

THE EXPECTATION GAP IN TRANSFER PRICING POLICY DOCUMENTATION IN SOUTH AFRICA

Mini dissertation by

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ABSTRACT

THE EXPECTATION GAP IN TRANSFER PRICING POLICY DOCUMENTATION IN SOUTH AFRICA

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Pricing for inter company trade is currently amongst the thorniest corporate problems and has been for a few decades. Tax authorities find it extremely difficult to tax these transactions as their inherent nature and substance are more often than not properly documented and they therefore need to rely solely on the companies to ensure that these transactions have been taxed correctly.

In South Africa disclosure requirements in terms of Practice Note 7 for companies relating to transfer pricing have been issued by the South African Revenue Services (SARS). Companies who are non-compliant with these requirements could face criminal charges. There is however, as will be seen from this study a lack of clear guidance as to the requirements from SARS pertaining to what information should be included in a transfer pricing policy document.

This study was aimed at investigating the shortcomings of transfer pricing policy documents in South Africa compared to international standards with a view to make recommendations for improvements.

Data for the study was collected by doing a literature study and interviewing transfer pricing specialists in the big four accounting firms and one specialist from SARS to obtain their views on the shortcomings and recommendations to improve transfer pricing policy documents.

Keywords: Transfer Pricing; Arm's Length Transactions; related party transactions

OPSOMMING

DIE VERWAGTINGSGAPING IN OORDRAGSPRYSBELEIDSDOKUMENTASIE IN SUID-AFRIKA

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Oordragprys vir inter-maatskappy handel is tans een van die netelige korporatiewe uitdagings en was dit ook vir die afgelope paar dekades. Belastingowerhede vind dit moeilik om die korrekte belastings te hef op die transaksies omdat hulle staatmaak op maatskappe om hierdie transaksies goed te dokumenteer.

Bekendmakingsvereistes is uiteengesit in Praktyk Nota 7 soos uitgegee deur die Suid-Afrikaanse Inkomstediens. Maatskappe wat nie voldoen aan hierdie vereistes staan vervolging in die gesig. Die vereistes vir oordragprysbeleidsdokumentasie is nie baie duidelik uiteengesit nie.

Die doelwit van hierdie studie was om tekortkominge van oordragprysbeleidsdokumentasie in Suid Afrika te ondersoek ten einde om voorstelle vir moontlike verbeteringe te maak.

Data vir die studie was verkry deur 'n literatuurstudie en onderhoude wat gevoer is met oordragprys spesialiste van die groot vier rekenmeestersfirmas en een spesialis van die Suid-Afrikaanse Inkomstediens om hulle standpunte en voorstelle om oordragprysbeleidsdokumente te verbeter, aan te hoor.

Sleutelwoorde: Oordragpryse, Arm lengte transaksies; verwante partye transaksies

TABLE OF CONTENTS

CHAPTER 1: INTRODUCTION AND PROBLEM STATEMENT	1
1.1 INTRODUCTION.....	1
1.2 RESEARCH PROBLEM.....	3
1.3 RESEARCH OBJECTIVES	4
1.4 DELIMITATIONS OF THE STUDY.....	5
CHAPTER 2: TRANSFER PRICING: HISTORICAL BACKGROUND, OVERVIEW AND SOUTH AFRICAN APPROACH	7
2.1 INTRODUCTION.....	7
2.2 TRANSFER PRICING: HISTORICAL BACKGROUND	7
2.3 TRANSFER PRICING.....	10
2.3.1 The arm’s length principle	13
2.3.2 Traditional transaction methods	16
2.3.3 Transactional profit methods	20
2.3.4 The non-arm’s length approach: global formulary apportionment	21
2.3.5 Considerations when selecting a method.....	21
2.4 TRANSFER PRICING: A GLOBAL OVERVIEW	22
2.4.1 OECD transfer pricing document requirements.....	22
2.4.2 Transfer pricing document requirements in Australia	23
2.4.3 Transfer pricing document requirements in Germany	25
2.5 TRANSFER PRICING IN SOUTH AFRICA.....	27
2.6 THE FOUR STEP APPROACH ADOPTED BY SARS.....	28
2.6.1 Understanding of cross-border transactions.....	28
2.6.2 Selection and application of the pricing methods	29
2.6.3 Processes introduced to support the chosen method.....	30
2.7 TRANSFER PRICING DOCUMENT REQUIREMENTS OF SARS.....	31
2.8 WEAKNESSES IN THE SOUTH AFRICAN TRANSFER PRICING POLICY REGULATIONS	32
2.9 CONCLUSION	33
CHAPTER 3: FINDINGS OF THE INTERVIEWS.....	34
3.1 INTRODUCTION.....	34
3.2 RESEARCH AND INTERVIEW QUESTIONS.....	34
3.3 RELIABILITY AND VALIDITY OF THE RESEARCH.....	35
3.4 DATA ANALYSIS	36
3.5 EXPERIENCE, EDUCATIONAL QUALIFICATIONS AND SPECIALIST TRAINING OF RESPONDENTS	37
3.5.1 Years of experience in transfer pricing.....	37



3.5.1 Highest educational qualifications	38
3.5.2 Specialist training in transfer pricing.....	38
3.6 SHORTCOMINGS ON TPPDs.....	38
3.7 RECOMMENDATIONS FOR IMPROVEMENTS TO TRANSFER PRICING POLICY DOCUMENTS.....	39
3.8 PROVING THAT DOCUMENTS ARE CONTEMPORANEOUS.....	40
3.9 SHOULD TRANSFER PRICING POLICY DOCUMENTS BE MADE STATUTORY?.....	40
3.10 CONCLUSIONS.....	42
CHAPTER 4: CONCLUSION AND RECOMMENDATION	44
4.1 INTRODUCTION.....	44
4.2 RESEARCH	44
4.3 RECOMMENDATION	45
LIST OF REFERENCES	46
APPENDIX: INTERVIEW NOTES.....	49

LIST OF FIGURES

Figure 1: Research problem statement, questions and objectives	5
Figure 2: Relationship between the environmental changes and major issues of intra-firm trade and transfer pricing (<i>Source: Tang; 2002:6</i>).....	11
Figure 3: Parental services (<i>Source: SARS, 2009</i>).....	12
Figure 4: Centralised services (<i>Source: SARS, 2009</i>).....	13
Figure 5: Cost sharing arrangements (<i>Source: SARS, 2009</i>).....	13
Figure 7: Interaction of the four steps (<i>Source: TR98/11, page 16</i>).....	24
Figure 8: Responses regarding whether transfer pricing policy documents should be made statutory.....	41

LIST OF TABLES

Table 1: Research questions and interview questions.....	34
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LIST OF ACRONYMS/DEFINITIONS/ABBREVIATIONS

AO	Abgabenordnung
APA	Advanced pricing agreements
APT	Asset protection trust
ATC	Australian tax code
ATO	Australian Tax Office
CEO	Chief executive officer
CFC	Controlled foreign corporation (US version) or company (South African version)
CFA	Committee on Fiscal Affairs
CFO	Chief financial officer
CUP	Comparable uncontrolled price method
CFC	Controlled foreign corporation (US version) or company (South African version)
DTA	Double tax agreements
EIA's	OECD Standards or Exchange of information agreements
FIF	Foreign investment fund
GFC	General Fiscal Code
IMF	International monetary fund
IT14	Income tax return for companies
MNE	Multinational enterprise
OECD	Organisation for Economic Co-operation and Development
OFC	Offshore finance centre
PS	Profit split method
RP	Resale price method
SAICA	South African Institute of Chartered Accountants
SARB	South African Reserve Bank
SARS	South African Revenue Service
SPV	Special purpose vehicle
STC	Secondary tax on companies
The Model Agreement	Agreement on exchange of information on tax matters by the OECD
TPPD	Transfer pricing policy document
TNC	Transnational corporation
TNMM	Transactional net margin method
VAT	Value-added tax
WTO	World trade organisation

CHAPTER 1 INTRODUCTION AND PROBLEM STATEMENT

1.1 INTRODUCTION

The price charged for goods and services by a subsidiary of a transnational corporation (TNC) in one country to another subsidiary in another country is called the transfer price. Transactions within transnational corporations (TNCs) can range from raw material, finished products, management services, to interest on loans etc. The international consensus on transfer pricing is that cross border transactions between associated parties should be conducted on an arm's length basis (Owens 2009:1).

From a global point of view it makes sense that in order to maximise profits for the various companies in the same group, certain services will be carried out by specific companies within the group as that is where the expertise lies. This creates more complex issues as many stakeholders are involved and because of the conflicting interest, transfer pricing is bound to be controversial and confrontational (Tang, 2002: 3).

Brem and Tucha (2005:1) states that Multinational Enterprises (MNEs) have significantly changed the way in which they are doing business as from "a parent runs any distant foreign sourcing or distribution subsidiaries into a more global organisation operating multi-cultural, multinational business lines and value chains". The business line with its products and services generated throughput in a value chain is now the predominant structural element of a large business organisation.

Fierce competition and the fact that companies are expanding globally is making companies increasingly sensitive to costs, including an increase in costs to regulate tax (Neil, 2007:1). Offshore financial centres (OFCs) or tax havens are used to minimise tax liabilities and is used typically in four ways, namely:

- physically moving the business to a tax haven and then attributing as much as profit to the tax haven as possible;

- setting up a company in a tax haven to tap into its favourable tax treaty network (treaty shopping);
- setting up business in OFC's that are tax neutral to avoid extra layers of tax rather than tax bills (treaty shopping); and
- shifting profits from high tax to low tax jurisdictions by transferring a company's financial risk (and potential) profits to an OFC. This can also be achieved by exploiting ambiguities of transfer pricing rules which govern how MNE's divide their profits amongst the countries they operate in. This strategy is a nightmare to regulating authorities.

Pricing of inter company trade is currently amongst the thorniest corporate tax problems and has been for a few decades. According to Olivier and Honiball (2005:399), the regulation of transfer pricing between connected parties is one of many anti-avoidance measures revenue authorities are making use of internationally. Regulating authorities find it extremely difficult to tax transfer pricing transactions as their inherent nature and substance are more often than not properly documented and they therefore rely solely on the companies to ensure that these transactions have been taxed correctly. Developing economies are facing the challenge of protecting their tax base while not hampering foreign investment and cross-border trade and are aware of the importance of establishing a robust legislative and administrative framework to deal with transfer pricing issues (Owens, 2009:3). Many countries have implemented new transfer pricing regulations to prevent potential transfer pricing abuse by multinational companies and have proposed other regulations to provide guidelines for taxpayers and enhance tax compliance. The common problems faced by tax authorities are (Tang, 2002:7):

- the inconsistency with current disclosures;
- lack of disclosure;
- insufficient record keeping of transactions with related persons (having a transfer pricing policy document (TPPD) forms part of record keeping); and
- international transactions are challenged by tax avoidance and tax abuse.

In the past the strict exchange control regulations provided protection against transferring profits from South Africa to lower tax jurisdictions by manipulating transfer prices. Changes made in the exchange control regulations made it easier for South African residents to invest offshore resulting in South Africa having less control over outflow of funds in the country. The legislature took the decision to use the tax system to control outflows of funds in South Africa hence the introduction of section 31 of the Income Tax Act, 58 of 1962. This is an anti-avoidance section specifically dealing with transfer pricing and thin capitalisation.

1.2 RESEARCH PROBLEM

In South Africa disclosure requirements for companies are contained in Practice Note 7, which has been issued by SARS. Because of the complex nature of transfer pricing, the involvement of (very often) multiple international transactions and methodologies and the fact that it can be time consuming and expensive to prepare TPPDs, Practice Note 7 indicates that taxpayers are not expected to go to such lengths as to prepare TPPDs. However, companies who are non-compliant with these requirements could face criminal charges if they do not submit documentation with their IT14, i.e. the tax return issued by SARS to companies and closed corporations (Honiball, 2005:22-23).

The requirement for submission of a TPPD was for the first time mentioned in the 2002 Income Tax Brochure: Information Brochure (IT14B), which stated that companies was required to “furnish” its transfer pricing policy if it had any international transactions with a connected person (Honiball, 2005: 22-23). The 2002 IT14B did however not refer to the information brochure when stipulating what supporting schedules were required to be submitted. Taxpayers were therefore unsure as to whether there was a requirement to submit transfer pricing policy documents with the 2002 IT14 form. The situation was clarified in 2004 on the IT 14 itself, where Part I 5 requires companies to furnish information stipulated in the accompanying brochures. Therefore, companies were required to submit a TPPD. SARS information on Income Tax does not describe what a policy document is, however SARS Practice Note 7 only mentions the TPPD once.

