive” strategy. Not only would such an approach undermine the tax yield, it would also disadvantage, and lead to uncertainty of treatment in, the country in which the other party to the relevant transaction(s) is located.<sup>8</sup>

APAs should thus adopt and implement internationally accepted standards on transfer pricing.

Both the UK<sup>9</sup> and the Indian<sup>10</sup> APA programme adopts international best practice and their main purpose of the APA programme is to provide certainty and the elimination of long drawn transfer pricing audits.

### **5.2.3. LIKELY TAX YIELD**

APAs should not be viewed as a means for increasing tax revenue. As mentioned above, APAs are primarily aimed at providing some certainty to taxpayers on the tax treatment of their cross-border activities. From the perspectives of both the taxpayer and the tax authority, an APA is often seen as an alternative to an audit into a company’s corporate tax position.<sup>11</sup>

If a country has the capacity to carry out effective audits, it is unlikely that devoting resources to APAs will be more effective at raising revenue than employing resource on audits.<sup>12</sup> This is because, it would be assumed that only compliant taxpayers will apply for an APA, an effective audit programme can be targeted at the highest risk taxpayers, and the threat of effective audit gives all taxpayers an incentive to voluntarily comply with the relevant transfer pricing rules.<sup>13</sup>

Both the UK<sup>14</sup> and the Indian APA<sup>15</sup> programmes view the APA process as a forum where the taxpayer and tax authority can communicate in an environment that encourages meaningful conversations that is less controversial as opposed to a transfer pricing audit where the atmosphere is seen to be more adversarial.

In addition, the conversations during the APA process in the UK<sup>16</sup> and in India<sup>17</sup> are to better understand the business model in order to determine the correct ALP as opposed to try and obtain a greater tax yield.

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<sup>8</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 3.

<sup>9</sup> See Section 3.4.1 above.

<sup>10</sup> See Section 4.4.1 above.

<sup>11</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 4.

<sup>12</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 4.

<sup>13</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 4.

<sup>14</sup> See Section 3.2.1 above.

<sup>15</sup> See Section 4.4.1 above.

<sup>16</sup> See Section 3.4.2 above.

<sup>17</sup> See Section 4.4.2 above.

#### 5.2.4. OPTIMISING RESOURCE UTILISATION

There are a number of considerations to be taken into account with respect to the most efficient way to utilise the tax authority resources.<sup>18</sup> It is important to note that the negotiation of an APA needs to be carried out by knowledgeable and experienced transfer pricing specialists in the tax administration.<sup>19</sup> Such resources are likely to be in short supply, and, of course, when employed on an APA, will have reduced availability for other compliance activities, including auditing. Usually there would be a tug-of-war to balance the resources between audit and the APA programme.

There are a number of aspects the tax authority would need to consider:<sup>20</sup>

- devoting all specialist resource to an APA programme, at the expense of audit activities, is unlikely to be successful – without the threat of eventual audit of their intra-group transactions taxpayers will have little incentive to seek an APA, or comply with the transfer pricing rules at all. Thus the tax authority would need to conduct an APA programme in conjunction with an effective audit programme.
- that it is likely that an APA can be carried out more efficiently than an audit into the same transaction(s). An APA will normally use contemporaneous data, and the taxpayer will have an incentive to co-operate and provide all relevant data and information.
- that only compliant taxpayers will apply for an APA, and there is thus a danger that scarce and valuable resource is tied up with compliant taxpayers, at the expense of time spent on auditing high risk cases.
- even when an APA is in place, the tax administration is not freed from further auditing activities. APAs invariably require a taxpayer to file periodic reports to confirm adherence to the agreement, and that the critical assumptions contained in it remain fulfilled. These reports will require consideration. Furthermore, transactions outside the scope of the APA may also be the subject of audit activity.

Resources considerations increase the significance of introducing clear criteria for accepting or rejecting APA applications. Which is important in order to allow the tax authority some control over the number of APA negotiations it enters into, and to ensure that its scarce specialist resources are engaged only on worthwhile cases that justify the resource cost. Countries may include an eligibility criteria for an APA request in the APA legislation, or

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<sup>18</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 4.

<sup>19</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 4.

<sup>20</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 4-5.

associated guidance. This might include, for example, restricting APAs only to “complex” transactions or those where there is uncertainty over the application of the most appropriate transfer pricing method.

Both the UK<sup>21</sup> and India<sup>22</sup> have dedicated APA teams that are specialists and knowledgeable of transfer pricing. Their resource utilisation is optimal which is clear in the amount of finalised APA applications which supports the view of the respective APA team’s competencies.

