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TRANSFER PRICING: A COMPARATIVE STUDY OF ANALOGOUS LEGISLATION IN DEVELOPING AND DEVELOPED COUNTRIES

by

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To my friends and family for their constant encouragement, what would the world be without pillars such as you?

But for the grace of God, none of this would have been possible.

SUMMARY

TRANSFER PRICING: A COMPARATIVE STUDY OF ANALOGOUS LEGISLATION IN DEVELOPING AND DEVELOPED COUNTRIES

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The world has shrunk. Business has evolved. Trade is no longer just a bilateral concept but rather a multidimensional and multifaceted organism, constantly changing. In a world where a Mauritian holding company is able to justify financially, the manufacture of its product by factories in China, its transportation by Danish shippers, its marketing by American branding agencies, its product support by Indian call centres, and its distribution across Africa at a substantial profit, revenue authorities are faced with the challenge of striking a balance between maintaining an adequate tax base while incentivising foreign direct investment. It is on the back of globalisation that the need for transfer pricing legislation is born.

Companies often structure business transactions in a manner most conducive to positive tax benefit. One such method involves the shifting of profits between associated enterprises. This results in the erosion of a tax base in one country and undue benefit in the other. Transfer pricing involves a process of adjustment where multinational corporations trade with related enterprises at prices different to arm's length prices.

Determining an arm's length price requires significant judgement. Careful consideration must be given to the relevant facts and circumstances surrounding the transaction. This study aims to evaluate factors which should be considered in determining an arm's length price.

South African legislation outlines methods which may be used to determine an arm's length price. These methods are unique to specific sets of facts and each method poses

its own challenges in application. This study aims to critically evaluate such methods of calculating an arm's length price.

The major risk arising from international trade with associated enterprises is that revenue authorities may adjust transfer prices, and this could result in double taxation for companies. It is therefore important for legislation in various countries to maintain some form of parity. The challenge however, is that countries often encourage foreign direct investment through favourable tax laws, and tax law is effectively modelled based on a country's objectives and fiscal policy. In addition, multinational corporations often have their head offices in developed countries and their operating subsidiaries in developing countries. Legislation is therefore designed to take into account this demographic, in that, legislation in developed countries may be designed differently to that of developing countries. As a result transfer pricing legislation may differ from country to country. The study therefore seeks to evaluate differences between legislation in various countries, and to assess South African legislation in comparison to other developed and developing countries.

OPSOMMING

OORDRAGSPRYSE: 'N VERGELYKENDE STUDIE VAN OOREENSTEMMENDE WETGEWING IN ONTWIKELLENDE EN ONTWIKKELDE LANDE

deur

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Die wêreld het gekrimp en besigheid het ontwikkel. Handel is nie meer net 'n bilaterale konsep nie, maar eerder 'n multidimensionele en multifavlakkige organisme wat voortdurend verander. In 'n wêreld waar 'n houermaatskappy in Mauritius in staat is om dit finansieel te regverdig dat sy produkte in China vervaardig word, die verskeping deur Deense skepe gedoen word, die bemarking deur 'n Amerikaanse agentskap behartig word, die inbelsentrum in Indië gevestig is en die verspreiding van sy produkte dwarsoor Afrika geskied, alles teen 'n aansienlike wins, is inkomste-owerhede gekonfronteer met die uitdaging om 'n balans tussen die instandhouding van 'n voldoende belastingbasis te behou en terselfdertyd direkte buitelandse beleggings aan te moedig. Dit is op die rug van globalisering dat die behoefte aan oordragspryswetgewing ontstaan het.

Ondernemings (maatskappye) struktureer dikwels hul besigheidstransaksies op 'n wyse wat positiewe belastingsvoordele inhou. Een so 'n metode behels die oorplasing van wins tussen geassosieerde ondernemings. Die resultaat van hierdie transaksies lei tot die erosie van die belastingsbasis in een land en die onverdiende voordeel in 'n ander. Oordragsprysing is die proses van aanpassing waar multi-nasionale maatskappye besigheid bedryf met geassosieerde maatskappye teen pryse wat nie op uiterste voorwaardes beding is nie.

Die bepaling van pryse wat op uiterste voorwaardes bereken is, verg merkwaardige oordeel. Deeglike oorweging moet aan die wesenlike feite en omstandighede van transaksies gegee word. Die studie beoog om die faktore te evalueer wat in ag geneem moet word by die bepaling van pryse wat op uiterste voorwaardes beding is.

Suid-Afrikaanse wetgewing beskryf die metodes wat gebruik kan word om pryse op uiterste voorwaardes te beding. Die metodes is uniek tot elke stel feite en elke metode beskik oor sy eie uitdagings in praktyk. Die studie beoog om die metodes wat gebruik word om pryse wat op uiterste voorwaardes beding bereken is, te evalueer.

Die groot risiko wat voortspruit uit die internasionale handel met geassosieerde vennote is dat die belastingowerhede die oordragspryse mag verhoog wat tot dubbele belasting kan lei. Dit is dus uiters belangrik dat die wetgewing in verskillende lande ooreenstem. Die uitdaging is egter dat verskeie lande dikwels buitelandse direkte investering aanmoedig deur gunstige belastingswette wat gebaseer is op daardie lande se doelstellingsen fiskale beleid. Ondernemings vestig dikwels ook hul hoofkantore in ontwikkelde lande en hul streekskantore in ontwikkelende lande. Wetgewing moet dus demografiese faktore in ag te neem; aangesien wetgewing in ontwikkelde lande verskil van dié van ontwikkelende lande. Dus sal die oordragspryswetgewing van land tot land verskil. Die studie poog om die verskille te evalueer in die wetgewing van verskeie lande en om die Suid-Afrikaanse wetgewing te vergelyk met dié van ontwikkelde en ontwikkelende lande.

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TRANSFER PRICING: A COMPARATIVE STUDY OF ANALOGOUS LEGISLATION IN DEVELOPING AND DEVELOPED COUNTRIES

CHAPTER 1
INTRODUCTION

1.1 BACKGROUND

In his book, “America and cosmic man”, Lewis (1949:21) referred to the world as “one big village”. Some 60 years later, he may have been surprised to see how apt his description is today.

It has become evident that there are few spatial barriers placed on communication across the world. Corporations no longer consider geographical location to be a limitation on consumer markets. In fact, China is literally a mouse click away. It is in light of this that revenue authorities have been paying special attention to the transfer of profits between group companies.