Olivier and Honiball (2005:420) is of the opinion that it is obligatory to prepare and submit a TPPD. The view of the researcher, based on what is mentioned above and in terms of Practice Note 7, taxpayers are not obliged to prepare a TPPD but that SARS recommends that they do prepare a TPPD. Having a TPPD provides insight to the business and the transactions and it enables the taxpayer to ascertain whether its cross border transactions conforms to the requirements of the Income Tax Act. In the absence of explicit statutory requirements to prepare transfer pricing documentation, it is in the taxpayer's best interest to keep adequate documentation to demonstrate to SARS that their transfer prices are consistent with the arms' length principle. This will minimise the risk of SARS adjusting the transfer prices if a tax audit is conducted.

SARS officials are forced to rely on less evidence if taxpayers have not maintained proper records to verify that they are in compliance with the arm's length principle. This leaves the taxpayer at risk as the Commissioner may substitute an alternative arm's length price for the one adopted by the taxpayer. The taxpayer would be in an unfortunate position due to the lack of documentation and it will be difficult for them to rebut the substitution to the Commissioner of SARS. With proper documentation the taxpayer can demonstrate to SARS that they have developed a sound transfer pricing policy and that the transfer prices are in accordance with the arm's length principle.

1.3 RESEARCH OBJECTIVES

The research questions objectives and propositions in terms of the problem statement are summarised in Figure 1 below.

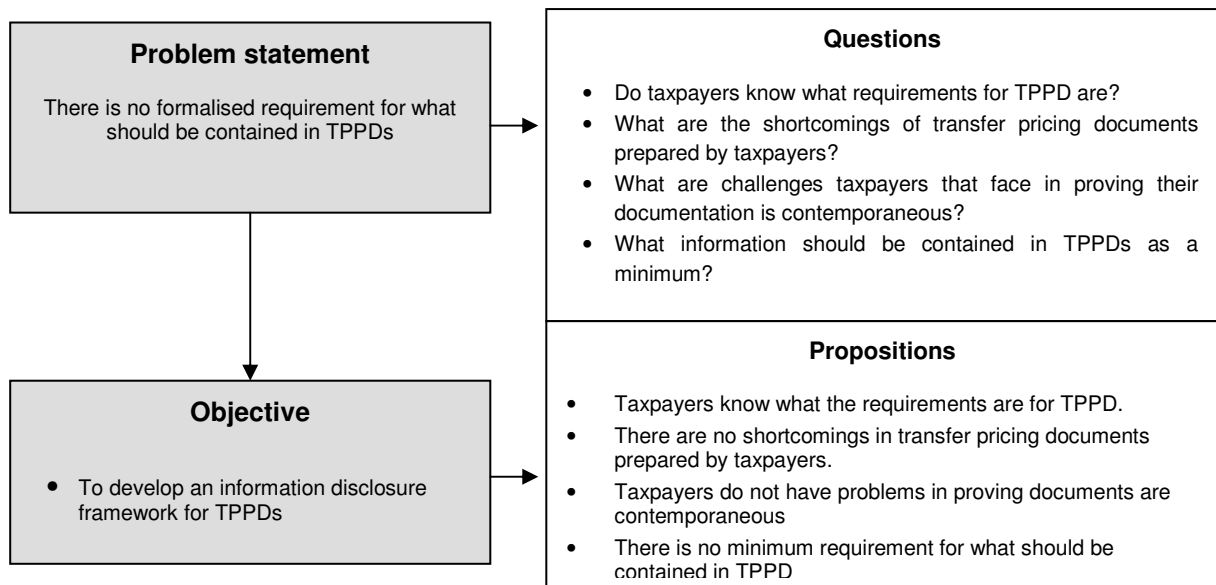


Figure 1: Research problem statement, questions and objectives

The main purpose of this research is to investigate what transfer pricing specialists who prepare documents for tax payers as well as transfer pricing experts employed by SARS think should be recorded in a TPPD and to make recommendations that can be useful to SARS when finally drafting legislation around this issue.

The following objectives will be addressed when conducting the proposed study:

- determining what the shortcomings are of TPPD's;
- identifying the risks for both SARS and the taxpayer associated to issues not currently being addressed in TPPD; and
- determining to what extent and detail information should be recorded in a TPPD.

1.4 DELIMITATIONS OF THE STUDY

There will be no consultations with taxpayers but only with specialists from accounting firms. This study will not attempt to dictate legislation for policy but recommendations will be made that can be used as input into a policy document to be used by SARS.

Transfer pricing is a difficult and technical issue and interviews will be held with one transfer pricing specialist in SARS and with specialists from the big four accounting firms that deal specifically with transfer pricing.

1.5 SUMMARY

The research problem, objectives and questions are defined in this chapter. In addition, the delimitations of the study and research design are outlined in this chapter

The next chapter discusses transfer pricing and focuses on the different methods used to determine transfer prices. It also discusses the transfer pricing documentation requirements outlined in the OECD guidelines and requirements for Australia and Germany and transfer pricing with specific reference to documentation requirement by SARS.

Chapter 3 contains the findings of the interviews held with respondents from the target population and the findings of the interviews.

The next, final, chapter provides a summary of the findings, the research outcome and the recommendation.

CHAPTER 2

TRANSFER PRICING: HISTORICAL BACKGROUND, OVERVIEW AND SOUTH AFRICAN APPROACH

2.1 INTRODUCTION

This chapter is to provide the reader with an overview on transfer pricing, a discussion on the different methods used to determine and a look at the transfer pricing documentation requirements as per the OECD guidelines, in Australia, Germany and South Africa.

2.2 TRANSFER PRICING: HISTORICAL BACKGROUND

In the early 1920s and 1930s, the arm's length principle was included in tax treaties concluded by France, the United Kingdom (UK) and the United States (US). The arm's length principle was first formulated in article 6 of the League of Nations draft Convention on the Allocation of Profits and Property of International Enterprises in 1936 (UN Secretariat, 2001:6). This article is very similar to article 9 of the Organisation for Economic Co-operation and Development (OECD) 1963 Draft Convention (UN Secretariat, 2001:6).

Administrative guidance on the application of legal provisions relating to transfer pricing was scarcely available prior to 1979 (UN Secretariat, 2001:7). Elaborate regulations for specific types of inter-company transactions were issued by the US in 1968. Discussions in the OECD on transfer pricing during the seventies were greatly influenced by these regulations. Members of the OECD considered it necessary to produce guidelines for their respective tax administrations on how to deal with transfer pricing due to the increase in the number of MNEs and the increase on cross-border transactions.

A report titled "Transfer Pricing and Multinational Enterprises" was issued by the OECD in 1979, setting out the problems and the considerations to be taken into account and to describe which methods and practices were acceptable for tax purposes in determining transfer prices. This report contains the following considerations and principles (OECD, 2001:7):

- the arm's length principle is an appropriate approach in arriving at profits of related entities for tax purposes;
- the consideration of transfer pricing problems should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be for such purposes;
- the dual purpose of the report is to enable interests of the national tax authorities to be protected and to enable double taxation of the enterprises involved to be prevented;
- the ideal method is the comparable uncontrolled price (CUP);
- if no useful evidence is available, cost plus, or resale are acceptable from an arm's length point of view;
- other methods like the profit split method (PSM) and the transactional net margin method (TNMM) are not excluded, but with respect to these other methods, the report was vague and negative;
- global methods and formulary methods for allocating profits to affiliates are not endorsed; as they were regarded as incompatible with Articles 7 and 9 of the Model; arbitrary, disregarded market conditions, ignored the management's own allocation of resources, do not bear a sound relationship to the economic facts and carried the risk of double taxation;
- it is always useful to begin with a functional analysis (actual functions, responsibilities and risks);
- the approach of the report was to recognise the actual transaction, not to substitute another transaction for it; (if required) the price or the actual transaction should be adjusted to an arm's length price; and
- transfer pricing policies of MNEs may in fact be market-oriented and, where the different entities within such groupings have their own profit responsibility, they may be free to contract either with an associated enterprise or with a third party with the result that there is a degree of bargaining with the group which produces a price effectively indistinguishable from the arm's length price.

The 1979 report were of such importance that it has been included in a recommendation of the OECD Council of Ministers to the Governments of the Member Countries. Tax administrations had to take the considerations and methods set out in the report into account. The report had no legal force but the fact that all Ministries of Finance of the OECD Member States have adopted the 1979 Report without reservations, gave it a high level of authority (UN Secretariat, 2001:9)

A second report titled “Three Taxation Issues” that elaborated on the issues raised in 1979 report was published by the OECD in 1984 addressing three issues (UN Secretariat, 2001:8):

- transfer pricing in the banking sector;
- the allocation of central costs; and
- mutual agreement procedure.

The need to reflect international developments in international trade, e.g. global trading, technological development etc resulted in a Task Force Working Party No 6 of the Committee on Fiscal Affairs to start work in 1992 on an update and consolidation of the 1979 and 1984 reports on transfer pricing. Bridging differences between the US and other OECD countries since the publication of the US White Paper in 1988 was another issue that needed to be addressed (UN Secretariat, 2001:3). In 1995, the updated guidelines were released in the form of a report titled “Transfer Pricing Guidelines for Tax Administrations and Multinational Enterprises” by the OECD (Owens, 2001:2). The report comprised of five chapters (Chapters I to V) and covered:

- Chapter I: The arm’s length principle;
- Chapter II: Traditional methods;
- Chapter III: Other methods;
- Chapter IV: Administrative approaches; and
- Chapter V: Documentation.

More guidelines were released in March 1996 covering Intangible Property (Chapter VI) and Services (Chapter VII) and another chapter on Contribution Methods (Chapter VIII) was published in October 1997. The guidelines were updated since then and the last update was done in 2009 to reflect the latest developments in the area of dispute resolution, including the introduction of mandatory arbitration to the OECD Model Tax Convention (Owens, 2009:2).

2.3 TRANSFER PRICING

Since the prices are controlled within the organisation, the typical external market mechanisms that are used to establish prices for such transactions between third parties may not be applicable. According to the UN Secretariat (2001:3) about half of the multinationals in the world transfer goods and services internally valued on a cost based system. Should an open market for the products and services transferred internally exist, the best solution from a business economics point of view is to use the market price as a transfer price. The market price may be the price charged by the group entity to its external (non-related) customers or it can be derived from published price lists for similar products and services. By charging prices for goods and services transferred within a group, managers of group entities are able to make quick and adequate decisions as to whether to buy or sell goods and services in or outside the group. The transfer price chosen will affect the allocation of the total profit amongst the segments of the organisation. This was and still is one of the major concerns for tax authorities that MNE may set transfer prices on cross-border transactions to reduce taxable profits in their jurisdiction (UN Secretariat, 2001:4).

Tang (2002:2) refers to four interdependent dimensions of environmental changes that could be attributable to inter company trade and transfer pricing:

- legal and taxation issues are significantly influenced;
- economic and international business issues;
- issues relating to technology; and
- issues relating to management and the organisation.

The management of corporate transfer pricing systems as well as the volume and direction of inter company transactions are significantly influenced by the environmental changes and the four dimensions as depicted Figure 2 below.