### **5.2.5. SKILLS BUILDING**

Taxpayers’ incentive to co-operate with the APA process and increased willingness to work with the tax administration often means that involvement in negotiating APAs can help build valuable specialist transfer pricing skills, and build knowledge and intelligence on sectors, industries and/or particular taxpayers.<sup>23</sup> In addition, forums like ATAF can assist with formal training where required.

The success of the amount of finalised APAs in the UK<sup>24</sup> and India<sup>25</sup> is testament to the taxpayer’s willingness to co-operate and liaise with the relevant tax authorities. This in return builds trust in the tax administration and assists with the upskilling of staff.

### **5.2.6. CAPACITY TO CONDUCT AN APA PROGRAMME**

It is sometimes perceived that less experienced tax administrations may lack the knowledge and skills to negotiate fair APAs, especially when faced with large, well-advised MNE.<sup>26</sup> Similarly, in the case of bilateral and multilateral APAs, there is a perceived risk that less experienced countries may be disadvantaged in negotiations by more experienced countries.<sup>27</sup>

Such perceptions can be mitigated by proposing a shorter period (3 years) perhaps with an option to extend for a longer period if both parties agree, and there should be no obligation on a tax administration to agree to an APA. Tax administrations may decline an APA request, and withdraw from negotiations if an acceptable outcome cannot be reached.<sup>28</sup>

As mentioned above, the UK and India has substantial experience in negotiating APAs and the programme can only be enhanced in South Africa by way of “trial and error”. It is noted

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<sup>21</sup> See Section 3.4.2 above.

<sup>22</sup> See Section 4.4.2 above.

<sup>23</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 5.

<sup>24</sup> See Section 3.2.2 above.

<sup>25</sup> See Section 4.2.2 above.

<sup>26</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 5.

<sup>27</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 5.

<sup>28</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 5.

that the UK and Indian APA programme was enhanced and developed over the years to ensure that the programme is still very much relevant. The development of the programme identified flaws and corrected them to ensure that APA negotiations can be handled in an efficient manner, within the prescribed time limits.

### 5.2.7. CORRUPTION ISSUES

Care should be taken to ensure that APA negotiations are subject to similar checks and balances as audits in order to mitigate risks of corruption.<sup>29</sup>

## 5.3. IMPLEMENTATION OF AN APA FRAMEWORK SOUTH AFRICA

In 2012, the OECD's Tax and Development issued a draft pilot programme on factors to consider when implementing an APA framework (the "draft"). This draft initiative is very much in line with the framework of the APA programme in the UK and India.

The draft suggests the following:

**a) Transactions to be covered:** the starting point is that an APA may be made in respect of any transaction or transactions that fall within the scope of the country's transfer pricing rules. The exact scope will differ between countries. For example, some country transfer pricing rules apply only to cross-border transactions, while others apply additionally to purely domestic transactions. Furthermore, some countries apply exemptions for smaller transactions from their transfer pricing rules. The key point is that an APA would not be available in respect of a transaction that is not within the scope of the country transfer pricing rules.<sup>30</sup>

Application: UK; Part 4 of TIOPA 2010 has to apply, India: in sections 92 to s92F and sections 94A of the Income Tax Act 1961 has to apply and; South Africa; section 31 of the Act has to apply.

**b) Pre-requisites for an APA programme:** some countries restrict the availability of APAs to specified classes of transaction, for example, those above a certain monetary value, or complex or high risk cases.<sup>31</sup> The APA programme should allow the tax authority to decline a taxpayer's request to enter into an APA. Provisions such as these are important in order to allow the tax authority some control over the number of APA negotiations it enters into, and to ensure that its scarce specialist resources are engaged only on worthwhile cases that justify the resource cost. Countries may include their criteria for acceptance of an APA request in the

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<sup>29</sup> Tax and Development, "Advance Pricing Arrangements: Approaches to Legislation" 2012, 5.

<sup>30</sup> Tax and Development, "Advance Pricing Arrangements: Approaches to Legislation" 2012, 9.

<sup>31</sup> Tax and Development, "Advance Pricing Arrangements: Approaches to Legislation" 2012, 9.



APA framework. This might include, for example, restricting APAs only to “complex” transactions or those where there is uncertainty over the application of the most appropriate transfer pricing method.

Application: UK; acknowledges that each case will be determined on its own merits However the UK considers transfer pricing issues that are complex rather than straightforward. Without an APA there is a high likelihood of double taxation and HMRC consider that it is a good use of taxpayer and governmental resources. India; as an initial first step, India performs a “feasibility study” and in addition requests an initial fee. For, South Africa; this will depend to an extent on the capacity of SARS to conduct an APA exercise with the taxpayer. The writer is of the view of taking a combined approach of adopting the pre-requisites of the UK and the Indian APA programme.