The impact of transfer pricing transactions manifests in many areas of a national economy. The effects can be seen on market structures, balance of payments, domestic capital formation, and tax and customs revenue. The scope and likelihood of such transactions is on the rise and is attributable mainly to the continued concentration of economic power in the hands of multinational corporations in both developed and developing countries and the increasing importance of intercompany transactions in global trade. (Greenhill & Herbolzheimer, 1980:1.)

It therefore becomes imperative, that governments strike the causal balance between legislation which is beneficial to the *fiscus* and simultaneously practical and easy to apply. Transfer pricing principles and legislation have to be specific enough to deter exploitation, yet generic enough to ensure broad-based applicability, ultimately conducive towards tax incentives promoting foreign direct investment. This is all the more important in developing countries striving to achieve growth through such foreign direct investment.

This study seeks to evaluate the fundamental principles underlying the arm's length principle and to critically evaluate the methods applied in determining an arm's length price. This study seeks to understand the transfer pricing practices adopted by developing and developed countries, and to compare such practices to each other in order to identify areas for improvement in a South African context.

Existing literature with regards to transfer pricing, seeks to evaluate the tax avoidance aspect through the use of effective transfer price planning. These studies do not consider South African transfer pricing legislation in comparison to other developing and developed countries. It is by keeping these matters in mind that this study seeks to address these shortfalls by evaluating transfer pricing from the perspective of developing economies and identifying areas for improvement in both legislation and practical application.

1.2 PROBLEM STATEMENT

The purpose of this study is to understand and critically evaluate the fundamentals and practical application of transfer pricing provisions in the context of developed and developing countries.

1.3 RESEARCH OBJECTIVES

The study is governed by the following specific research objectives:

- to evaluate the fundamentals underlying the arm's length principle;
- to critically evaluate the methods applied in calculating an arm's length price and the shortcomings of such methods; and
- to perform a comparison of transfer pricing practices between developing and developed countries.

1.4 IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY

The tax liabilities of multinational corporations are determined by tax authorities through the application of transfer pricing methodologies. These methodologies are based on assumptions regarding firm behaviour and market structures which are rarely empirically valid. It is for this reason that multinational firms remain at risk of double taxation. Such methodologies further expose multinational corporations to the risk of penalties and additional tax liabilities. (King, 2009:1.)

This study should contribute greatly to understanding the practical application of transfer pricing provisions in the broad categories of developing and developed economies. The study will compare South African transfer pricing provisions to those of other developed and developing countries in an effort to identify areas of key consideration and improvement both in legislation and practical application. The study will also seek to provide further guidance to South African companies with regards to documentation requirements related to transfer pricing transactions.

1.5 DELIMITATIONS AND ASSUMPTIONS

1.5.1 Delimitations

The following delimitations must be considered in relation to this study:

- this study has only considered the transfer pricing legislation and other guidance issued by the national tax authorities in South Africa, India, Japan and the United States of America;
- transfer pricing provisions have been considered mainly in the context of the transfer of goods between associated enterprises;
- transfer pricing provisions have not been considered in the context of the transfer of intangible assets or the rendering of services between associated enterprises;
- changes in legislation and other guidance issued by national tax authorities of the above mentioned countries have only been considered up to 30 June 2010;

- matters related to thin capitalisation have not been considered;
- the study has not considered the definitions of residents and non-residents in the various countries; and
- reliance has been placed on the classification of the relevant countries into the developing and developed categories as provided by the World Bank.

1.5.2 Assumptions

The study is performed based on the following assumptions:

- it is assumed that the legislation in the various countries is enforced and accurately applied by the national tax authorities of the relevant countries; and
- the original Japanese legislation and guidance is published in Japanese. The Japanese National Tax Authority has provided an English translation thereof. The translation is assumed to be accurate.

1.6 DEFINITION OF KEY TERMS

Pertinent to the understanding of the study, the some key definitions have been discussed below.

1.6.1 Arm's length principle

The arm's length principle is the principle of including in the profit of an associated enterprise, any amount which would have accrued to such enterprise, were it not for special conditions being enforced upon such enterprise. Such special conditions would be conditions which would not be imposed upon independent enterprises. (OECD, 2009:17.)

1.6.2 Associated enterprise

Associated enterprises are enterprises which have conditions imposed on them which are different to conditions between independent enterprises (OECD, 2009:17).

The following abbreviations have been used in this study.

Table 1: Abbreviations used in this document

Abbreviation	Meaning
GDP	Gross domestic product
IRS	Internal Revenue Service
NRS	National Revenue Services
NTA	National Tax Administration
OECD	Organisation for Economic Co-operation and Development
SARS	South African Revenue Services
USD	United States Dollar

1.7 DESCRIPTION OF OVERALL RESEARCH DESIGN

The study focuses primarily on the evaluation of available legislation and other literature. It is therefore a pure analysis and evaluation of secondary literature. It is therefore considered appropriate to apply non-empirical research methodologies in conducting the proposed study.

Mouton (2005, 176) defines a theory building study as studies which are aimed at developing new theories to explain phenomena.

The study is considered to be a theory building study as it seeks to evaluate methods of transfer pricing, administrative burdens on the tax payer, and a critical evaluation of the complexities involved in arriving at a satisfactory arm's-length price. The aforementioned are critical concepts in the overall theme of transfer pricing.

At a macro level, this study seeks to evaluate the existing sources of literature surrounding specific aspects of transfer pricing implementation, evaluation of legislative provisions and guidance provided by revenue authorities and evaluation of the textual opinions of informed individuals (such as journal articles). Specific sources would include, primary legislation in the various countries, relevant case law which provides guidance on determination of transfer prices,

journal articles from the perspective of the taxpayer, conveying areas of particular difficulty in the application of transfer pricing provision.

1.8 STRUCTURE OF CHAPTERS

Chapter 1 outlines the background to the study, the problem statement and the research objectives governing the study. In addition, the chapter details the delimitations and assumptions of the study, provides a definition of key terms and provides a description of the overall research design.

Chapter 2 will consider a brief history of transfer pricing, the role of the Organisation for Economic Co-operation and Development ("OECD"), and the problem of transfer pricing by defining the concept of transfer pricing. The chapter will also explore the background of the various countries selected for the purpose of this study.

Chapter 3 will analyse the arm's length principle, and considers the fundamental aspects of determining an arm's length price. The chapter will evaluate the aspects which should be considered in assessing comparability of transactions.

Chapter 4 will critically evaluate the traditional transaction methods of determining an arm's length price. The chapter will consider practical aspects of the application of the methods, as well as the rationale for the method, and a critical analysis thereof.

Chapter 5 will consider the transactional profits methods of determining an arm's length price. The chapter will consider practical aspects of the application of the methods, as well as the rationale for the method, and a critical analysis thereof. The chapter will also consider a non-arm's-length method, being the global formulary apportionment method.