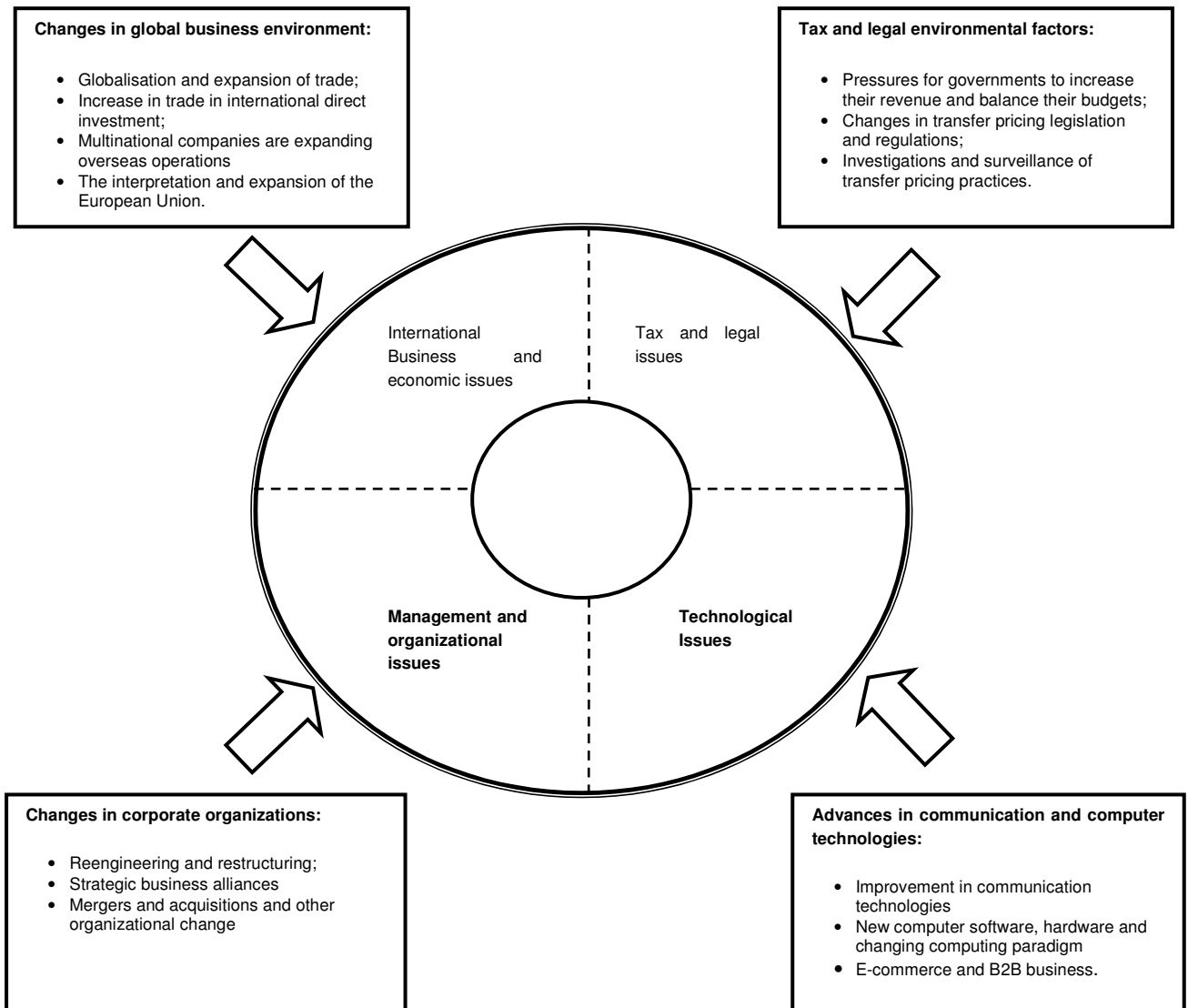


Figure 2: Relationship between the environmental changes and major issues of intra-firm trade and transfer pricing (Source: Tang; 2002:6).

Changes in the global business environment and expansion in international trade may lead to expansion of overseas operations and an increase in international direct investments (Tang, 2002:5). Increase in international trade may require more mergers and acquisitions which might lead to restructuring or other organizational changes. This may necessitate an overhaul of the corporate transfer pricing system.

Advances in communication and computer technology should facilitate the globalisation process. This will lead to expansion of e-commerce, trade and international transactions. This create new challenges for tax authorities as they need to keep abreast with advanced technology and changes to facilitate more effective and efficient tax audits on transfer pricing. (Tang, 2002:19)

There are three typical arrangements between group companies; parental service arrangements, centralised service arrangements and cost sharing also known as cost contribution arrangements.

Parental services are provided by the parent company and often on a cost recovery basis. Examples of these services are for instance group tax, group finance, human resources, administration, Information technology etc. See Figure 3 below for illustration.

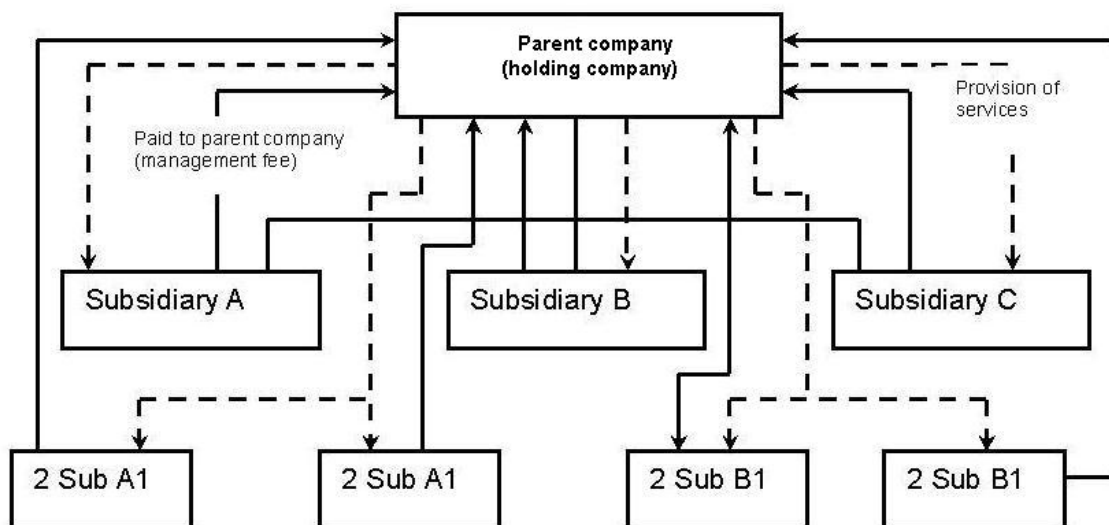


Figure 3: Parental services (Source: SARS, 2009)

Centralised services are provided by a service company in the group usually on a cost plus basis. These services include IT support, technical, finance and treasury services as depicted in Figure 4 below.

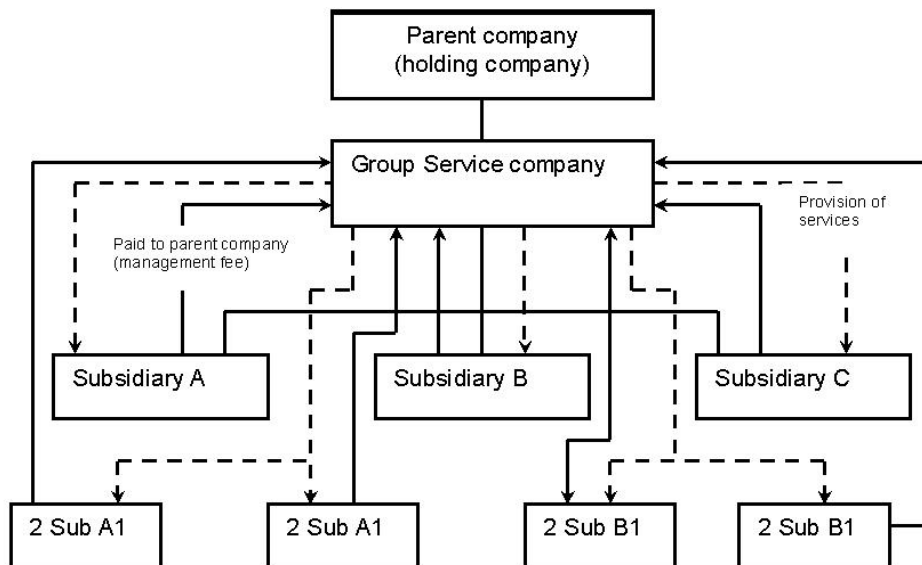


Figure 4: Centralised services (Source: SARS, 2009)

Cost sharing/contribution arrangements are provided by each group member for the benefit of the group as a whole on a cost contribution basis commensurate with benefit. Such services include research and development and procurement.

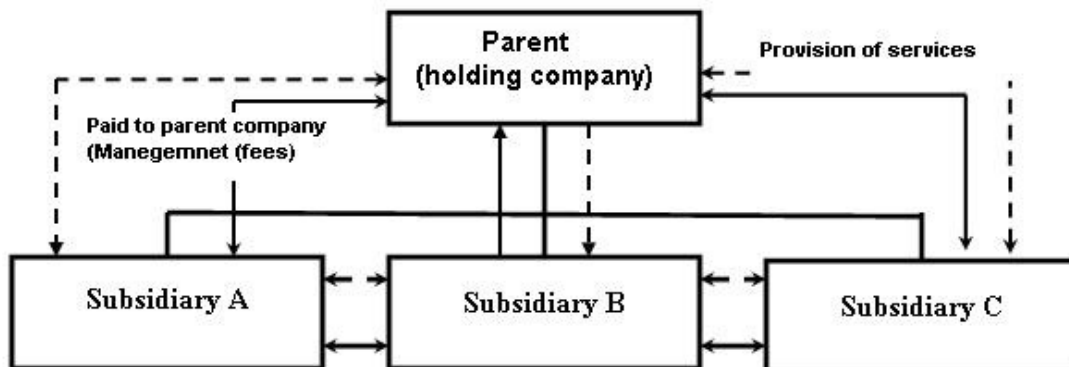


Figure 5: Cost sharing arrangements (Source: SARS, 2009)

2.3.1 The arm's length principle

The international consensus on transfer pricing with which everyone is familiar with is the arm's length principle, according to which the conditions of cross-border

transactions between associated enterprises should not be distorted by the special relationship between related parties (Owens, 2009:1).

Prices determined for transactions between group companies should for tax purposes be derived from prices which would have been applied by non-related parties in similar transactions under similar conditions in the open market. Dealing on an arm's length principle is the internationally accepted standard for transfer pricing transactions. The arm's length principle should not be distorted by the special relationship between the related parties. The arm's length principle has two different origins according to the UN Secretariat (2001:4):

- the first origin is found in continental European countries like Austria, Germany, Luxembourg, Netherlands and others, where the term was used as a basis for adjustment of income of shareholders who received extraordinary benefits from a company instead of declaring dividends. Adjustments were made by deeming such benefits to be dividends and were called constructive dividends;
- the second origin is found in the UK and US. Specific transfer pricing provisions focussing on international transactions were introduced for the first time During World War I in the United Kingdom and the United States. These anti-avoidance provisions were aimed at preventing/deterring companies from shifting profits to associated companies overseas through inflating the pricing of cross-border transactions (UN Secretariat; 2001:5).

The OECD Guidelines (1997:II-2–III-9), article 9 of the Model Tax Conventions outlines the following methods; three of which are transactional based and two profit based that is appropriate for setting and evaluating transfer prices:

- traditional transaction methods:
 - cost plus method (CP or C);
 - resale price method (RPM); and
 - comparable uncontrolled price method (CUP);
- transactional profit methods:
 - profit split method (PSM); and

- transactional net margin method (TNMM).

The OECD Guidelines (1997:II-17) favours the traditional transaction method while the other methods should be used as a last resort, especially where the data used is unreliable or where no data is available. However there is no best method rule in terms of the Guidelines. The method chosen must take into account the facts and circumstances that provides the “most reliable measure” of an arm’s length result (OECD, 1997: II-17).

Factors to be taken into account by tax authorities when applying the arm’s length principle, when faced with transfer prices are:

- comparability analysis - this is a comparison of a controlled transaction with an uncontrolled transaction or transactions. Factors considered when determining the comparability of transactions are a functional analysis, analysis of the contractual terms, an analysis of economic circumstances, an analysis of business strategies and an analysis of the characteristics of property or services;
- recognition of actual transactions undertaken – the key question to answered are whether the transactions were structured in a way that would never have taken place between independent parties;
- evaluation of separate and combined transactions – very often separate transactions are so closely linked or continuous that they cannot be separately evaluated for example contracts for the supply of long term services or rights to use intangible property. The key principle to be followed in considering whether transactions should be evaluated on a combination or package basis is that the revenue authority should treat the transaction between controlled parties in the same way as it would a similar deal between independent enterprises;
- the arm’s length range – is achieved by applying the most appropriate method or methods to achieve a range of prices that are comparable;
- multiple year data – is used to take account the effect of product or business cycles and short term economic conditions. It is useful to have a complete

understanding of the fact and circumstances pertaining to a transaction when considering the year under consideration as well as previous years;

- losses – should be closely monitored, especially in cases where one enterprise in a multinational group is realising losses, but the multinational group is profitable. Prices that result in losses should be compared to what comparable independent parties would accept in similar circumstances. Legitimate reasons for losses are huge start up costs, unfavourable economic conditions, inefficiencies and temporary strategic decisions;
- government policies – should be taken into account because government interventions such as price cuts, controls over payment of royalties affect the market conditions in a country;
- intentional set-offs – occur when one enterprise provides a benefit to another enterprise balanced by a benefit it receives from the other enterprise. These types of arrangements should be assessed in terms of the arm's length principle; and
- customs valuations – may be useful to tax administrations in evaluating the arm's length character of controlled transaction price because officials and tax authorities seek to determine the value of products at the time of import (OECD, 1997:11–127).