**c) APA applies to only transactions that are documented:** an APA will apply only to the transaction or transactions specified within the APA. For example, an APA might specify that it applies to “the sale of manufactured components by Company A (resident in Country A) to Company B (resident in Country B), over the period 1<sup>st</sup> January 2012 to 31<sup>st</sup> December 2015”.<sup>32</sup>

Application: Both the UK and the Indian APA programme follows this approach. South Africa should follow the same approach to ensure consistency and compliance in relation to only documented transactions. Any transactions that falls outside the scope of the APA will most likely be subject to a transfer pricing audit.

**d) Considering whether or not to provide reasons for rejecting the APA application:** the draft does not require a tax authority to provide reasons for the rejection of a request for an APA. Some countries do provide taxpayers with reasons for such a rejection, and countries need to consider whether they wish to do so, and, if they do, whether they wish to make it a statutory obligation to do so.<sup>33</sup>

Application: both UK and India provides reasons for rejection and also provides an additional opportunity to the taxpayer to present its case should it not be satisfied with the outcome. This behaviour on part of the revenue authority allows for a more effective communication and gaining trust in in the system. South Africa should adopt the same approach as followed by UK and India.

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<sup>32</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 9.

<sup>33</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 9.

**e) Documentation to be provided to the taxpayer when applying for an APA:** a list of initial documentation to be provided to the tax authority when the APA application is made. Some tax authorities also allow taxpayers to meet with them informally before a formal application is made. Such a meeting may allow the tax authority to express a view at an early stage on a) whether an APA is legally available in respect of the relevant transactions and b) whether it is willing to enter into APA talks and negotiations in respect of those transactions.<sup>34</sup>

Application: UK; this is done at the expression of interest stage. HMRC regards the expression of interest as a vital step in the process, and in addition it would be exceptional for them to turn down a request for a meeting. India; this done and the pre-filing and filing of the APA stage. Documents and the application are submitted in the prescribed manner and form together with an application fee. South Africa: should follow a combined approach.

**f) Possibility of MAP APAs:** a authority may enter into bilateral or multilateral APAs, in addition to unilateral APAs. It should be noted, however, that such bilateral and multilateral APAs are normally only possible if treaties, or relevant multilateral agreements, are in place between the countries involved.<sup>35</sup>

Application: both the UK and India enters into MAP APAs, provided the relevant treaty and article are in place. The same would follow for South Africa.

**g) Applying the arrangement retrospectively:** allows an APA to cover periods prior to the date the arrangement is made. An APA will be operative for specified periods as soon as the APA is in force as set out in the arrangement. APAs, however, can take a considerable length of time to negotiate and to reach agreement.<sup>36</sup> This may lead to a situation where some of the years for which the arrangement is sought will have already passed and the taxpayer may have already needed to submit their returns for those years.<sup>37</sup> Countries may also want to be able to “roll-back” the arrangement as an appropriate means of resolving a transfer pricing issue in earlier years although, in bilateral or multilateral cases, the possibility of doing so will depend on the ability or willingness of the tax authority of the other country or countries involved to do so.<sup>38</sup>

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<sup>34</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 10.

<sup>35</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 10.

<sup>36</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 11.

<sup>37</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 11.

<sup>38</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 11.

Application: UK; HMRC has shown flexibility in applying the agreed APA methodology to years before the initial APA period, referred to as the “roll-back period.” Some taxpayers have used this approach as a way of resolving tax audits for prior years as the more cooperative nature of the APA negotiations has sometimes proved more successful in reaching common ground in comparison to an adversarial atmosphere during an audit. India; initially the roll-back period was not applicable when the APA programme commenced. Subsequently, the rollback of APAs enables taxpayers to apply the transfer prices agreed upon in an APA to be rolled back for a period not exceeding four previous years, subject to certain conditions. South Africa; should follow a similar approach adopted by the UK and India.

**h) Monitoring compliance with the Arrangement:** post APA approval requires that the taxpayer to submit an annual report to demonstrate that the APA has been applied as envisaged in the agreement. It is important that the tax authority is able to establish that the taxpayer is abiding by the terms and conditions on which the APA is based, throughout its duration.<sup>39</sup> Most countries require the taxpayer to prepare an Annual Report. In many instances, the taxpayer is required to submit the report as part of its annual tax return. The broad intention is that Annual Reports should demonstrate in a concise format that the business has complied with the terms and conditions of the APA. This includes the taxpayer making available the information needed for the tax authority to decide if the critical assumptions or other safeguards in the APA have been met.<sup>40</sup>

Application: UK; once an APA is finalised in the UK the taxpayer is to submit an Annual Report with the annual tax return. The purpose of the Annual Report is to confirm whether the business has complied with the terms and conditions of the APA. India; The taxpayer is required to furnish an annual compliance report to the DGIT for each year covered in the agreement, within thirty days of the due date of filing the revised income tax return for that year, or within ninety days of entering into an agreement, whichever is later. Failure to file this report or filing a report containing material errors can result in cancellation of APA. The taxpayer will however be given an opportunity of providing reasons for the non-compliance before such cancellation. South Africa; should follow a similar approach and adopt a zero tolerance for non-compliance as adopted in the Indian APA programme.