Chapter 6 will critically analyse and compare different legislation and guidance provided by national tax authorities of the developing and developed countries selected.

Chapter 7 will provide a summary and conclusion of the findings of the research along with recommendations for future research. The chapter will also outline the implications of the research on South African enterprises involved in controlled transactions, as well as implications and considerations for the South African Revenue Service.

1.9 CONCLUSION

In this chapter the background and the research objectives governing the study were considered.

The following chapter will consider the concept of transfer pricing, definitions critical to the study, and backgrounds to the countries selected for the study.

CHAPTER 2
UNDERSTANDING THE CONCEPT OF TRANSFER PRICING

2.1 INTRODUCTION

The previous chapter provided an introduction to the study along with the problem statement, research objectives, delimitation, assumptions and the overall research design.

This chapter will further evaluate the concept of transfer pricing, the need for transfer pricing legislation and guidance, and the business risks associated with transfer pricing. The countries to be considered further on in the study will also be evaluated.

2.2 HISTORY OF TRANSFER PRICING

According to Miller and Oats (2009:306-307), the Internal Revenue Service ("IRS") of the United States of America, was first authorised to adjust the taxable profits of related parties in 1928. Although no requirement existed to provide consolidated statements, the profits of individual companies could be adjusted. The requirement for an arm's length method was then introduced into the model tax treaty in 1935 by the League of Nations. The League of Nations was a predecessor to the OECD.

The model tax treaty also provided an alternative method to the arm's length method, being the split of profits based on the percentage of turnover. This method has come to be known as the global formulary apportionment method. (Miller & Oats, 2009:307.)

2.3 ROLE OF THE OECD

The OECD was established in 1961. The OECD has, as its mission, provision of forum where governments "compare policy experiences, seek answers to

common problems, identify good practice and coordinate domestic and international policies" (OECD, 2009).

In 1979 the OECD issued its first set of guidelines on transfer pricing and firmly rejected non-arm's-length methods, such as methods of allocating profits based on formulae. The OECD reconfirmed its position in 1994, when the transfer pricing guidelines were reissued. (Miller & Oats, 2009:308-309.)

2.4 ILLUSTRATING THE PROBLEM OF TRANSFER PRICING

The Commissioner for the SARS issued Practice Note 7 embodied within the South African Income Tax Act 58 of 1962 in 1999. The Practice Note provides guidelines for the application and administration of transfer pricing provisions.

Practice Note 7 of the Income Tax Act defines a transfer pricing as the process by which connected persons determine prices for the sale of goods between each other. Transfer prices are consequently defined as the prices determined through such process.

Lebovitz, Van Herksen, Kirschenbaum and Nijhof (2003) point out that transfer pricing is considered to be one of the most pervasive tax issues affecting a multinational company. Similarly, Ernst & Young (2003:12), a leading global audit firm, in a survey detailing interviews with 641 parent companies and 200 subsidiary corporations in 22 countries, found that transfer pricing remains the leading tax issue for multinational corporations.

Over the last 20 years, tax authorities have introduced and overhauled significant practices surrounding the application of transfer pricing provisions to prevent the erosion of their tax bases (Lebovitz *et al.*, 2003). Tax legislation has, from its inception, undergone drastic changes in order to close the various avenues which allow the tax payer to utilise benefit by exploiting the constructs of the law, that is, exploitation of avenues of legally manipulating the provisions of legislation. One such avenue is the use of transfer pricing as a means of evading tax. (Kuschnik, 2008:17.)

An increasing number of countries are enacting relevant transfer pricing legislation, while those with an existing transfer pricing regime continually strive to strengthen and enforce such rules of law. All this is accomplished by emphasising requirements placed on multinational corporations to document and report intercompany transactions and internal policies related to transfer pricing. Many countries have also enacted penalties to enforce the preparation of detailed documentation packages which are to be readily available to tax authorities. (Lebovitz *et al*., 2003.)

Transfer pricing allows for an overriding of the general principle of source based taxation by transferring profits within entities that are part of a multinational corporation. This transfer of profits is performed by inflating the sales price of goods or services sold to intergroup companies, thereby resulting in lower profits in one entity and higher profits in the other. Thus, an appropriately planned scheme of transfer pricing will allow for reduced taxation for the group as a whole. (Styron, 2007:40.)

It is noted from the above that such a scheme, while not only violating the principle of economic neutrality, will result in considerable loss in revenue to one tax authority and a consequent gain in another. It is for this reason that tax authorities around the world have in recent years placed significant emphasis on the drafting and implementation of transfer pricing legislation. (Kuschnik, 2008:17.)

In light of the above, it is evident that transfer pricing is a focal point of revenue generation for revenue authorities around the world, and consequently a significant detractor of the bottom line of multinational corporations. Multinational corporations have to therefore strike a keen balance between managing profits and taxes.

2.5 BUSINESS RISKS ARISING DUE TO TRANSFER PRICING

According to Holland (1999), transfer pricing is perceived to be a soft target by companies due to major complexities surrounding its application and this is a matter of concern to revenue authorities. This consequently results in:

- a possible increase in local taxation due to price adjustments;
- the potential for double taxation, where authorities rectify the pricing in one country, but no corresponding relief is provided in another country;
- penalties and interest on overdue tax;
- uncertainty as regards the tax burden of the group; and
- an inevitable breakdown in the long-term relationship between the group and the revenue authorities.

Multinational corporations seeking to limit such risks and to ward off tax audits and legislative penalties must adopt, what are perceived to be, the emerging best practices related to transfer pricing. Ernst & Young (2003:26), in the global survey, outlines the following emerging best practices:

- obtaining a keen understanding of where the main transactions and jurisdictions risk areas are within the group;
- placing focus on documentation efforts where the business returns are likely to be the highest;
- involving management outside of the tax department in transfer pricing, so as to gain a thorough understanding of revenue trends;
- ensuring that documentation is globally consistent and takes new legislation and audit trends into account;
- implementing protocols to maintain documentation; and
- managing the flow of information to tax authorities.

Holland (1999) notes that an estimated 60% of all international trade can be attributed to transactions between related parties. As a result of this, four main approaches have developed in tax systems across the world in order to counteract tax avoidance through transfer pricing: These are:

- provisions made binding by law, in that, legislative provisions. These are generally accompanied by formal, detailed and binding regulations such as those in the United States of America;
- provisions made binding by law, in that, legislative provisions, which are accompanied by detailed guidelines entailing acceptable pricing methodology such as those in Germany;
- provisions made binding by law, in that, legislative provisions coupled with reliance on arm's length concepts to dictate acceptable pricing practices which rely strongly on the OECD guidelines such as those in the United Kingdom; and
- no specific legislation on transfer pricing, instead reliance is placed on normal, general anti-avoidance provisions and tax law to combat transfer pricing, such as those in the Netherlands.