2.3.2 Traditional transaction methods

2.3.1.1 Cost plus method (CP)

The cost plus method (CP) is generally used for the trade of finished goods and evaluates the arm's length nature of intra-group prices based on the prices applied in comparable uncontrolled (unrelated) transactions. This method is determined by adding an appropriate mark-up to the cost incurred by the seller in manufacturing/purchasing the goods or services provided. It is then compared with the mark-up used by other companies comparable to the tested party. Costs incurred by the seller takes into account the following according to the UN Secretariat (2001:16):

- complexity of assembly or manufacturing;
- engineering of production and process;
- procurements, purchasing and inventory control;
- cost incurred for testing;
- foreign currency risks;
- administrative, selling and general expenses; and
- warranties, credit terms (contractual terms).

Cost based approaches are not as transparent as they appear since it is easy for a company to manipulate its cost accounts to alter the magnitude of the transfer price. Companies adopting the cost based transfer pricing method have to choose between the following alternatives:

- actual cost approach;
- marginal cost approach;
- standard costing approach; and
- variable costing approach.

Apart from the above, companies also have to decide on the treatment of their fixed costs as well as their research and development costs. For a company that adopts a cost based transfer pricing method; these issues can be problematic. The cost based method leads to challenges for the selling profit centres. Therefore if a company wants to produce efficiently, the transfer price may erode the competitiveness of a final product in the market place (OECD, 199:II-12).

2.3.1.1 Resale price method

The resale price method (RP) is established by working backwards from transactions taking place at the next stage in the supply chain (OECD, 1997: II-5). The RP is the inverse of the CP method. Transactions taking place at the next stage in the supply chain is determined by subtracting a gross mark up from the sale price to an unrelated third party with an appropriate gross margin being determined. This is done by examining the conditions under which the goods or services are sold and

comparing the said transaction to other third party transaction (UN Secretariat, 2001:II-5). Considering an example from the clothing industry, the resale price at arm's length, would be determined by subtracting an appropriate gross margin from the selling price at which the distributor sold the products (received from the manufacturer) to third parties retailers such as department stores, chain stores, boutiques, etc.

Both the CP and RP methods could be applied to the same transaction. Availability of data and comparable transactions determines whether one of the methods can be used.

2.3.2.3 Comparable uncontrolled price method (CUP)

The comparable transaction method (CUP) compares the price charged for goods or services (this includes property) in a transaction that is controlled, to the price agreed in a comparable transaction between unrelated enterprises in comparable circumstances (UN Secretariat, 2001:23). Transactions fall into two categories, namely external comparable and internal comparables. The taxpayer is required to find independent parties to perform the same type of transaction when using the CUP method. The following must be present (OECD, 1997:II-3):

- same terms;
- same type of goods;
- same services or technology; and
- an independent party with which the MNE deals with on similar terms as it does with its associated enterprise.

Example of the application of the CUP method

A company in the Far East manufactures ceramic products and ships it to related and unrelated parties in Europe. General conditions and terms of sale are the same for both related and unrelated parties are the same, except for the payment terms. Related parties have payment terms of 120 days whilst unrelated parties have

payment terms of 60 days. Based on the information, the unrelated party sales represent a comparable uncontrolled price for inter-company transfer pricing. Difference in payment terms must be taken into account, before the actual arm's length inter company price can be determined (PWC, 2004:22).

An uncontrollable transaction is therefore comparable to a controlled transaction for purposes of the CUP method if one of the following 2 conditions is met:

- none of the differences (if any) between the enterprises undertaking those transactions could materially affect the price in the open market; or
- reasonably accurate adjustments can be made to eliminate the material effects of such differences.

Comparability between controlled and uncontrolled transactions exists when there are very little or no differences between these transactions. Where there are minor differences, these differences do not have a material effect for which reasonable adjustments can be made (OECD, 1997:II-3). In easy terms; the CUP method determines the price through comparing the selling price charged to a related party with the selling price charged between two unrelated parties for the same product.

The method is often very difficult to apply as it is unusual for multinationals to have details on appropriate comparable transactions (PWC, 2004:20). The OECD (1997:II-3) suggests that MNEs and tax authorities take a more adaptable approach to use the method.

The main situations in which the CUP method cannot be applied (Onsando, 2007:27) are when:

- components or parts or semi-finished parts used within a group are not available in the open market;
- related parties within a MNE renders to each other a wide range of back-up and technical support as opposed to independent companies; and

- production arrangements within a specific multinational group are not replicated by independent companies that are not part of the MNE group.

2.3.3 Transactional profit methods

The arm's length price can be determined by non-traditional methods of which the two most common are the profit split method (PS) and the other the transactional net margin method (TNMM) (OECD, 1997:III-1).

2.3.3.1 Profit split method

The profit split method (PS) is used for interrelated transactions where the enterprises involved in the transaction are too integrated to allow for a separate evaluation (OECD, 1997:III-3).

Transfer pricing is established by dividing the profits of a multinational enterprise in a way that would be expected of independent enterprises in a joint venture (PWC, 2004). Expected profits, rather than actual profits are used in order to avoid hindsight. Calculating the profits requires the knowledge of how the profit split between unrelated parties based on the same facts and circumstances as in the related party situation.

The OECD Guidelines (1997:III-5) outlines two alternative approaches to the profit split, namely the residual split approach and the contribution analysis approach. These approaches are noted to be not necessarily exhaustive or mutually exclusive in paragraph 3.15 of the OECD Guidelines (1997:III-5).

2.3.3.2 Transactional net margin method (TNMM)

The transactional net margin method (TNMM) looks at the net profit margin relative to an appropriate base (for example costs, sales, assets) that a taxpayer makes from a controlled transaction (PWC, 2004:27).

The net margin of this method should be established by reference to the net margin that the same entity earns in comparable transactions with un-related entities. The net margin of an independent entity can be the starting point where this is not possible. To determine the degree of comparability, a functional analysis of both the related entity and the un-related entity is required (UN Secretariat, 2001:25).

Factors that have a direct or indirect effect on the gross margin/price can influence the net margin resulting in a weakness in this method. For example, different products that require different sales efforts per unit sold might be sold by two distributors. This may lead to very different gross margins. The operating margin reflects a competitive return and would therefore not be expected to be materially different. Since the level of interest is a function of how a company decides to finance its operations and unrelated to the transfer pricing, the margin is measured pre-interest (OECD, 1997:III-2).

2.3.4 The non-arm's length approach: global formulary apportionment

Paragraphs 3.61 to 2.74 in the OECD Guidelines discuss the global formulary apportionment approach. This method allocates profits of a multinational group on a consolidated basis among associated enterprises (PWC, 2004:29).

2.3.5 Considerations when selecting a method

According to the UN Secretariat (2001:22) the following should be considered when selecting a transfer method:

- no ONE method is suitable in every possible situation/transaction ;
- it is not possible to provide specific rules that will cover each and every case;
- application of more than one method is NOT required;
- to make it obligatory for taxpayers to perform analysis under more than one method would create a significant burden on them;
- any method which is agreeable to the tax administrations in the jurisdictions of all those countries and the members of the multinational group can be accepted;

- in understanding the transaction under review evidence from other group enterprises engaged in controlled transactions may be useful; and
- no more minor adjustments should be made by the tax administration.

2.4 TRANSFER PRICING: A GLOBAL OVERVIEW

Transfer pricing has become a major issue for MNEs and tax administrations that monitor them. Companies are now under, more pressure due to heightened scrutiny and documentation requirements (Williams, 2009:1). Key findings of the KPMG report titled "Global Transfer Pricing Review" (KPMG, 2009: 1-17) were as follows:

- transfer pricing audit activity is increasing globally as governments expand their experience in analysing transactions and look for new sources of tax;
- tax authorities have been most active in Asia-Pacific, but there has also increased focus on transfer pricing in Eastern Europe and Africa; and
- governments in the Americas have taken divergent approach. Canadian authorities appear to favour "taxation by negotiation" while the US and some Latin American jurisdictions appear to prefer advance pricing agreements.

2.4.1 OECD transfer pricing document requirements

Chapter 5 of the OECD Guidelines (1997:V-1 – V-9) provides guidance to taxpayers as to which documentation would be useful in showing the arms length principle relating to their controlled transactions. These principles are:

- there is no obligation at the time of determining prices or filing the tax return to produce contemporaneous documentation;
- it is not the intention of the guidelines to impose an even greater burden of proof on the taxpayer than imposed by domestic rules;
- the calculation and determination of transfer prices should be based upon information reasonable available at the time of determination;
- business management principles should be prudent covering the preparation or collection of documentation;
- taxpayers discretion is used when storing documentation;

- the amount of documentation should be limited by tax administrators at the stage of filing the return;
- trade secrets should not be disclosed publically except when obliged by the courts;
- essential information relating to foreign associated enterprises might be difficult to obtain by the minority shareholder or subsidiaries; and
- taxpayers should not be required to provide documentation that are not in their possession and cannot be obtain through normal enquiry.

The following categories of information are given and a minimal compliance requirement:

- structure of the organisation;
- shareholdings and linkages within the MNE;
- financial history for the last few years;
- extent of transaction with associated enterprises;
- data on similar transaction with competitors and unrelated parties;
- any changes in trading conditions;
- changes in the conditions they trade in;
- strategy of management; and
- cost reports on manufacturing, distributing, research and development, marketing and general administrative expenses.

2.4.2 Transfer pricing document requirements in Australia

The Australian Tax Office (ATO) expects taxpayers to create and keep contemporaneous documentation on their transfer prices adopted in accordance with the arms length principle. Taxpayers are required to complete schedule 25A in accordance with Regulation 15 of the Income Tax Regulations and state whether they have international related party transactions greater than AUD1million (Price Waterhouse Coopers, 2004:173. They also have to declare whether contemporaneous documentation exists for these transactions. Tax Ruling 98/11

(Australian Tax Office, 2005:16) recommends the four step process when setting or reviewing transfer prices for cross boarder transaction. Figure 6 below depicts the interaction of the four steps.

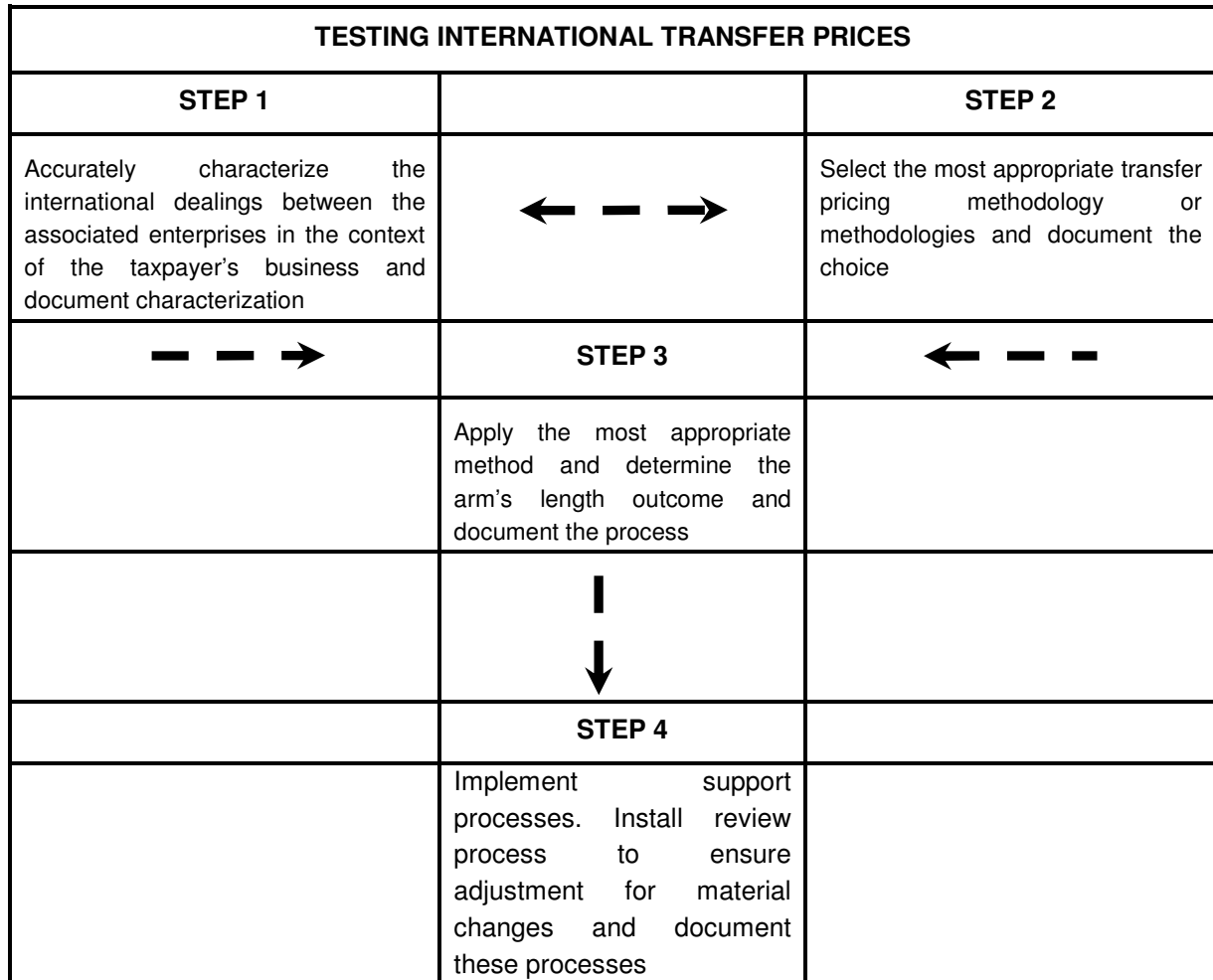


Figure 6: Interaction of the four steps (Source: TR98/11, page 16)