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<sup>39</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 11.

<sup>40</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 9.

### **i) Consequences of providing inaccurate information:**

During the course of an APA application, and subsequent discussions and negotiations, the taxpayer will often provide a substantial amount of information to the tax authority concerned. Such information will, of course, be a major determining factor in a) whether the tax authority agrees to enter into an APA, and b) the terms of any APA. It is thus essential that information submitted by the taxpayer is complete and accurate.<sup>41</sup>

A framework should be in place to address a situation in which the taxpayer has submitted inaccurate information, and done so through negligence, carelessness or willful default. The framework should allow the tax authority in such situations to revoke the APA.<sup>42</sup> This means that the APA is nullified, and the transfer pricing rules then apply as they would in the absence of the APA for all periods covered by the APA, including prior periods.<sup>43</sup> The use of the word “may” in the illustrative wording allows some flexibility, recognising that revocation may not always be the tax authority’s interest even where negligence, carelessness or willful default is involved. In such cases, the tax authority may choose a different course of action.<sup>44</sup>

The framework should further sanction against the provision of inaccurate or incomplete information by the taxpayer, due to negligence, carelessness or willful default. This should allow the tax authority to impose a monetary penalty of no more than a specified amount.<sup>45</sup>

Further the framework should address a situation in which the taxpayer has submitted inaccurate information, but that this is not due to negligence, carelessness or willful default. In such cases, the illustrative framework allows flexibility of action depending on the facts and the circumstances of the case.<sup>46</sup> Three courses of action are specified:<sup>47</sup>

- the APA may be amended retrospectively. In such cases, the APA remains in operation throughout the intended period (unlike in the case of revocation or cancellation), but the terms are amended from the date the APA came into force;
- the APA may be amended from a specified date. Periods prior to that date, however, are unaffected.

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<sup>41</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 12.

<sup>42</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 12.

<sup>43</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 12.

<sup>44</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 12.

<sup>45</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 12.

<sup>46</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 12.

<sup>47</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 12.

- the APA may be cancelled. This means that, from a specified date, the APA is no longer in force. The terms of the APA do remain in force, however, for the periods prior to the cancellation.

**Application:** both the UK and India follows a similar approach in most instances. The same would follow for South Africa.

**j) Avoidance of double taxation – revisit the terms of the unilateral APA:** the framework should address the situation where a unilateral APA gives rise to potential double taxation.<sup>48</sup>

As an example, assume that:<sup>49</sup>

*“Taxpayer A in Country A sells goods to an associated enterprise, Taxpayer B, resident in Country B, and that Taxpayer A enters into a unilateral APA with the tax authorities of Country A in respect of the sale of these goods. The APA will specify a transfer pricing approach acceptable to Country A for the duration of the APA. It might specify, for example, that Taxpayer A reports a net profit margin of 4.5% in relation to those sales, for periods 1,2 and 3. Assume also that, subsequently, the tax authorities of Country B examine the transfer pricing between Company A and Company B in the course of an audit of Company B relating to one or more of these periods. As a result of that audit, they may take the view that the transfer pricing agreed in the unilateral APA is not in accordance with the arm’s length principle, and propose an adjustment to the transfer pricing – perhaps to a price that results in a net profit margin of 3.5% to Company A. In this case, there will be potential economic double taxation. As a result, Company A may approach Country A and request that it enters into the MAP with Country B, in respect of the affected transaction.”*

The framework in such a case, and if there is a relevant treaty between Countries A and B, Country A will enter into MAP discussions with Country B, with a view to avoiding double taxation. If necessary, and if the relevant agreement between Countries A and B can be reached, this might require Country A to revisit the terms of the unilateral APA.<sup>50</sup>

Of course, such an issue will not arise in respect of a bilateral or multilateral APA, which will contain terms acceptable to both (or all) countries involved.

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<sup>48</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 12.

<sup>49</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 12.

<sup>50</sup> Tax and Development, “Advance Pricing Arrangements: Approaches to Legislation” 2012, 12.

## **5.4. INCORPORATING THE APA FRAMEWORK INTO SOUTH AFRICAN LAW**

In order for an APA programme to be successful it is imperative that the APA framework can practically be incorporated into South Africa's legislation. This section discusses the possibility of adopting the APA programme into legislation and will be focused primarily on the possible implementation of the unilateral and bilateral/multilateral APAs.