2.6 TRANSFER PRICING AND THE ARM'S LENGTH PRINCIPLE

World over, it is acknowledged that the calculation of an arm's length price is far from being an exact science, and that the process requires the exercise of significant judgement on the part of the taxpayer and the tax authorities. As a result of such judgement, an arm's length price may be represented by a range of prices. (Ernst & Young, 2000.)

Ernst & Young (2000) notes that the preferred arm's length methods are based on the premise of comparison between transactions of connected persons to that of unrelated, independent entities in similar dealings. Therefore yet another element critical to comparability is that transactions being compared must have a high level of correlation between them, for any such comparison to be meaningful.

As noted by Hawkins (2008:204), the original United States of America transfer pricing regulations, published in 1968, prescribed a variety of pricing methods. These methods focussed mainly on prices of transactions within groups. In practice, these methods did not satisfy revenue authorities due to the distinct lack

of comparable data and taxpayers' advantage of having access to more information than the government. Differences in volume, markets, branding, and terms and conditions all had an impact on transfer prices, and it was believed that taxpayers made use of information which provided them with best advantage and to the disadvantage of revenue authorities.

According to Hawkins (2008:205), the fact that the arm's-length standard is common international practice, disputes over primary taxing jurisdiction would exist if the United States unilaterally adopted a transfer pricing method that violated this common practice. To avoid such confusion and disruption to international trade, the Organisation for Economic Co-operation and Development (OECD) introduced the transaction net margin method, a method analogous to the comparable profits method.

2.7 THE ADMINISTRATIVE BURDEN OF TRANSFER PRICING

All South African companies are required to disclose the particulars of international transactions on their annual tax returns. Revenue authorities have outlined onerous guidelines, including but not limited to full details of the pricing methods applied, comparative arm’s length prices for the same transactions (Holland, 1999).

Regarding transfer pricing planning, Holland (1999) points out that companies should consider:

- whether they have implemented a transfer pricing policy;
- whether the policy has been fully documented and is commercially viable;
- whether the policy has been appropriately implemented and updated on a regular basis; and
- whether the outcome of the policy is commercially realistic.

It is evident that these requirements, onerous though they may be, are critical to ensuring the sound application of appropriate transfer pricing. It is however notable that such onerous requirements are undoubtedly costly to the taxpayer,

as the information which will be furnished should be well researched and substantiated.

Although similarities may exist in the approaches applied by various countries to the application and implementation of transfer pricing legislation, there is no consistent view on the arm's length principle. This is despite the fact that many countries make use of guidelines provided by the OECD. As a result of this various countries have instituted regimes of extensive documentary requirements to facilitate understanding and disclosure of such transactions. Non-compliance with such legislation has, as a consequence, several penalties. This places significant strain on multinational corporations as they are required to comply with varying legislative and documentary requirements in every country in which they trade (Lebovitz *et al.*, 2003)

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According to Lebovitz *et al.* (2003), some of the documents that multinational corporations will require, possibly in each country of trade, include:

- descriptions of its businesses and analyses of the functions and risks performed in each country;
- detailed summaries of transactions within the group;
- detailed analyses of similar transactions in each market along with comparable prices; and
- descriptions and analyses of the transfer pricing methods applied.

The multinational corporations are required to prepare extensive documentation in each country of business which places severe strain on time and costs of compliance. The corporation will require local expertise with central governing functions, which increase the risk that the entity may fall short in terms of compliance in any specific country. Needless to say, administrative burdens with high risk of penalties may act as a significant disincentive to investment, thus hampering the growth of the corporation, and limiting opportunities in the possible host countries (Lebovitz *et al.,* 2003).

2.8 COUNTRIES SELECTED FOR EVALUATION

This proposed study aims to transfer pricing legislation and practices adopted by the following countries:

- South Africa (developing economy);
- India (developing economy);
- Japan (developed economy); and
- United States of America (developed economy).

The selection of these countries is based on an evaluation of the relevant countries growth and foreign trade statistics. The primary objective of the study is to assess whether South Africa, a fast developing economy has legislation which is geared towards achieving the countries goals of steady economic growth. This will be done by comparison of various aspects as detailed below between the countries selected.

2.8.1 South Africa

According to Mazansky (2005:2), transfer pricing and thin capitalisation rules were introduced into the Income Tax Act in 1995. The South African Revenue Service (SARS) subsequently issued the Practice Note 7 “Determination of Taxable Income of Certain Persons from International Transactions: Transfer Pricing” in 1999. The Practice Note contains comprehensive guidance on acceptable transfer pricing methods as well as documentation requirements. The Practice Note is based largely on the OECD guidelines on transfer pricing.

In 2001 The South African Revenue Service (SARS) circulated questionnaires on interest-free loans to non-residents. This was in an effort to monitor transfer pricing compliance. The main aim of this questionnaire was the identification of problem areas and targets for further investigation, with specific reference to transactions between group companies. South Africa has taken its cue from Australian tax authorities, who have also implemented similar measures in policing and enforcing transfer pricing legislation. (Jacobs & Grove, 2002.)

The tables below provide a brief summary of South African trade information.

Table 2: Background economic information on South Africa

BASIC INDICATORS				
Population (thousands, 2008)	48 687	**Rank in world trade**, 2008	Exports	Imports
GDP (million current US$, 2008)	276 764	Merchandise	41	34
		excluding intra-EU trade	27	22
		Commercial services	47	41
		excluding intra-EU trade	29	25
		Annual percentage change		
		2000-2008	2007	2008
Real GDP (2000=100)		4	5	3
Exports of goods and services (volume, 2000=100)		4	8	3
Imports of goods and services (volume, 2000=100)		9	10	6

Source: World Trade Organisation (2010)

The table above indicates background information related to South African. The table is based on 2008 figures of the population of South Africa, the total gross domestic product ("GDP"), South Africa's rank in world trade, as well as percentage growth in GDP; exports; and imports. From the information above it is evident that overall exports and imports have grown substantially over the eight year period ending 2008.

The table below provides detailed merchandise trade information.