The above approach assumes that the international dealings are fairly extensive and require a thorough analysis. The data collection and analysis referred to in the above diagram are neither mandatory nor prescriptive and need to be tailored to the facts of the case. A much simpler approach has been developed by the ATO to review the transfer pricing process for small to medium business, aiming to minimize costs for these businesses. This approach applies to business:

- with annual turnover of less than AUD 100million unless they form part of a
- multinational group listed on any stock exchange; or

- private group with any international subsidiary or other offshore related party that has the resources to deal with global transfer pricing transactions.

Under the simplified approach the ATO expects small businesses to address what is expected in a functional analysis and provide evidence of how they set cross-border pricing and undertake a benchmarking exercise.

2.4.3 Transfer pricing document requirements in Germany

Transfer pricing issues are mostly dealt with as part of routine tax audits, which is a regular event for most companies, and transfer pricing for related parties transactions are established based on the arm's length principle (PWC, 2004:309). Pricing methodologies and competent authority proceedings is undergoing constant changes, in response to international developments Section 1 of the Foreign Tax Code (AStG: 2008) has been revised in 2008 to cover aspects concerning the legal basis for determining intercompany transfer prices (PWC, 2004:309).

No specific preparation deadline is applicable for common transactions, but companies have to submit contemporaneous documentation for extra-ordinary transactions within six months after the end of the fiscal year within which the so-called extraordinary transactions took place. (KPMG, 2009:56). Taxpayers are not obliged to provide transfer pricing documentation when filing returns. The documentation is only required on request from the tax authority during a tax audit involving transfer pricing transactions. The taxpayer then has 60 days to provide the information to the tax authorities and documents must be provided within 30 days in the case of extraordinary transactions, (KPMG, 2009:56).

Germany extended section 90, paragraph 3 General Fiscal Code(GFC) or Abgabenordgun (AO) in 2003 dealing with the taxpayers' duty to cooperate and section 162 of the GTC previously dealing with the estimation of the taxpayers' income (Price Waterhouse Coopers, 2004:310). The taxpayer is, under the new rule, obliged to provide relevant information and document the economic and legal basis for the arms length prices and conditions of its transactions with related parties.

Contemporaneous documentation should be prepared for extraordinary transactions. The new documentation requirements apply to cases in article 9 of the ECD Model Treaty as well as article 7 of the OECD model (income attributable between head office and its branch).

Extraordinary transactions are not defined on the GFC. In terms of section 3 of the decree extraordinary business transactions are considered as:

- concluding of cost –sharing agreements;
- restructuring (asset transfer);
- amendments to long-term contracts (and its conclusion) having a substantial impact on the revenue generated from business with related parties;
- provision or transfer of assets/advantages in connection with a change of risks and activities within the group; and
- a change of the group's business strategy relating to a business transaction (having significant impact on the setting of transfer prices).

In Germany the tax authorities have the right to request for the information to be in German. Due to the volumes of transfer pricing documentation the German tax authority has allowed taxpayers to submit documentation that were prepared in English. As a minimum the documentation to be submitted includes the following:

- transfer pricing analysis;
- shareholding;
- business operations;
- organisational structure;
- functional and risk analysis; and
- business relations with related companies.

Section 5 of the decree-law contains a list of documentation required if taxpayers claim that their transfer prices have been influenced by exceptional circumstances.

Relief from documentation is provided in terms of section 6 of the decree-law for small companies and taxpayers that generate income from business relationships other than profit income. The obligation to prepare contemporaneous documentation does not apply to them either. These taxpayers must provide oral information and any available documentation within 60 days to determine whether its transfer prices are at arm's length.

2.5 TRANSFER PRICING IN SOUTH AFRICA

Before 1995, transfer prices was primarily controlled and managed by South African Reserve Bank (SARB) through exchange controls with the source of income playing the major role in tax determination with section 31 of the Income Tax Act being the applicable legislation. The application of section 31 was limited to the purchase and sale of commodities where one of the related enterprises was a foreign resident in a country where South Africa had concluded a double tax agreement (DTA). This legislation was however found to be inadequate due to the following reasons with the introduction of South Africa into the international market because:

- re-emergence into the international markets resulted in the expansion of international trade with an increase in business for MNE's;
- South Africa was not able to tap into and protect the growing tax base due to multinational transfer pricing schemes;
- non-resident investors manipulated the control restrictions applied for purposes of repatriation of profits and capital earned by foreign investors; and
- section 31 was only applicable to the sale and purchase of commodities where one of the related parties was a foreign enterprise resident in a country which South Africa concluded a DTA.

Section 31 of the Income Tax Act was introduced on 19 July 1995, following the recommendations of the Katz Commission in the report 1995 titled "First and Second Interim Reports of Inquiry into Certain Aspects of the Tax Structures of South Africa"(Onsando, 2007:37). Section 31 of the Income Tax Act refers to the supply

/acquisition of goods and services. The main aim of the revision was to prevent taxpayers from manipulating transfer pricing by transferring profits from South Africa to tax jurisdictions with lower tax rates.

South Africa adopted the OECD guidelines through the reference of section 31 of the Income Tax Act and practice note 7 (SARS, 1999:1-41). The view of practice note 7 is that the following of OECD Guidelines will promote tax equality and reduce the possibility of South Africa contributing to the establishment of a harmful preferential tax regime (SARS, 1999:6).

South Africa also adopted the OECD Guidelines through double taxation agreements (DTAs) it has entered into with other countries. The South African DTAs originated in the terms of the provisions of section 108 of the Income Tax Act, which provides that the government of South Africa may enter in a DTA' with the government of a foreign country.

2.6 THE FOUR STEP APPROACH ADOPTED BY SARS

In Annexure B to practice note 7 (SARS, 1999:39), SARS has adopted a four step approach to transfer pricing:

- *Step 1:* to understand in the context of the business the cross border transactions between related parties;
- *Step 2:* the selection of pricing methods;
- *Step 3:* the application of the chosen methods; and
- *Step 4:* the introduction of processes to support the chosen method and arriving at an arms' length price.

2.6.1 Understanding of cross-border transactions

It is important that the taxpayer should be able to explain the following to SARS:

- the purpose of the international transaction;

- what the impact is on the taxpayers' overall business activities as a result of the intra-firm trading.
- how their transactions are undertaken; and
- what the taxpayer is gaining from its participation in these transactions.

At this stage the taxpayer should develop a preliminary functional analysis explaining the functions performed by the relevant parties to the transactions. This would serve as supporting documentation when a pricing method is selected, according to Practice Note 7 (SARS, 1999:39).

2.6.2 Selection and application of the pricing methods

In terms of Practice Note 7 (SARS, 1999:40), the selection of transfer pricing methods should take into account:

- the relationship between the uncontrolled transactions and the controlled transactions of the taxpayer;
- how reliable these assumptions are;
- how complete and accurate the data is; and
- the sensitivity of the results.

The results of this data should enable the taxpayer to determine which pricing methods are likely to be more consistent and the most reliable measure for the arm's length price.

Once the appropriate pricing methods have been decided upon the functional analysis should be updated to reflect which method is adopted. Functional analysis is a term used to describe the collating of facts about the operations of a business in terms of its activities, risks and intangibles and how these are allocated between the related parties to the transfer pricing transaction. The scope of a full functional analysis requires the gathering of information from various resources such as employees, competitors, industry experts and publications about the industry.

Information from employees can be acquired via onsite interviews, telecom conferences or online questionnaires that require the employees to submit their responses online. As a minimum the interview questions or online questionnaires should be structured in such a way that sufficient information is obtained relating to:

- distribution channels and activities around it;
- marketing activities and potential shortfalls;
- manufacturing activities; and
- after sales service i.e. warranties and guarantees.

In addition organisation charts, existing intercompany pricing policy agreements, statements, licences, cost sharing, research and development and management services should be examined and documented. It is important to note that the research is not limited to the company and its employees only. Determining which entity has the responsibility for a particular function or risk is simply not enough. The importance of each function in the transfer pricing transaction is crucial and should be described and documented in detail by the analyst. Typical business functions are sales and marketing, accounting, research and development, manufacturing, public relations (Price Waterhouse Coopers, 2002:35).

When documenting the business risks associated to the transaction, the analyst should document the extent of these risks and the impact on the related entities. Typical business risks are; market risk, foreign exchange risks, environmental risks, inventory risks, etc (Price Waterhouse Coopers, 2003:36).

When the analysis is finalised it is important to consider the significant differences of the functions and risks to each of the businesses and take these differences into account.

2.6.3 Processes introduced to support the chosen method

The taxpayer need to clearly document and demonstrate how its data has been used in the application of the chosen transfer pricing method. The determination of a

relevant and reliable transfer pricing method will require an element of judgement, hence the need for proper documentation. The taxpayer then still need to implement processes to ensure the availability of data for subsequent reviews and allow for changes in the pricing method to reflect the changes in the market conditions or company policies (SARS, 1999:40- 41).

2.7 TRANSFER PRICING DOCUMENT REQUIREMENTS OF SARS

Transfer pricing is complex and involves multiple international transactions methodologies and comparisons. The burden of preparing documents is further amplified by the fact that the preparation of transfer pricing documents can be time consuming and expensive (Onsando, 2007:69). There is no specific requirement for the production of documents, but the general provisions of the Income Tax Act places a duty on the taxpayer to furnish information when submitting tax returns. With the aforesaid considered, paragraph 10.2.6 of Practice Note 7 (SARS, 1999:23) states:

“..... it will not be expected of the taxpayer to go to such lengths that the compliance costs related to the preparation of the documentation are disproportionate to the nature, scope and complexity of the international agreement entered into by the taxpayer with connected persons.”

Paragraph 10.3 of Practice Note 7 (SARS, 1999:23-24) sets out the factors to be considered by taxpayers when determining the appropriate level of documentation for specific circumstances. This is in line with the documentation guidelines of Chapter V of the OECD guidelines. Based on the provisions of Practice Note 7, Olivier and Honiball (2005:420-421) states the transfer pricing policy documents submitted by taxpayers should include the following:

- identification of the relevant transactions in terms of international agreements with connected parties, and the extent of any other commercial or financial relations with connected parties within the scope of section 31 of the Income Tax Act;

- description of the nature and terms, including prices, of all relevant transactions, including a series of transactions and any other off-setting transactions;
- copies of international agreements entered into with connected parties;
- the method that has been used to arrive at the nature and terms of the relevant transaction;
- an explanation of the process used to select and apply the method used to establish the transfer prices and the reason why it is considered to provide a result that is consistent with the arms' length principle;
- information relied upon in arriving at the arm's length price such as commercial agreements with third parties, financial information, budgets and forecasts; and
- details of any circumstances that may have influenced the prices that have been set.