### **5.4.1. Unilateral APAs**

South Africa currently has an advance tax ruling and like the APA programme brings about certainty to taxpayers regarding their tax matters. Like the APA the advance tax ruling is concluded by a taxpayer and SARS. The advance tax ruling is not available to transfer pricing matters and the reason for the exclusion is based on the lack of capacity by SARS.<sup>51</sup>

“the unavailability of an APA procedure to South Africa and the specific exclusion of the ability to obtain an advance tax ruling on the matter of the pricing of goods and services ...is presumably because of a lack of administrative capacity within SARS.”

Further SARS PN7 at par 16.2. states:

*“Due to various factors, the APA process will not in the foreseeable future, be made available to South African taxpayers. This Practice Note will thus not deal with APA's.”*

Should an APA be fully operational in South Africa the programme should be implemented by means of an advance tax ruling and be incorporated into the Tax Administration Act accordingly.

### **5.4.2. Bilateral/ Multilateral APAs**

The development of working arrangements between Competent Authorities is considered in the Annex to Chapter IV of the OECD Guidelines. In particular, paragraph 4.175 states:<sup>52</sup>

“Between those countries that use APAs, greater uniformity in APA practices could be beneficial to both tax administrations and taxpayers. Accordingly, the tax administrations of such countries may wish to consider working agreements with the Competent Authorities for the undertaking of APAs. These agreements may set forth general guidelines and understandings for the reaching of mutual agreement in cases where a taxpayer has requested an APA involving transfer pricing issues.”

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<sup>51</sup> Olivier, L. *et al*/2011. International Tax: A South African Perspective, 638.

<sup>52</sup> OECD, 2017. OECD Guidelines, 471.

The objective of the Annex is to improve the consistency of the application of APAs by providing guidance to tax administrations on how to conduct mutual agreement procedures involving APAs (MAP APAs). Although the focus of the Annex is on the role of tax administrations, there is also a possibility for the taxpayer to contribute to the process. This guidance is intended for use by both OECD member and non-member countries that wish to use APAs.<sup>53</sup>

The bilateral or multilateral APAs are the main subject of this Annex – these APAs are referred to as “MAP APAs”. However, in some cases where a bilateral APA has been sought and the treaty is not appropriate, or where a treaty is not applicable, the Competent Authorities of some countries may nevertheless conclude an arrangement using the executive power conferred on the heads of tax authorities. The term MAP APA should be interpreted, with the necessary adaptations, as including such exceptional agreements.<sup>54</sup>

#### **5.4.2.1. Eligibility of MAP APAs**

MAP APAs are governed by the mutual agreement procedure of the applicable double tax agreement, Article 25 of the OECD Model Tax Convention, and are administered at the discretion of the relevant tax administrations. The guidelines provide that if a taxpayer does not request a MAP APA, then the reason should be reviewed, and wherever possible, tax authorities should encourage the taxpayer to request a MAP APA if the circumstances are suitable.

The eligibility of a taxpayer to apply for a unilateral APA will be determined by the specific domestic requirements of the relevant tax administration. MAP APAs are governed by the mutual agreement procedure of the applicable double tax agreement, Article 25 of the OECD Model Tax Convention, and are administered at the discretion of the relevant tax administrations. The work pursuant to Action 14 of the BEPS Action Plan to ensure the timely, effective and efficient resolution of treaty related disputes that countries should implement bilateral APA programmes as soon as they have the capacity to do so, recognising that APAs provide a greater level of certainty in both treaty partner jurisdictions, lessen the likelihood of double taxation and may proactively prevent transfer pricing disputes.

The negotiation of MAP APAs requires the consent of the relevant Competent Authorities. In some cases the taxpayer might voluntarily take the initiative by making simultaneous requests to the affected Competent Authorities. However, Article 25 does not oblige the Competent Authorities to enter into MAP APAs at the request of the taxpayer. The willingness to enter

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<sup>53</sup> OECD, 2017. OECD Guidelines, 471 – 472.

<sup>54</sup> OECD, 2017. OECD Guidelines, 472.

into MAP APAs will depend on the particular policy of a country and how it interprets the mutual agreement article of its bilateral treaties. The desire of the taxpayer for certainty of treatment is therefore not, in isolation, sufficient to execute MAP APAs. Other Competent Authorities apply a less restrictive threshold for entering into MAP APAs, based on their view that any MAP APA process should be encouraged. Additionally, the taxpayer must qualify for the benefit of a particular treaty (e.g. by qualifying as a taxpayer of one of the Contracting States) and must satisfy any other criteria contained in the Mutual Agreement Article.<sup>55</sup>

The fact that a taxpayer may be under audit or examination should not prevent the taxpayer from requesting a MAP APA in respect of prospective transactions. The audit or examination and the mutual agreement procedure are separate processes and generally can be resolved separately. Audit or examination activities would not normally be suspended by a tax administration whilst the MAP APA is being considered, unless it is agreed by all parties that the audit or examination should be held in abeyance because the obtaining of the MAP APA would assist with the completion of the audit or examination.