Table 3: South African international merchandise trade information

MERCHANDISE TRADE	*Value*	*Annual percentage change*		
	2008	2000-2008	2007	2008
Merchandise *exports* , f.o.b. (million US$)	80 782	13	20	16
Merchandise *imports* , c.i.f. (million US$)	99 500	16	12	12
	2008			2008
Share in world total exports	0.50	**Share in world total imports**		0.60
Breakdown in economy's total exports		**Breakdown in economy's total imports**		
By main commodity group (ITS)		By main commodity group (ITS)		
Agricultural products	8.7	Agricultural products		6.1
Fuels and mining products	35.4	Fuels and mining products		25.7
Manufactures	54.5	Manufactures		67.4
By main destination		By main origin		
1. European Union (27)	31.9	1. European Union (27)		31.3
2. Japan	11.0	2. China		11.3
3. United States	10.8	3. United States		8.0
4. China	5.8	4. Saudi Arabia		6.3
5. India	3.1	5. Japan		5.6

Source: World Trade Organisation (2010)

The table above places the value of merchandise exports at approximately USD 81 billion and the value of like imports at approximately USD 100 billion. The table also provides information regarding the main categories of trade and the countries with whom such trade is conducted.

2.8.2 India

According to Mogul (2007), the Finance Act of 2001 introduced transfer pricing provisions into the Indian Income Tax Act 43 of 1961. The transfer pricing provisions apply with effect from April 2001 and provide that profits, being income, expenses and finance costs, arising from transactions between "associated enterprises" must be calculated by giving consideration to prices in similar transaction between non-associated enterprises, in that, by applying an arm's-length price. The relevant legislation provides guidance on what constitutes an "associated enterprise" by considering criteria such as shareholding pattern, amount of loans or guarantees, directorship and commercial considerations.

The tables below provide a brief summary of Indian trade information.

Table 4: Background economic information on India

BASIC INDICATORS					
Population (thousands, 2008)	1 139 965	**Rank in world trade**, 2008		Exports	Imports
GDP (million current US$, 2008)	1 217 490	Merchandise		23	14
		excluding intra-EU trade		17	8
		Commercial services		10	12
		excluding intra-EU trade		5	6
			Annual percentage change		
			2000-2008	2007	2008
Real GDP (2000=100)			8	9	7
Exports of goods and services (volume, 2000=100)			12	8	0
Imports of goods and services (volume, 2000=100)			15	8	0

Source: World Trade Organisation (2010)

The table above indicates background information related to India. The table is based on 2008 figures of the population of India, the total gross domestic product ("GDP"), India's rank in world trade, as well as percentage growth in GDP; exports; and imports. From the information above it is evident that overall exports and imports have grown substantially over the eight year period ending 2008.

The table below provides detailed merchandise trade information.

Table 5: Indian international merchandise trade information

MERCHANDISE TRADE	*Value*	*Annual percentage change*		
	2008	2000-2008	2007	2008
Merchandise *exports* , f.o.b. (million US$)	194 828	21	23	30
Merchandise *imports* , c.i.f. (million US$)	321 031	26	29	40
	2008			2008
Share in world total exports	1.21	**Share in world total imports**		1.95
Breakdown in economy's total exports		**Breakdown in economy's total imports**		
By main commodity group (ITS)		By main commodity group (ITS)		
Agricultural products	12.0	Agricultural products		4.0
Fuels and mining products	24.4	Fuels and mining products		45.6
Manufactures	63.2	Manufactures		43.3
By main destination		By main origin		
1. European Union (27)	21.6	1. European Union (27)		13.9
2. United States	11.8	2. China		10.0
3. United Arab Emirates	10.5	3. United States		7.8
4. China	5.6	4. Saudi Arabia		7.3
5. Singapore	4.9	5. United Arab Emirates		6.2

Source: World Trade Organisation (2010)

The table above places the value of merchandise exports at approximately USD 194 billion and the value of like imports at approximately USD 321 billion. The value of exports is in excess of two times that of South Africa, and the value of imports is in excess of three times

2.8.3 Japan

Transfer pricing rules were first introduced in 1986. Since this time, Japan's tax authority, the National Tax Administration Agency, has proposed tax reassessments to the tune of USD 1.5 billion. As a result of developments in the United States, the Japanese tax authority, in 1993, announced detailed policies outlining a new system of aggressive monitoring and extended scope of examination. To further emphasise the commitment of the National Tax Administration Agency to the enforcement of the transfer pricing legislation, special teams were formed to investigate transfer pricing matters in 1995 (Paul, Swaneveld, Osoro & Rasodha, 2005).

According to Utsumi (2006), tax authorities in Japan may estimate arm's-length prices using the comparable substitutes approach in instances where the information supplied by the tax payer is considered to be insufficient or inadequate.

The 2006 tax reform proposal added to the existing methods of calculating transfer prices. Such additional methods included the transactional net margin method (TNMM); and the profit-split method (Utsumi, 2006). The 2007 tax reform also instituted some relief for the tax payer in the form of a grace period for payments to revenue authorities, where entities are involved in transfer price negotiations with tax authorities (Lim, Aikawa, Parsch, Hongom, & Sekiya, 2007).

The Asia-Pacific is regarded as the world's fastest growing region. This region is of particular interest to many multinational corporations as it renders significant investment opportunities (Li, 2006). It is for this reason that Japan and India have been chosen as representative nations.

The table below outlines background economic information of Japan.

Table 6: Background economic information on Japan

BASIC INDICATORS					
Population (thousands, 2008)	127 704	**Rank in world trade**, 2008		Exports	Imports
GDP (million current US$, 2008)	4 909 272	Merchandise		4	4
		excluding intra-EU trade		4	4
		Commercial services		5	4
		excluding intra-EU trade		3	3
			Annual percentage change		
	2008	2000-2008	2007		2008
Real GDP (2000=100)	111	1	2		-1
Exports of goods and services (volume, 2000=100)	146	6	...		...
Imports of goods and services (volume, 2000=100)	126	4	...		...

Source: World Trade Organisation (2010)

As noted from the table above, Japan has a substantially larger economy than South Africa and India. Export and import growth is however lower on account of Japan being a developed country.

The table below outlines Japan's international merchandise trade information.

Table 7: Japanese international merchandise trade information

MERCHANDISE TRADE	*Value*	*Annual percentage change*		
	2008	2000-2008	2007	2008
Merchandise *exports* , f.o.b. (million US$)	782 047	6	10	9
Merchandise *imports* , c.i.f. (million US$)	762 534	9	7	23
	2008			2008
Share in world total exports	4.86	**Share in world total imports**		4.62
Breakdown in economy's total exports		**Breakdown in economy's total imports**		
By main commodity group (ITS)		By main commodity group (ITS)		
Agricultural products	1.1	Agricultural products		10.6
Fuels and mining products	4.8	Fuels and mining products		42.8
Manufactures	88.6	Manufactures		44.9
By main destination		By main origin		
1. United States	17.8	1. China		18.8
2. China	16.0	2. United States		10.4
3. European Union (27)	14.1	3. European Union (27)		9.2
4. Korea, Republic of	7.6	4. Saudi Arabia		6.7
5. Taipei, Chinese	5.9	5. Australia		6.2

Source: World Trade Organisation (2010)

The table above places the value of merchandise exports at approximately USD 782 billion and the value of like imports at approximately USD 762 billion.