2.8 WEAKNESSES IN THE SOUTH AFRICAN TRANSFER PRICING POLICY REGULATIONS

Onsando (2007:79) concluded after analysing the approach of the OECD transfer pricing in the South African legal regime that:

- the selection of the midpoint range in the absence of persuasive evidence when determining a transfer price is questionable;
- advice by SARS to convince the commissioner that prices are at arm's length by applying more than one method seems questionable as it deviates from the OECD guidelines; and
- clarity is needed in the area of transfer pricing regulation of intra-group services such as financial assistance with specific reference to intra-group debt.

In terms of the adopted OECD guidelines, the following weaknesses were identified by Onsando (2007:79):

- the arm's length standard does not reflect the economic reality of MNEs;
- the arm's length standard cannot be efficiently applied in some circumstances, for example in transactions that independent parties would not undertake; and

- the application of the arm's length principle in the area where trade is conducted electronically (e-commerce) needs attention.

2.9 CONCLUSION

Transfer pricing is dating back to as far as world war two has become and will be a major issue for MNEs and tax authorities in years to come.

The accepted international norm for determining transfer prices is the arm's length principle, which is based on the premise that the relationship between related parties should not be used to distort transfer prices.

South Africa, whilst not being an OECD member also adopted the OECD in part to promote tax equality and reduce the possibility of South Africa contributing to the establishment of a harmful preferential tax regime.

The next chapter is presenting the findings of the interviews held with transfer pricing specialists regarding the shortcomings of transfer pricing documents and their views on improvements.

CHAPTER 3

FINDINGS OF THE INTERVIEWS

3.1 INTRODUCTION

This chapter presents the findings of the interviews with transfer pricing specialists and the answers to the research questions, based on the findings.

3.2 RESEARCH AND INTERVIEW QUESTIONS

A number of open ended and closed questions were prepared and posed to the respondents. The questions posed to the respondents during the interview as well as the link to the research questions are listed in Table 1 below.

Table 1: Research questions and interview questions

Research questions	Interview questions
<p>Do taxpayers know what requirements for TPPD are?</p> <p>What should be contained in a TPPDs as a minimum?</p>	<ol style="list-style-type: none"> 1. The more complex the document, the bigger the risks for accounting firms. If you worked for SARS, what recommendations would you make in terms of developing TPPD? 2. Does the fact that transfer prices need to be set at arm's length have an effect on the way companies do business with cross border partners?
<p>What are the shortcomings of transfer pricing documents prepared by taxpayers?</p>	<ol style="list-style-type: none"> 1. What are the shortcomings in Transfer Pricing Policy Documents based on documents that you reviewed? 2. In your experience, when reviewing documents prepared locally, have you found that documents prepared was not well prepared and flow of information between the various sections was not well since it was prepared by junior staff, to minimize the costs to the client?
<p>What are challenges taxpayers that face in proving their documentation is contemporaneous?</p>	<ol style="list-style-type: none"> 1. How difficult is it for taxpayers to prove that documentation prepared was contemporaneous, especially a number of years after the transactions under consideration took place?

A number of general questions, not specifically aimed at answering the research questions directly were also posed. These questions were not prepared before the

interviews, but were formulated during the interviews, based on the responses and were as follows:

1. Do South African companies find it difficult to find data to do benchmarking for transfer pricing purposes?
2. Should TPPDs documents be made statutory?
3. Based on your response that it should be made statutory, how will this benefit the taxpayer and SARS?
4. Are you aware of what the documentation or methods of other jurisdictions are in terms of transfer pricing?

3.3 RELIABILITY AND VALIDITY OF THE RESEARCH

Reliability and validity of measures taken in a study is partly reflecting the level of confidence one can have in the results yielded by the research (Page & Meyer, 2003: 84). Reliability, the extent to which data collection techniques or analysis procedures yield consistent findings, can be assessed by posing the following questions:

- will the measures yield the same results on other occasions?;
- will similar observations be reached by other observers?; and
- is there transparency in how sense is made from the raw data?

Leedy and Ormrod (2005:93) suggest that the following measures be taken to enhance reliability of research instruments:

- the instrument should always be administered in a consistent measure, there should be standardization;
- specific criteria should be established that dictates the kinds of judgement the researcher makes; and
- the researcher who uses the measuring instrument should be well trained in order to obtain consistent results.

Validity is concerned with whether the findings of a study are really what they appear to be and is usually discussed in terms of internal and external validity (Page & Meyer, 2005:86). External validity refers to the assumption of generalisability and internal validity refers to the extent to which the measure can be said to reflect changes in responses caused by manipulation of independent variables.

The following steps were taken to ensure reliability and validity of the research:

- the interview questions were checked by an independent expert at SARS and changes made based on the recommendations by the expert;
- all interviews were held in the similar setting; and
- responses from interviewees were recorded on a recording device after which it was documented and sent to interviewees for review.

3.4 DATA ANALYSIS

There is no standard approach to analysing qualitative data (Saunders, Lewis & Thornhill, 2007:478). The nature of qualitative data is sometimes such that a large body of knowledge must be sorted and categorised and boiled down to a small set abstract, underlying themes through inductive reasoning (Leedy & Ormrod, 2005:150). Saunders et al (2007:478) grouped strategies for analysing qualitative data into four main categories:

- understanding the characteristics of language;
- discovering irregularities;
- comprehending the meaning of the text or action; and
- reflection.

The first two strategies are associated with analytic strategies that require greater structure and set procedures to follow in comparison to the second two strategies. Also, some approaches begin deductively whilst other begin inductively. Data collected for this study was analysed using a content analysis approach, which

involves analysing the text with respect to its content, with the factors of interest most often relating to meaning, or how many times particular phrases /terms. The method is extremely useful of analysis for open response questions in interviews appear (Page & Meyer, 2003:129).

3.5 EXPERIENCE, EDUCATIONAL QUALIFICATIONS AND SPECIALIST TRAINING OF RESPONDENTS

The experience, educational qualifications and specialist training of the respondents will now be discussed.

Experience, educational qualifications specialist training of the respondents Demographic information considered to be important for this study was, year of experience in the transfer pricing environment, educational qualification and whether respondents had any specialist training in the area of transfer pricing. The validity of the findings is mainly based on the experience of the respondents. A total of five specialists from different organisations, of which one SARS (the tax authority), were interviewed

Age, gender and race were not deemed to be important as the study did not investigate the influence of race gender or age on the views of the respondents on transfer pricing.

3.5.1 Years of experience in transfer pricing

Years of experience in transfer pricing recorded for the interviewees range from maximum 11 years to a minimum of 6 years, with the average being 8,6 years. Three respondents have international experience in Australia, Netherlands and UK respectively.

In terms of background, three respondents started their careers in the accounting environment whilst one respondent has and economics background. The last respondent has a history background. This was expected, as in the experience of

the researcher, not all professionals who become transfer pricing specialists started of by enrolling for a course in transfer pricing.

3.5.1 Highest educational qualifications

Three (3) respondents hold an M. Com degree with specialization in international tax, transfer pricing and tax respectively. One respondent holds an honours degree in business management and the last respondents holds a degree in history.

3.5.2 Specialist training in transfer pricing

All respondents received mostly on the job training and did not attend any course in transfer pricing as there are no courses. Training was therefore aimed at specific areas of transfer pricing. This was expected as transfer pricing forms part of the undergraduate training tax courses at South African universities, but is limited to a chapter in the text book or course notes.

Being part of international firms afforded some of the respondents the opportunity to get international exposure and to rub shoulders with specialists abroad.

3.6 SHORTCOMINGS ON TPPDs

The main shortcomings mentioned by the respondents were the areas covering the economic and functional analysis, benchmarking supporting documents and the fact that taxpayers do not necessarily understand the goals and objectives of documentation. The issues raised are:

- functional and economic analysis is a major issue for some of the respondents was the fact that the industry value chain and value chain of the companies operation in the industries needs to be well documented in order to show what drives value and profitability in the company and industry;
- benchmarking is carried out based on adjusted information from European databases because information from South African companies is not available. Private companies are not obliged to make their financial information available

which means that the only information available is those of listed or public companies;

- supporting documentation, a big gap is often found between the main transfer pricing report and the supporting documents. The main reason can be assumed to be the fact that companies often only prepare documents a few years after transactions have occurred; and
- understanding the goals and objectives of documentation. The respondents indicated that documents varied from company to company with some documents focussing on the functional analysis, whilst other on economic analysis. Documents are not well prepared since the goals and objectives are well understood. South African operations of MNE's are not always properly accounted for and in some cases the South African industries are not even noted in documents.

3.7 RECOMMENDATIONS FOR IMPROVEMENTS TO TRANSFER PRICING POLICY DOCUMENTS

Recommendations for improvements of TPPDs were made by the respondents with the following principles in mind:

- taxpayers and the auditing firms should understand the value chain of the industries that companies operate in and what drives value and profitability as well as the main risks and functions;
- a clear understanding of the transactions at hand from a business point of view is also required from the taxpayer; and
- the number of transactions entered into by the taxpayer will determine the detail that is required for documents.

The respondents made the following recommendations:

- a functional analysis and economic analysis should for part of TPPDs;

- South African policy document requirements should be aligned with the OECD guidelines since the current scenario is that some of the guidelines are adopted in full whilst others are disregarded; and
- criteria for TPPDs should be split based on revenue and number of transactions. Companies with only a few transactions should be separated from companies with lots of transactions and agreements. Also companies with low revenues, from offshore transactions would be separated from companies with higher revenue.

3.8 PROVING THAT DOCUMENTS ARE CONTEMPORANEOUS

Respondents indicated that it is a challenge to prove that documents are contemporaneous; especially a few years after transactions took place, because:

- information provided by the taxpayers is sketchy and transactions are explained in detail, with no detailed financial information given to support it;
- high staff turnover at taxpayers causes a lack of continuity and existing staff keep on changing their explanations when queries are raised. The end result is that the taxpayer settles with SARS, when they cannot prove documents is contemporaneous to avoid litigation;
- SARS sometimes request documents and information that are irrelevant to the transaction and impossible to acquire. Finalising issues with SARS and reaching an agreement as to what the arm's length price should be is delayed as the taxpayer end up requesting extensions to gain some time; and
- auditors find themselves in the difficult situation to verify information pertaining to transactions without any substantive documents from the clients.

3.9 SHOULD TRANSFER PRICING POLICY DOCUMENTS BE MADE STATUTORY?

Views on whether policy documents should be made statutory or not differed amongst the respondents. Three (60%) indicated that documents should be

statutory, one (20%) responded said no, whilst the last respondent (20%) said that it does not matter (see Figure 7 below).

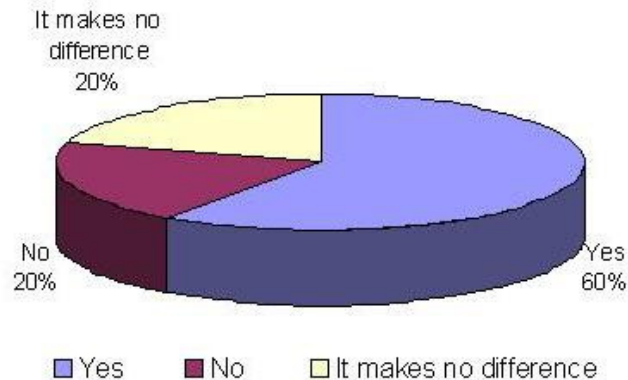


Figure 7: Responses regarding whether transfer pricing policy documents should be made statutory.

Benefits for SARS and the taxpayers if transfer TPPDS are made statutory were pointed out as follows:

- there will be certainty on the side of SARS and the taxpayers as to what the requirements are for TPPDs and the current confusion regarding whether policy documents are statutory or not can be removed;
- taxpayers will be in a better position to answer queries from SARS and get proper documents in place when they start transactions;
- transfer pricing policy documents will be taken seriously by taxpayers;
- direct benefits from policy documents can be derived in the area of thin capitalisation, since it is doing away with a 3:1 ratio and moving to an arm's length principle;
- SARS will have assurance that prices submitted in documents are arm's length; and
- there will be uniformity in the submission, i.e. some sort of standardization will be achieved.

3.10 CONCLUSIONS

Conclusions, based on the research questions posed, can be summarised as follows:

Question 1: Do taxpayers know what the requirements for transfer pricing policy documents are:

It was found that transfer pricing documents vary from company to company and is prepared based on what companies feel is important.

Question 2: What are the shortcomings of TPPDs prepared by taxpayers?