#### **5.4.2.2. High-level overview of the process of executing MAP APAs**

The OECD Guidelines provide for extensive involvement and interaction between the taxpayers and interaction between the taxpayers and tax authorities in the process of executing a MAP APA.<sup>56</sup>

Some of the important considerations are set out below:

1. Preliminary discussions between the taxpayer and the tax administration to discuss the type of APA, the extent and type of information required, and the scope of any analyses to ensure that MAP APA is expedited. Based on these discussions, a taxpayer will make a decision whether this route should be pursued or not;<sup>57</sup>

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<sup>55</sup> *Ibid.*

<sup>56</sup> This section provides a very high-level overview of the MAP APA process for a detailed explanation of the process please refer to Annex II of Chapter IV of the OECD Guidelines (2017).

<sup>57</sup> Deloitte, "Recommendations for a model: Advance Pricing Agreement scheme in India" 2011, 10.



2. If the taxpayer wishes to pursue a MAP APA request, then the second stage is to make a detailed proposal to the relevant tax administration, pursuant to any domestic procedural requirements, e.g. a requirement to file the request with a designated part of the domestic tax administration.<sup>58</sup> For a MAP APA, the purpose of the taxpayer's proposal is to give the relevant Competent Authorities all the information needed to evaluate the proposal and to undertake mutual agreement discussions. In certain countries, the taxpayer is able to make the proposal directly to the Competent Authority whereas in other cases a copy of the domestic APA proposal can be made available to the other participating jurisdictions:<sup>59</sup>

3. The exact form and content of the MAP APA proposal should be established between the taxpayer and tax administration based on preliminary meetings.<sup>60</sup> The MAP APA proposal may cover all of the transfer pricing issues of a taxpayer (or of the members of a MNE group) or may be more limited, for example to a particular transaction, sets of transactions, product lines or to only some members of a MNE group.<sup>61</sup> Further, the content of the proposal and the extent of the necessary supporting information and documentation will depend on the facts and circumstances of each case and the requirements of the individual participating tax administrations. It is therefore not considered practicable to list or define exactly what should be provided. The guiding principle, however, should be to provide the information and documentation necessary to explain the facts relevant to the proposed methodology and to demonstrate its application in accordance with the appropriate article of the relevant treaty.<sup>62</sup> The proposal should therefore be consistent with any general guidance given by the Commentary of the OECD Model Tax Convention on the corresponding articles, together with the guidance on the application of the arm's length principle of Article 9 given by the Transfer Pricing Guidelines in cases involving transfer pricing between associated enterprises;<sup>63</sup>

4. The term of an APA is generally negotiated between the Competent Authorities on a case-by-case basis. Experience to date has shown that a MAP APA might, on average, last for three to five years;<sup>64</sup>

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<sup>58</sup> OECD, 2017. OECD Guidelines, 482.

<sup>59</sup> Deloitte, "Recommendations for a model: Advance Pricing Agreement scheme in India" 2011, 10-11.

<sup>60</sup> Deloitte, "Recommendations for a model: Advance Pricing Agreement scheme in India" 2011, 11.

<sup>61</sup> OECD, 2017. OECD Guidelines, 482.

<sup>62</sup> Deloitte, "Recommendations for a model: Advance Pricing Agreement scheme in India" 2011, 11.

<sup>63</sup> Deloitte, "Recommendations for a model: Advance Pricing Agreement scheme in India" 2011, 11.

<sup>64</sup> Deloitte, "Recommendations for a model: Advance Pricing Agreement scheme in India" 2011, 11.

5. Once a taxpayer's proposal has been received by the tax administrations, they should mutually agree on the co-ordination of the review, evaluation and negotiation of the MAP APA. The MAP APA process is broken up into two main stages; (1) fact finding, review and evaluation and (2) the Competent Authority discussions. The taxpayers can withdraw from the MAP APA at any time but any late withdrawal is generally discouraged;<sup>65</sup>

6. Once the MAP APA has been finally agreed, the participating tax authorities give effect to the same by executing an agreement in their own jurisdiction. The tax administrations should enter into some kind of a confirmation or agreement with their respective taxpayers consistent with the mutual agreement entered into by the participating Competent Authorities.<sup>66</sup> This agreement would provide the taxpayer with the certainty that the transfer pricing transactions covered by the MAP APA would not be adjusted, as long as the taxpayer complies with the terms and conditions of the mutual agreement. The terms and conditions would include certain assumptions which, if not met, might require an adjustment to be made or the agreement to be reconsidered;<sup>67</sup> and

7. The tax administrations and the taxpayer are not bound to apply the methodology agreed upon as part of the MAP APA to tax years ending prior to the first year of the MAP APA (often referred to as “rolling back”).<sup>68</sup>

#### **5.4.2.3. South African perspective**

The general rule is that for a MAP APA to apply there has to be a treaty in place, which covers Article 9 and Article 25.