2.8.4 United States of America

The transfer pricing provisions in the United States of America are contained within section 482 of the Internal Revenue Code of 1954. The section authorises the Internal Revenue Service (IRS) to adjust profits where prices between companies within a group are not at arm's length. Section 482 applies to both domestic and international transactions. (USA International Offshore Company Tax, 2010)

According to USA International Offshore Company Tax (2010), situations where section 482 may apply between associated enterprises include:

- loans given at a rate which is not at arm's length;
- services are provided at prices which are not at arm's length;
- property leased at premiums which is not at arm's length; and
- sale of property a price which is which is not at arm's length.

The table below outlines background economic information of the United States of America.

Table 8: Background economic information on United States of America

BASIC INDICATORS					
Population (thousands, 2008)	304 060	**Rank in world trade**, 2008		Exports	Imports
GDP (million current US$, 2008)	14 204 322	Merchandise		3	1
		excluding intra-EU trade		3	2
		Commercial services		1	1
		excluding intra-EU trade		2	2
			Annual percentage change		
	2008	2000-2008	2007		2008
Real GDP (2000=100)	119	2	2		1
Exports of goods and services (volume, 2000=100)	119	3	...		...
Imports of goods and services (volume, 2000=100)	131	5	...		...

Source: World Trade Organisation (2010)

As is evident by the GDP, the United States of America is the largest economy of all countries selected.

The table below outlines America's international merchandise trade information.

Table 9: United States international merchandise trade information

MERCHANDISE TRADE	*Value*	*Annual percentage change*		
	2008	2000-2008	2007	2008
Merchandise *exports* , f.o.b. (million US$)	1 287 442	6	12	12
Merchandise *imports* , c.i.f. (million US$)	2 169 487	7	5	7
	2008			2008
Share in world total exports	8.00	**Share in world total imports**		13.15
Breakdown in economy's total exports		**Breakdown in economy's total imports**		
By main commodity group (ITS)		By main commodity group (ITS)		
Agricultural products	10.9	Agricultural products		5.3
Fuels and mining products	9.8	Fuels and mining products		25.7
Manufactures	74.8	Manufactures		65.3
By main destination		By main origin		
1. European Union (27)	21.2	1. European Union (27)		17.4
2. Canada	20.1	2. China		16.5
3. Mexico	11.7	3. Canada		15.7
4. China	5.5	4. Mexico		10.1
5. Japan	5.1	5. Japan		6.6

Source: World Trade Organisation (2010)

The table above places the value of merchandise exports at approximately USD 1.2 trillion and the value of like imports at approximately USD 2.1 trillion. It is evident that the quantum of international trade is far higher than the other countries selected. This creates large exposures with regards to transfer pricing, and therefore it is expected that comprehensive legislation should be in place.

2.9 CONCLUSION

The chapter consider the background to transfer pricing by evaluating the basic transfer pricing problem, looking at the history of transfer pricing, the need for transfer pricing legislation and other administrative requirements. The chapter also provided some background information on the countries which will be considered.

India, Japan and United States of America were chosen for the purposes of the study as they South Africa's main trading partners as noted from the merchandise trade statistics above. The statistics above indicate significant disparity in the economies being compared in this study, South Africa being the lowest in import and export value. Therefore the countries were considered appropriate, as South Africa is a growing economy and should have legislation in place which is conducive to growth.

The following chapter will consider the fundamental aspects of the arm's length principle and factors to consider in determining an arm's length price.

CHAPTER 3
UNDERSTANDING THE FUNDAMENTALS OF THE ARM'S LENGTH PRINCIPLE

3.1 INTRODUCTION

In the previous chapter, the backgrounds to concept of transfer pricing and the countries to be evaluated were considered.

In order to understand and apply the transfer pricing provisions to a transaction, it is important to firstly understand what is meant by the arm's length principle. In this chapter the fundamentals of the arm's length principle will be considered.

3.2 DEFINING THE ARM'S LENGTH PRINCIPLE

According to the OECD guidelines on transfer pricing (2009:26-27), the OECD model tax convention provides an authoritative statement on the arm's length principle. This principle forms the basis on which the OECD member countries model bilateral tax treaties. Paragraph 1 of Article 9 of the OECD model tax convention provides that when conditions are set between two associated enterprises, any profits which do not accrue to an enterprise as a result of those conditions, may be included in the profits of that enterprise and taxed accordingly. This is based on the premise that the conditions differ from those between independent enterprises. (OECD, 2009:27.) What the paragraph is in fact alluding to is the agreement between entities within multinational corporations to transfer profits so as to obtain tax or other benefit. The arm's length price is therefore the price which reflects the market forces and is identified between independent parties. (OECD, 2009:26.)

The arm's length principle follows the approach of treating transactions between members of a multinational corporation as though they are separate independent entities. The application of the arm's length principle essentially avoids the creation of tax advantage which otherwise distorts enterprise competitiveness. In so doing, international trade and investment are promoted. (OECD, 2009:27.) The

application ensures that the tax base of a multinational group is fairly shared amongst the various tax jurisdictions in which it operates (Miller & Oats, 2009:306).

Some regard the principle as flawed as it does not take into account the various activities which arise as a result of an integrated business. Great practical difficulty may be encountered in applying the arm's length principle as it often occurs that independent enterprises do not normally engage in similar transactions as those undertaken by associated enterprises. This would be the case where the entities trade in highly specialised goods for example. An inherent portion of the cost would be the intangible value contributed by the entities through expenditure on research and development, and as a result, a comparable market may not be clearly evident. (OECD, 2009:27.) What is clearly evident is that the application of the arm's length principle requires significant judgement.

3.3 EVALUATING THE GUIDELINES IN APPLYING THE ARM'S LENGTH PRINCIPLE

The guidance established by the OECD outlines certain criteria which should be considered in applying the arm's length principle. The principles have been evaluated below.

3.3.1 Comparability analysis

Comparability is defined as the state in which any differences that exist between the situations being compared do not materially affect the conditions being examined, or where such differences can be eliminated by accurate adjustments (OECD, 2009:30). In determining the degree of comparability it is therefore critical to understand the manner in which independent enterprises assess and evaluate potential transactions. The OECD guidelines outline a number of factors to be considered in determining comparability. These factors have been discussed below.