Shortcomings were found to be:

- functional analysis and economic analysis does not receive the required attention and is not documented properly;
- benchmarking is done using European and UK financial information, which is not representative of the South African conditions;
- the link between the main transfer document and supporting documents is often not clear; and
- company and industry value chains are often not reflected in TPPDs. It is therefore not easy to see what drives value and profitability in the companies or industries.

Question 3: What are the challenges taxpayers face in proving their documentation is contemporaneous?

Taxpayers struggle particularly to prepare supporting documentation after a number of years due to the fact that staff involved in the particular is not with the company anymore. Also, there is a lack understanding of the transaction involved, thus information furnished to auditing firms are not sufficient to address queries by SARS.

Question 4: What should be contained in a transfer pricing policy document as a minimum?

The minimum documents proposed by the specialists are:

- economic analysis;
- functional analysis;
- an overview of the industry;
- all supporting documentation relating to the transactions in the transfer policy document; and
- the method chosen to calculate the transfer price based on the arm's length price.

CHAPTER 4 CONCLUSION AND RECOMMENDATION

4.1 INTRODUCTION

The purpose of this chapter was to draw conclusions from the literature review and data. This research contribution to theory and practice will be discussed and lastly recommendations for future research are made.

4.2 RESEARCH

The main purpose of this study was to investigate what transfer pricing specialists who prepares documents for tax payers as well as transfer pricing experts employed by SARS think should be recorded in a TPPD and to come up with recommendations that can be useful to SARS when finally drafting legislation around this issue.

The following objectives were formulated for the proposed study:

- determining what the shortcomings are of TPPD's;
- identifying the risks for both SARS and the taxpayer associated to issues not currently being addressed in TPPD; and
- determining to what extent and detail information should be recorded in a TPPD.

The study of literatures revealed that:

- transfer pricing dates back to as far as world war two, has become and will be a major issue for MNEs and tax authorities in years to come;
- the accepted international norm for determining transfer prices is the arm's length principle, which is based on the premise that the relationship between related parties should not be used to distort transfer prices; and
- South Africa, whilst not being an OECD member also adopted the OECD in part to promote tax equality and reduce the possibility of South Africa contributing to the establishment of a harmful preferential tax regime.

4.3 RECOMMENDATION

The findings of the study showed what the challenges are that taxpayers, SARS and the auditing firms face in terms of transfer pricing documentation. The following is recommended:

- a more detailed study focussing on a bigger sample of transfer pricing specialists to focussing on the practical implementation of the proposals for improvements should be done; and
- SARS engage with taxpayers by sending out a questionnaire to assess what other issues are that hampers their compliance.

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APPENDIX: INTERVIEW NOTES

NOTES OF THE INTERVIEW CONDUCTED ON THURSDAY, 6 SEPTEMBER 2010 AT THE OFFICES OF SARS, MEGAWAT PARK AT SUNNINGHILL

1. INTRODUCTION AND ATTENDANCE

1.1 Introduction

The transfer pricing specialist interviewed was a Senior Transfer Pricing Specialist at SARS. He has around 11 – 12 years experience in the Transfer Pricing at HMRC. Prior to SARS he was the Assistant Director responsible for Transfer Pricing at HMRC in the United Kingdom (UK). He was responsible for the litigation of the DSG transfer pricing case in the UK.

The interviewee holds a Degree in History and has 3 years of internal tax exams at HM Revenue & Customs and has received on the job training, as there are no specific courses in transfer pricing available in the industry.

1.2 Attendance

Name

SARS Specialist

Denise Weston (interviewer)

Recording

2. INTERVIEW QUESTIONS AND RESPONSES

QUESTION: What are the shortcomings in Transfer Pricing Policy Documents based on documents that you reviewed?

RESPONSE: Shortcomings are:

- Some companies focus on including legislation and transfer pricing guidelines, which is actually a repetition of things that everybody already knows.
- The functional analysis is not always as in-depth as it should be. Any shortcomings or omissions in the functional analysis are carried over to the transfer pricing methodology.
- Transfer pricing documents can also benefit from a greater insight into the industry in which the company operates as it is important to look at what drives value in the industry under consideration. There should also be a look into how the company activities fit into the value chain of the group.

QUESTION: The more complex the document, the bigger the risks for accounting firms. As a SARS employee, what recommendations would you make to make Transfer Pricing Policy Documents simpler?

RESPONSE: Transfer pricing documents should not have a repetition of the OECD guideline and legislation and should consist of four (4) sections namely:

- An industry overview.
- A description of the company activities.
- A functional analysis
- A methodology or benchmarking exercise

QUESTION: Should Transfer Pricing Policy documents be made Statutory?

RESPONSE: No, not the policy documents, but what needs work is information prowess of tax administrations and making sure that they know how to use it.

QUESTION: When SARS audit taxpayers, they find it very difficult to prove that the documentation prepared is contemporaneous. What is SARS looking as prove that documents are contemporaneous and what will put them in a position to put forward a good case to defend their position.

RESPONSE: Making sure that all agreements and documents are signed and dated correctly as are reflection of the flow of events. Documents and contracts should not be prepared and signed post-facto, when taxpayers realize that they need to produce documents to substantiate the transaction etc. It can take a number of years before SARS will look at a transaction. Taxpayers should therefore prepare documents as they go along and not wait for an enquiry.

QUESTION: Accounting firms would prefer that transfer pricing documents be made statutory as it will mean more income for them. What benefits will there be for SARS and the taxpayer if it was statutory?

RESPONSE: A transfer pricing document is a summary with underlying facts and really a risk assessment tool. Very often the facts in the documents are wrong and the entire document can be questioned. Based on my experience in litigation, the issues contested are way above transfer pricing documents, and based on the underlying documents.

QUESTION: What are the shortcomings of transfer pricing documents, based on your experience?

RESPONSE: One major problem is the fact that there is no South African comparable information and commercial databases do not have much information about South African companies. UK, US or EU comparables are used and it causes problems when benchmarking is done. The taxpayer and the revenue authority are adversely affected. Transfer Pricing Policy documents cover certain transaction and it was found when digging deeper during litigating that other related party transactions actually took place. The scope given to the accounting firm is often not covering all the transactions. Suspicion is therefore raised since the authority is questions why not all the transactions are not covered by the documents.

QUESTION: Do you think that Porter's five forces should be considered when recommending improvements in the transfer pricing policy documents?

REPSONSE: Economics are normally covered fully. Porters' five forces can be useful in doing comparison in terms of how the taxpayers bargaining power compares to the pother parties' bargaining power. Work is increased as you are now looking at not only the tested party, but the other party to the transaction as well.

QUESTION: Do you have any general issues in terms of transfer pricing that you would like to rise?

REPSONSE: Yes. An important issue would be to have all the underlying documents to a transfer pricing policy document well referenced. Very often taxpayers are not able to produce supporting documents because it cannot be found.

3CLOSURE

The interview was closed and D Weston thanked the interviewee for his time.

NOTES OF THE INTERVIEW CONDUCTED ON TUESDAY, 14 SEPTEMBER 2010 AT THE OFFICES OF PRICE WATERHOUSE COOPERS, RIVONIA AT 15:00.

1. INTRODUCTION AND ATTENDANCE

The purpose of the interview is to obtain the view of the tax practitioners on the shortcomings of transfer pricing policy documents reviewed and the challenges faced when a transfer pricing audit is conducted by The South African Revenue Services.

1.1 Introduction

The transfer pricing specialist interviewed is an Associate Director in the Transfer Pricing team at Price Waterhouse Coopers. The interviewee has an economics background and holds an Honours degree in Business Management, Diplomas in Financial Markets and Instruments and Taxation. She has 8 years experience in the transfer pricing environment and has received on the job training, as there are no specific courses in transfer pricing available in the industry.

1.2 Attendance

Name

Interviewee

Denise Weston (interviewee)

Carl Weston (Scribe)

2. INTERVIEW QUESTIONS AND RESPONSES

QUESTION: What are the shortcomings in Transfer Pricing Policy Documents based on documents that you reviewed?

RESPONSE: Shortcomings are:

- Reports vary from company to company with the emphasis being either on financial analysis or economic analysis.
- The general shortcomings are however mostly in the area of economic analysis due to the information used for the economic analysis is based on European databases. Input information is therefore not necessarily relevant to the South African environment. Assessments normally raised are based on the view of the applicable tax authority and the European comparables do not cater for what happens in South African companies.
- They do not consult the accounting firm when setting transaction and give sketchy information about the transaction with no numbers to it.

QUESTION: The more complex the document, the bigger the risks for accounting firms. If you worked for SARS, what recommendations would you make in terms of developing Transfer Pricing Policy Documents?

RESPONSE: Practice Note 7 states what should be contained in a transfer pricing document, but taxpayers prepare documents based on their risk with the level of detail in the document focused on the number of transactions they engaged. More transactions means documents are more detailed. Typical criterion can for example be a split in the taxpayers based on their revenue of number related party transactions. Taxpayer should be obliged to prepare Rolls Royce document if they only had a few related party transaction.

The fact that South Africa is not a member of the OECD is another challenge. Taxpayers never know where the stand because certain aspects of the OECD guidelines are disregarded whilst other are adopted by South Africa. A lack of court cases is also not to the benefit of the process. Differences between the OECD guidelines and Practice Note 7 and is causing uncertainty in terms of what is acceptable in terms of documents. South Africa should become a member of the OECD in order to ensure that is never a lag or difference between the OECD Guidelines and Practice Note 7.

QUESTION: Should Transfer Pricing Policy documents be made Statutory?

RESPONSE: Yes. The motivation for this answer is:

- It will create certainty with taxpayers around requirements for transfer pricing policy documents because auditing firms are advocating the preparation of documents top their clients whilst SARS is issuing Addendums that states documents are not statutory.
- Taxpayers only have 20 – 30 days to prepare transfer pricing policy documents when SARS calls for it, which is not enough time. If taxpayers have prepared documents, they are already geared to them to defend their prices if queried by SARS. The onus will be on SARS substantiate their queries and prove that the taxpayer

QUESTION: Based on your response that it should be made statutory, how will this benefit the taxpayer and SARS?

RESPONSE: Benefits for SARS:

- SARS will have clarity in terms of what is required and there be no need to issue questionnaires requesting answers for historic transactions. Taxpayers are burdened because SARS is in a position to go back as far as is deemed necessary (sometimes up to 6 years back). High staff turnover in some companies causes current staff to correspond with SARS for a few years before issues are resolved. Other companies prefer to settle immediately to mitigate as they do not want to take 2-3 years to go to court. .

Benefits for the Taxpayers:

- The taxpayer will have also have clarity in terms of SARS requirements.

QUESTION: How difficult is it for taxpayers to prove that documentation prepared was contemporaneous, especially a number of years after the transactions under consideration took place?

REPSONSE: Two problems are normally encountered:

- Gathering historical information is always a challenge due to high staff turnover in some companies. Time lapse and high staff turnover is a challenges
- The level of detail required by SARS is sometimes unrealistic, especially if information about the offshore companies, which does have nothing to do with the local entity, is requested by SARS. Taxpayers are then requesting for extension of the deadline a number of times as it is difficult to compile all the information within the stipulated time.
- Taxpayers are sometimes changing their story when clarification is needed from SARS in terms of previous answers. The chain of information flow between SARS and the taxpayer becomes a problem and the person answering the queries is under pressure. Checking the answers by the taxpayer is also a problem for the auditing firm.

QUESTION: Are you familiar with Porter's five forces?

REPSONSE: No.

QUESTION: In your experience, when reviewing documents prepared locally, have you found that documents prepared was not well prepared and flow of information between the various sections was not well since it was prepared by junior staff, to minimize the costs to the client?

REPSONSE: Yes. The role of the auditing firm is to make sure that the final document is well prepared and checked.

QUESTION: Does the fact that transfer prices need to be set at arm's length have an effect on the way companies do business with cross border partners?

REPSONSE: Transfer pricing informs the way companies are structured as penalties are high and they would want to comply with transfer pricing regulations. Companies want set up the most tax efficient supply chain, based on transfer pricing regulations.

QUESTION: Do you have any general issues in terms of transfer pricing that you would like to

REPSONSE: No.

3. CLOSURE

The interview was closed and D Weston thanked the interviewee for her time.

NOTES OF THE INTERVIEW CONDUCTED ON MONDAY, 02 SEPTEMBER 2010 AT THE OFFICES OF KPMG, JOHANNESBURG.