In addition SARS has issued a 2<sup>nd</sup> edition to its guide on MAP which was released on 10 October 2018.<sup>69</sup> In terms of the practical guide at par 2.1.3 this guide excludes a MAP case for the request for an APA.

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<sup>65</sup> Deloitte, “Recommendations for a model: Advance Pricing Agreement scheme in India” 2011, 11.

<sup>66</sup> Deloitte, “Recommendations for a model: Advance Pricing Agreement scheme in India” 2011, 11.

<sup>67</sup> Deloitte, “Recommendations for a model: Advance Pricing Agreement scheme in India” 2011, 11.

<sup>68</sup> Deloitte, “Recommendations for a model: Advance Pricing Agreement scheme in India” 2011, 11.

<sup>69</sup> Available at <https://bit.ly/2PFtsxQ> (Accessed 19 November 2018).

Further par 7.1 of the practical guide states:

*“An APA is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (for example, method, comparable and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. South Africa does not have an APA programme in place.”*

No further reason is provided as to why an APA programme is not in place or further efforts from SARS to implement the programme.

South Africa has an extensive treaty network which includes Article 9 and Article 25.

The basis of entering into a MAP APA is found under Article 9(2) of the relevant treaty:

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

Further, Article 25 (1) OECD Model Tax Convention of the states:

*“Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the Competent Authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.”<sup>70</sup>*

Income which is earned by a MNE can be subject to double taxation if there is a possibility that different tax authorities assert the right to tax that income.<sup>71</sup> In such a case double taxation would arise as different tax authorities uses different transfer prices to allocate that income.

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<sup>70</sup> Own emphasis added.

<sup>71</sup> De Waegenaere, *et al*, (2007) *National Tax Journal*, 173.

The question that now arises is whether a taxpayer can compel the Competent Authority to institute a MAP APA case based on Article 9 (2) subject to Article 25 of the relevant treaty, where there is a possibility of double taxation by an MNE between two/ multiple tax authorities?

To answer this question the role of domestic and international law has to be considered.

Section 108 (1) of the Income Tax Act states:

*“The National Executive may enter into an agreement with the Government of any other country, whereby arrangements are made with such Government with a view to the prevention, mitigation or discontinuance of the levying, under the laws of the Republic and of such other country, of tax in respect of the same income, profits or gains, or gains, or donations, or to the rendering of reciprocal assistance in the administration of and the collection of taxes under the said laws of the Republic and of such other country.”*

Further section 108 (2) of the Income Tax Act states:

*“As soon as may be after the approval by Parliament of any such agreement, as contemplated in Section 231 of the Constitution, the arrangements thereby made shall be notified by publication in the Gazette and the arrangements so notified shall thereupon have effect as if enacted in this Act.”*

Consequently from the above it can be concluded that, Section 108 of the Income Tax Act is a deeming provision which gives a tax treaty the same status as domestic statutory tax law when the provisions of section 231 of the Constitution have been met.

The provisions of a tax treaty and the Income Tax Act should be interpreted so as to be consistent with each other, if there is a conflict then the treaty would prevail. Should that not be the case, the provisions in the treaty providing for the prevention, mitigation or discontinuance of the liability for tax would be nullified.<sup>72</sup>

Thus to conclude, should there be inconsistency with the domestic law (i.e. lack of an APA programme) the relevant treaty will prevail. SARS has provided no reasons or even proposed a model for commencing with an APA programme in South Africa, this in turns affects a taxpayer’s risk of the possibility of double taxation with respect to transfer pricing cases. An attempt to foresee the possible risk and have more certainty can be mitigated by way of an APA. The only possibility to avoid this risk will be by entering into a MAP APA.

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<sup>72</sup> Olivier, L. *et al* 2011. International Tax: A South African Perspective, 638.

However the writer is of the view that where there is inconsistency with the domestic legislation (i.e. no APA programme) the relevant treaty should prevail and the taxpayer should have the right to enforce the treaty, thereby requesting the Competent Authority to compel SARS to embark on the APA process.

## **5.5 CONCLUSION**

This chapter has shown that the incorporation of an APA programme, as well implementation of an APA programme into South African law is not impossible. In addition, with regards to bilateral/multilateral APAs South Africa has an extensive treaty network that forms the basis of APAs which can be found in Article 9(2) of the relevant treaty(ies) that South Africa has in place with other countries.