3.3.1.1 *Characteristics of property or services*

In assessing comparability, some characteristics which the entity should consider include quality, reliability, physical features, availability and volume of supply (OECD, 2009:32). The characteristics will be unique to each situation and the nature of the product sold. However, it is evident that the characteristics of a product will play a part in the difference in value on the open market.

3.3.1.2 *Functional analysis*

“Functional analysis is a method utilised to find and organise facts about an enterprise in terms of its functions, assets and risks and is therefore recognised as a tool for assisting in the selection of an appropriate transfer pricing method and arm’s length price.” (Ernst & Young, 2000)

Compensation given by one independent enterprise to another is reflective of the functions performed by the enterprise. It is therefore important to understand the functions undertaken by the enterprises in assessing comparability. (OECD, 2009:32.)

The functional analysis seeks to compare the activities and responsibilities undertaken by independent enterprises. Aspects for consideration include the structure and organisation of the group as well as the juridical capacity in which the enterprise performs its functions. Various functions performed by the enterprise such as manufacturing and assembly, servicing, research and development, marketing, distribution, financing and management should be considered. It is important to note that it is not the number of functions performed by an enterprise, but rather the economic significance of the functions in terms of frequency, nature and value, which is of importance. (OECD, 2009:33.) The rationale behind the functional analysis is a larger proportion of profits should be allocated to the enterprises performing the more important functions (Miller & Oats, 2009:309).

Two critical aspects to consider in performing the functional analysis include assessment of assets employed and the risks assumed by the respective parties. This forms the crux of the functions undertaken by each entity. The analysis should consider the nature and type of assets used. Under open market conditions, increased risk assumed is rewarded by increased compensation. A significant difference in the risks assumed for which adjustments cannot be made would imply that a controlled and uncontrolled transaction are not comparable. (OECD, 2009:33.)

The type of risks associated with the transaction which should be considered include risk of loss and success, market risks such exposures to fluctuating prices, financial risks such as exposures to fluctuating exchange and interest rates and credit risk, being the risk of default by customers (OECD, 2009:33).

It is important to consider the economic substance of the transaction. Contractually it may appear that a party carries certain risks, however in substance the risks may be negated through other interactions between the parties. The conduct of the parties would likely be the best evidence of the allocation of risks. (OECD, 2009:33.)

Miller and Oats (2009: 310) point out that a good functional analysis should achieve an understanding of the following:

- the economics of the business and the markets in which it operates;
- price sensitivity and the distinctiveness of the products;
- the intangible value and invisible factors; and
- exposure to risk.

3.3.1.3 *Contractual terms*

The contractual terms in arm's length dealings generally outline the risks, responsibilities, and benefits attributable to each company which is party to the agreement. Therefore the evaluation of the contractual terms should form part of

the functional analysis (OECD, 2009:35). The relationships can also be discerned through the conduct of the parties as discussed above.

According to Miller and Oats (2009:310), some common differences identified between contractual terms of independent enterprises and associated enterprises are:

- the accounting for consideration, in that, this is purely an accounting entry to intercompany accounts in the case of associated enterprises, as opposed to being an actual cash flow in the case of independent enterprises;
- warranty terms, in that, associated enterprises will likely require less onerous warranties; and
- collateral transactions, in that, limited or no security may be required by associated enterprises.

3.3.1.4 *Economic circumstances*

It is quite common for arm's length prices to vary in different markets. This is even the case where the same product is sold. Therefore, to achieve comparability between controlled and uncontrolled transactions, the markets in which the enterprises operate should be comparable. (OECD, 2009:35.) The OECD (2009:35) provides a list of some circumstances which may be relevant to determining market comparability. These circumstances include the following:

- size of the market and extent of competition;
- geographic location;
- availability of substitutes;
- consumer buying power;
- government regulation;
- fixed and variable costs;
- timing of the transaction; and
- competitive positions in the market.

Additionally, Miller and Oats (2009:312) also provide the following circumstances which may warrant adjustment:

- similarity of geographic markets;
- the level of the market, in that, wholesale or retail;
- the market share for the products: and
- industry conditions.

In addition to the aforementioned, the enterprise must consider circumstances which are specific to the transaction.

3.3.1.5 *Business strategies*

The business strategy applied by the enterprise may have a significant influence on whether comparability can be achieved (OECD, 2009:35). An example of this would be where a company has a strategy of market penetration and as a result sells products at reduced profitability. It would not be appropriate to compare such a company with an established enterprise which, for example, has already penetrated the market and has the strategy of maintaining and enhancing its existing customer base. (OECD, 2009:36.) The practical problem that arises as a result of such strategies is that the taxpayer may be utilising the strategy to mask transactions which are not at arm's length. As such the revenue authorities have to be vigilant in this regard. (OECD, 2009:37.)

3.3.2 Recognition of actual transactions undertaken

The OECD guidelines on transfer pricing propose that the determination of the transfer price should be based on actual transactions undertaken. The guidelines further establish two instances in which the actual transactions may be disregarded. These two instances include transactions where the economic substance of a transaction differs from its legal form, and transactions where the substance is the same as the form however the arrangement does not make commercial sense from the perspective of independent enterprises and the structuring of the arrangement impedes the tax authorities from determining a valid transfer price. (OECD, 2009:38.)

In the former instance above, the tax authority should disregard the legal form of the transaction and give consideration to the economic substance of the transaction. In the latter case, it may be appropriate for the tax authorities to make the necessary adjustments to the transaction to ensure that it can be viewed in a commercially rational manner. The reasoning behind this is that the transaction would have been structured differently had the parties been trading at arm's length and has only been structured in this manner due to the relationship between the parties. (OECD, 2009:39.)

3.3.3 Evaluation of separate and combined transactions

The OECD guidelines on transfer pricing provide that the most appropriate manner of calculating an arm's length price is likely an evaluation on a transaction-by-transaction basis. However, in situations where the separate transactions are so closely linked such that evaluation on a separate basis is impractical, the arm's length terms should be assessed for the transactions on an aggregate basis. The inverse also holds true, in that some transactions although structured in a combined manner should be evaluated on a separate basis. (OECD, 2009:40.)

3.3.4 Use of an arm's length range

Due to the complexities and application of judgement involved in determining an arm's length price, it may often occur that the application of the most appropriate methods may yield a range of prices which are all equally reliable. Where such differences occur due to the application of various methods, it may indicate inaccuracies within input data, or factors which require additional adjustment in order to achieve comparability. (OECD, 2009:42.)