1. INTRODUCTION AND ATTENDANCE

The purpose of the interview is to obtain the view of the tax practitioners on the short comings of transfer pricing policy documents reviewed and the challenges faced when as transfer pricing audit is conducted by The South African Revenue Services.

1.1 Introduction

All present were welcomed by R Naude and he explained the background and purpose of the interview.

The tax practitioner interviewed is a Senior manager at KPMG. He holds a M. Com degree from the University of Witwatersrand and has a approximately six (6) years experience in the transfer pricing environment at KPMG. Being part of a global organization enables him to be get specialist training from expats within the company who would come to South Africa from time to time, or secondees. KPMG also funds specialist training, based on the need and applicability.

1.2 Attendance

Name

Interviewee

Roy Naude (Study leader/ Interviewee)

Denise Weston (Interviewer)

Carl Weston (Scribe)

2. INTERVIEW QUESTIONS

QUESTION: What are the shortcomings in Transfer Pricing Policy Documents based on documents that you reviewed?

RESPONSE: Only occurs when MNE prepares documents offshore and send it to South Africa to have it reviewed to check whether it will be accepted by SARS. Companies do not want to engage with specialist as they feel it would be expensive. Want to incur minimal cost .Some of the issues picked up are:

- South African operations not properly accounted for.
- South African industry is not noted. The car manufacturing market in South Africa cane for example is totally different from the car manufacturing market in another country. One size does not fit all. The accounting firms should therefore prepare the offshore documents to suit the South African environment.

QUESTION: The more complex the document, the bigger the risks for Accounting firms. If you worked for SARS, what recommendations would you make in terms of developing Transfer Pricing Policy Documents?

RESPONSE: Very difficult to answer but:

- SARS will appreciate full and transparent disclosure no matter the quantum of the transaction involved.
- All transactions should be at arms length.

Detailed financial analysis is required to the required result. Generic statements about risks and functions are often made in Transfer pricing documents, but the fact whether they are economically significant is not always indicated. Transfer pricing documents should be tailored fro South African conditions.

QUESTION: Should Transfer Pricing Policy documents be made Statutory

RESPONSE: Yes

QUESTION: Based on your response that it should be made statutory, how will this benefit the taxpayer and SARS?

At this point in time, it is not a requirement to submit a document and taxpayers may need to defend their price in a short space of time. Alternatively, penalties are mitigated if taxpayers have applied their mind in and incurred the cost in preparing a document. The onus will therefore be on SARS to prove that the prices under question are not at arm's length.

The traditional things can also be helped for instance;

- the new proposals in terms of Thin Capitalization also TP needed strengthens taxpayers case.
- Diversionally rules in Section 9D also has a transfer pricing component
- The taxpayer will therefore be covered not only for Section 31 but other

External to your tax affairs Reserve bank wants an auditor's sign-off at a transaction arms length when you want to remit or introduce funds for a transaction outside SA. The taxpayer can either get a corporate finance opinion or apply TTP principle to prove that he transaction was arms length documents. The principle behind the Reserve bank requirement is that there was fair remuneration for South African assets

QUESTION: How difficult is it for taxpayers to prove that documentation prepared was contemporaneous, especially a number of years after the transactions under consideration took place?

REPSONSE: Practically it is difficult IT 14, plus financial statements & TP report forms the basis on which SARS will perform an audit. It is time-consuming to prepare the data SARS

require, due to the time lapse between when the documents were prepared and when SARS queries or audits the documents submitted by the taxpayer. The accounting firm is a custodian of the law and fiscus, regardless of the fact that they are paid by the client. The end result of the answer of the queries should therefore be a reconciliation of what SARS want whilst the taxpayer is adequately accounting for the transactions in question.

QUESTION: In your experience, when reviewing documents prepared locally, have you found that documents prepared was not well prepared and flow of information between the various sections was not well since it was prepared by junior staff, to minimize the costs to the client?

REPSONSE: Yes it was found, but not specifically for KPMG.

QUESTION: Are you aware of what the approach of other jurisdictions are in terms of Transfer pricing?

REPSONSE: From an African context, Kenya and Namibia started to introduce transfer pricing documentation and are mainly following what is happening in South Arica. The emerging markets are all moving towards introducing

3. CLOSURE

The interview was closed and D Weston thanked the interviewee for his time.

NOTES OF THE INTERVIEW CONDUCTED ON MONDAY, 08 SEPTEMBER 2010 AT THE OFFICES OF ERNST AND YOUNG, JOHANNESBURG.

1. INTRODUCTION AND ATTENDANCE

1.1 Introduction

The tax practitioner interviewed was a partner at Ernst & Young. She holds an M. Com degree in tax law has been involved in transfer pricing since 2000. She received on the job training in transfer pricing at Price Waterhouse Coopers, mainly over a three years when she was based in Australia.

1.2 Attendance

Name

Interviewee

Denise Weston (Interviewee)

Carl Weston (Scribe)

2. INTERVIEW QUESTIONS

QUESTION: What are the shortcomings in Transfer Pricing Policy Documents based on documents that you reviewed?

RESPONSE: The biggest issue is than one understands what needs to be achieved with transfer pricing documents. When doing it as a compliance requirement, the biggest issue that clients tend to forget is that the source of the underlying documents does not always talk to the main document. SARS will normally first look at the documents submitted and then request for supporting documents. The biggest gap is between the document submitted to SARS and the supporting documents.

Other documents are more defence oriented namely Advanced Pricing Agreements or Mutual Agreement Procedure, which is a different type of document to compliance documents.

QUESTION: The more complex the document, the bigger the risks for Accounting firms. If you worked for SARS, what recommendations would you make in terms of developing Transfer Pricing Policy Documents?

RESPONSE: For compliance documents, the global the focus is more on a high level approach. The document is put together as a master file with the different components of the document put together. Key elements would be the functional analysis and economic analysis. Clients are then made aware that the documents are prepared for compliance purposes only and there is no guarantee that it will be accepted by the tax administration as they will make their own conclusions anyway.

QUESTION: Should Transfer Pricing Policy Documents be made Statutory?

RESPONSE: It does not make a difference as it does not guarantee that the taxpayer is protected and the risks are not decreased.

QUESTION: **How difficult is it for taxpayers to prove that documentation prepared was contemporaneous, especially a number of years after the transactions under consideration took place?**

RESPONSE: SARS says it is contemporaneous if prepared as part of the tax return completion process. The issue with SARS is that clients justify the thought process that went into the preparation of the documents, which is different from the taxpayer submitting the documents as part of their tax return. Clients are therefore advised to get the auditors involved at the start of the transaction to get the evidentiary documents ready, even if it is not in the correct format.

QUESTION: **As a recommendation, do you think the Porter's 5 forces model should be taken into account when preparing a transfer pricing document?**

It is a good way to approach the industry analysis as it keeps it focused. SARS has already raised the issue about the industry analysis is not well prepared as it applies to what the document is demonstrating. The Porter's 5 forces model will help to demonstrate how the industry affects the company and the transactions taking place.

QUESTION: **Do you have any general issues in terms of transfer pricing that you would like to add?**

RESPONSE: In the past, taxpayers used to huge documents with lots of information, but there will be a shift towards documents being concise and to the point.

QUESTION: **Do you agree or disagree with the view that the value chain of companies should be looked at when preparing their transfer pricing documents before a decision is made in terms of what formula to use to calculate the arm's length price?**

RESPONSE: Yes the business context and value chain is important. A typical example is the Dickson case.

QUESTION: **Without disclosing any information, what is the split of work in terms of clients wanting to be advised in terms of setting up transactions or them wanting to defend their case on historic transactions?**

More clients are now starting to have a relationship with the auditing companies to get advised when starting a transaction, and then having documents updated annually. There is however still clients who need assistance to defend their documentation or have documents prepared for historic transactions.

3. CLOSURE

The interview was closed and D Weston thanked the interviewee for her time.

NOTES OF THE INTERVIEW CONDUCTED ON THURSDAY, 06 SEPTEMBER 2010 AT THE OFFICES OF DELOITTE, JOHANNESBURG.

1. INTRODUCTION AND ATTENDANCE

The purpose of the interview is to obtain the view of the tax practitioners on the short comings of transfer pricing policy documents reviewed and the challenges faced when as transfer pricing audit is conducted by The South African Revenue Services.

1.1 Introduction

All present were welcomed by D Weston and she explained the background and purpose of the interview.

The tax practitioner interviewed was a Senior Manager at Deloitte. He holds a M. Com (International Tax), B Com and B Com (Hons) degrees as well as a Higher Diploma in Tax. Stephen has been working in the transfer pricing arena since 2003. There are unfortunately no standard courses in transfer pricing and transfer pricing is normally just a module at undergraduate level. The interviewee expanded his knowledge in transfer pricing by attending a number of conferences where certain aspects of transfer pricing was part of the proceedings. He was also involved in a number of studies in transfer pricing.

1.2 Attendance

Name	Role
Interviewee	Interviewee
Denise Weston (Interviewee)	Interviewer
Carl Weston	Minutes

2. INTERVIEW QUESTIONS previously you had AND RESPONSES – You are inconsequent!

QUESTION: What are the shortcomings in Transfer Pricing Policy Documents based on documents that you reviewed?

RESPONSE: Shortcomings are

- Taxpayers look at transfer pricing as a management accounts do not read practice note 7.
- They do not consult the accounting firm when setting transaction and give sketchy information about the transaction with no numbers to it.

QUESTION: The more complex the document, the bigger the risks for accounting firms. If you worked for SARS, what recommendations would you make in terms of developing Transfer Pricing Policy Documents?

RESPONSE: To really understand the value chain of the company and what drives company and profitability. Identification of main risks and functions is very important in the process of looking at the value chain. Once that is done, it needs to be tested in order to provide the right measurements and to see if transactions were at arms length. An understanding of the transaction from the business point of view is very important. The people in the company involved in the transaction needs to be interviewed. Sign-off from the company in terms of the information provided is important to ensure that they told the truth. If the approached is correct, then it could either be for the benefit or disadvantage of the company.

QUESTION: Should Transfer Pricing Policy documents be made Statutory

RESPONSE: Yes. If it is not statutory, then the taxpayers will take transfer pricing not seriously. They will also strip out profits and capital outflow out of the country will occur.

QUESTION: Based on your response that it should be made statutory, how will this benefit the taxpayer and SARS?

RESPONSE: Benefits for SARS:

- SARS will be ensured that the transactions will be at arms length in terms of the tests and thought process behind the transaction.
- The documents will be methodological SARS can concentrate SARS can focus on the big companies.

Benefits for the Taxpayer –

- The taxpayer will have more assurance that they have defense should SARS come and audit
- Management accounts can be improved as a lot of the costing in transfer pricing is management accounting. Companies can do better planning in terms of their planning and efficiency etc. Transfer pricing is therefore not only useful for only tax purposes.

QUESTION: How difficult is it for taxpayers to prove that documentation prepared was contemporaneous, especially a number of years after the transactions under consideration took place?

REPSONSE: Contemporaneous is illustrated or defined in practice Note 7 but in general, it means the documents should have some substance to it. All information in terms of what the company does, what industry it operates in and have the applied their minds the test etc. People who do not read Practice Note 7 will explain the applicable transaction with no numbers. There is no proof that the transaction is arms length with no benchmarking has been done.

QUESTION: Does South African companies find it difficult to find data to do benchmarking for transfer pricing purposes?

RESPONSE: Yes it is a problem. Only listed companies have their financial statements made public, whilst private companies do not reveal their statements. There is international database information of international companies available. The few South African multinational companies in the database cover a number of industries, but the information is too wide spread amongst industries to be useful. European companies (private and public) are forced by legislation to make their financial information available. It does not make sense to use information on European companies to benchmark as the South African and European companies as South Africa is an emerging market. Country risk adjustment can be made by using political and economic but it is not useful.

QUESTION: Do you have any general issues

RESPONSE: Emerging markets in South America, Africa and the east are now moving towards transfer pricing. Some African countries like Uganda, Rwanda, Namibia and Kenya are now changing their anti-avoidance towards transfer pricing. Countries do not want to lose out on taxes to be paid for off-shore transactions.

Transfer pricing assist management accountants especially in the manufacturing and services industries when looking whether you are costing things correctly.

QUESTION: Do you believe in one set of books since it appears that some companies are using one set of information to account for domestic operations and other information to account for off-shore operations and transfer pricing?

RESPONSE: Companies should have one consolidated set of books as it does not make sense to have more than one set of books.

3.CLOSURE

The interview was closed and D Weston thanked the interviewee for his time.