It would seem that the reason for not proceeding with an APA programme is still unknown. Neither SARS nor the South African government have provided any reasons as to why South Africa has not yet to proceed with the programme. Transfer pricing in general in South Africa, be it in practice or at the revenue authority, lacks the capacity of staff in this very niche area of tax. Taking into account the number of MNEs that are currently situated in South Africa it would seem that SARS would foresee a number of APA applications and will not be able to have capacity to support and sustain the programme.

## CHAPTER 6: CONCLUSION

### 6.1 SUMMARY OF FINDINGS

The objective of this dissertation was to comparatively explore the regulatory framework of APAs in the UK and India and the implementation thereof from a South African perspective.

In order to achieve this objective the following research questions were considered:

- factors to consider when deciding to implement an APA in a developing country;
- practical implementation: with reference to the UK and Indian APA programme'; and
- whether implementation of an APA programme is possible in South Africa.

As illustrated in Chapter 2, an APA aims to achieve certainty amongst taxpayers on the arm's length pricing and policy that are set amongst associated enterprises. The use of APAs can be beneficial to both taxpayers and tax administrations and involves more co-operation and communication by both taxpayers and tax administrations.

The study comparatively explored two countries, specifically the UK (chapter 3) and India (chapter 4), which have published regulations on the APA programme. The study further addressed the secondary objectives that supported the primary objective, namely:

- discussion and concept of transfer pricing and the regime in South Africa;
- discussion of the concept of an APA in context of transfer pricing as well as the processes involved;
- advantages and disadvantages of APAs;
- research into the regulatory framework of APAs in the UK;
- research into the regulatory framework of APAs in the India;
- possibility of the implementation of APAs into the South African legal framework;
- distinguishing between APAs and Advance Tax Rulings;
- make possible recommendations and suggestions on whether SA should implement the APA regime;

Chapter 5 ends this research study with a discussion and response to the problem statement on the possibility of implementing an APA programme in South Africa.

## 6.2 CONCLUSION

An APA is a written binding/non-binding contract between a taxpayer and a tax administration to determine some agreed criteria in transactions that are under review, including the price, method, comparability analysis, duration and assumptions as well as to mitigate any potential transfer pricing audits or disputes. Ultimately the purpose of the APA is to provide certainty for both the government and taxpayers.

Because of the increase in cross border transactions, transfer pricing is a priority for most taxpayers, the key benefit for a taxpayer is gaining certainty over its transfer pricing arrangements, which can be achieved by a country which has an APA programme in place.

Most transfer pricing audits leads to the utilisation of a taxpayer's key internal resources and inevitably decrease in profitability of that taxpayer should the tax authority make any necessary transfer pricing adjustments. A country which has aggressive transfer pricing audits conducted by the tax authority but has no possible mechanism to alleviate this issue of being selected for a transfer pricing audit could possibly be a key consideration that MNE should take into account when exploring to invest in a particular country. Having an APA programme in place could possibly promote investment into the country which could be beneficial to the economy of that particular country.

Taxpayers are taking the initiative and seeking APAs to reduce the risks of transfer pricing audits and double taxation, and to achieve certainty of tax treatment going forward as well as gaining certainty on roll-back periods.

Countries like the UK and India that have implemented an APA programme received positive responses from taxpayers. This in turns promotes investment into a country and avoids long-drawn disputes with tax authorities. The bilateral/multilateral APAs also provides much certainty to taxpayers who have global operations.

Once implemented an APA programme can only be successful if the relevant tax authorities has a keen interest in the programme and are able to sustain such a programme. For developing countries the success of the programme lies in the capacity and skills of the staff at the tax authority as well as leveraging off past experiences of an APA programme in a more developed country such as the UK.

Through this research it can be concluded that the incorporation of an APA programme, as well implementation of an APA programme into South African law is not impossible. At this stage it is uncertain as to why the APA programme has not been considered. However, taking into account the number of MNEs that are currently situated in South Africa it would seem that SARS foresees a number of APA applications and will not have the capacity to support and sustain the programme.

### **6.3. RECOMMENDATIONS FOR FUTURE RESEARCH**

At the time of concluding this research Morocco has not yet successfully concluded an APA with a taxpayer. Future research should be considered from an African context by exploring the advantages and disadvantages of the APA programme in Morocco. In addition further research to be performed on whether the success of the APA programme promoted investment of MNEs interest into Morocco.

Further research should be conducted on whether a taxpayer can compel the Competent Authority to institute a MAP APA case based on Article 9 (2) subject to Article 25 of the relevant treaty, where there is a possibility of double taxation by an MNE between two/multiple tax authorities? This research involves giving due consideration to public law in South Africa as well as public international law which falls outside the scope of this research.



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