3.3.5 Losses

Instances where an associated enterprise continues to realise losses where the group realises profits may be an indicator of circumstances which warrant

scrutiny of transfer pricing issues. This may indicate that the loss making enterprise is not adequately compensated in relation to the benefit derived by the group. Recurring losses may however be as a result of valid business reasons as well. (OECD, 2009:44.)

3.3.6 The effect of government policies

Instances may arise where government intervention such as price control, interest rate control, exchange control, other taxes and duties may distort comparability. In some instances the group may compensate the associated enterprise for the effect of these policies. However, it may occur that some groups do not take into account the effect of such policies. In these instances, the profit of the associated enterprises would be significantly affected. The key consideration is that independent enterprises would not continue to provide such goods or services where they were unable to earn profits from these activities. As such, these factors must be accounted for in determining an arm's length price. (OECD, 2009:46.)

3.3.7 Intentional set-offs

Associated enterprises may provide different benefits to each other (OECD, 2009:46). The enterprises may claim that such benefits are in full or part settlement of their obligation and may require that the benefits be set-off against each other and reviewed on a net basis to assess the tax liability. Similar circumstances may occur with independent enterprises and as such the arm's length principle must be applied in quantifying the value of the benefits. It is important to note that the nature of set-off transactions between independent enterprises is generally of a non-complex nature, and therefore complex set-off transactions will likely require adjustment. (OECD, 2009:47.)

3.3.8 Use of multiple year data

It is important to review current as well as prior year data, as this provides an indication of circumstances which may have been prevalent, such as losses which have been recurring for a number of years (OECD, 2009:42). The review also provides information about the business, the product life cycles and most importantly whether any comparable economic conditions had similar effects on independent enterprises. The OECD guidelines also provide for the use of the following years data to clarify facts and circumstances. (OECD, 2009:43.)

3.3.9 Use of customs valuations

Customs authorities also make use of the principle of comparison to determine whether the price at which associated enterprises are importing goods is reasonable. As this assessment occurs at the time of import, it may be valuable to consider the customs valuations performed. In addition, contemporaneous documentation may be available. (OECD, 2009:48.)

3.3.10 Selection of an appropriate pricing methodology

There is no requirement on the taxpayer to use any specific method for the determination of the arm's length price; however the method selected must be supported by the appropriate documented reasoning. The method selected is highly facts and circumstances specific and may take some time in evaluating. (OECD, 2009:49.) The methods of determination of transfer prices will be discussed in detail in the following chapter.

3.4 CONCLUSION

In this chapter the fundamentals of the arm's length principle were considered. The OECD outlines ten factors for consideration in applying the arm's length principle. These factors were considered in detail. In the following chapter, the traditional transaction methods of calculating an arm's length price will be evaluated.

CHAPTER 4
ANALYSIS OF THE TRADITIONAL TRANSACTION METHODS USED IN CALCULATING THE ARM'S LENGTH PRICE

4.1 INTRODUCTION

As discussed in the previous chapter, the arm's length price in transactions between associated enterprises is determined through the application of the fundamental principles and appropriate methods of calculating transfer prices.

In this chapter, the various methods of calculating transfer prices will be considered. The methodologies applied, the circumstances in which such methodologies are applicable, a review of the practical application of such methodologies, a review of the rationale for the methodologies, and a critical analysis of the rationale will be considered. Circumstances under which the methods would be most appropriate would also be considered.

4.2 THE TRADITIONAL TRANSACTION METHODS

Traditional transaction methods are preferred over other methods which are used to determine the arm's length price. These methods provide a concise reflection of the true financial and commercial relationship between associated enterprises. (OECD, 2009:65.)

The OECD transfer pricing guidelines (2009:52) outline three traditional transaction methods. These are:

- the comparable uncontrolled price method;
- the resale price method; and
- the cost plus method.

The methods have been discussed in detail below.

4.2.1 The comparable uncontrolled price ("CUP") method

4.2.1.1 *Definition*

The comparable uncontrolled price method compares prices in a controlled transaction with the prices in a comparable uncontrolled transaction. Differences in these prices would indicate that the transaction is not at arm's length. (OECD, 2009:53.)

4.2.1.2 *Practical application of the comparable uncontrolled price method*

According to the OECD transfer pricing guidelines (2009:53), transactions are considered to be comparable if either one of the following conditions is met:

- none of the differences between the transactions or enterprises being compared, may materially affect the market price; or
- appropriate adjustments can be made to remove the effects of such differences.

Where comparability is possible, the comparable uncontrolled price method is preferred over all other methods of determining transfer prices. However, the need to make adjustments should not preclude the use of the comparable uncontrolled price method. The reliability of the outcome generated by the comparable uncontrolled price method remains dependent, however, on the accuracy of these adjustments and therefore care should be taken in this regard. (OECD, 2009:53.) King (2009:22) indicates that the comparable uncontrolled price method requires a high standard of comparability.

4.2.1.3 *Rationale for the comparable uncontrolled price method*

King (2009:23-24) states that the comparable uncontrolled price method is based on the assumption that prices equalise due to competitive pressure and as such a comparison of prices in a controlled transaction to that of a comparable

uncontrolled transaction would likely provide the best indication of an arm's length price.

4.2.1.4 *Analysis of the comparable uncontrolled price method*

The comparable uncontrolled price method presupposes price equilibrium in competitive markets. Although this remains a valid economic principle, the assumption is dependent of the competitiveness of the market. (King, 2009:24.)

King (2009:24) outlines the circumstances under which a market can be considered competitive:

- products are similar;
- existing firms can expand into the market;
- new firms can enter the market the market;
- consumers are well aware of alternative products; and
- changing suppliers is inexpensive.

4.2.1.5 Circumstances under which the comparable uncontrolled price method is applicable

According to King (2009:26), the comparable uncontrolled price method is most appropriate in a competitive market, where closely comparable transactions or enterprises are available.

4.2.2 Resale price method

4.2.2.1 *Definition*

The resale price method makes use of the prices at which the associated enterprise sells the goods purchased under a controlled transaction to independent third parties as its basis. This price is then adjusted for by an appropriate resale price margin and the residual is regarded as the arm's length price. (OECD, 2009:55.) King (2009:19) simplifies this as being the comparison of

the gross margin earned on goods purchased from associated enterprises to those purchased from independent enterprises.

4.2.2.2 *Practical application of the resale price method*

The resale margin takes into account, amongst others, the following factors:

- selling and general administrative expenses which the reseller would recover; and
- an appropriate profit margin giving consideration to the assets used and risks assumed. (OECD, 2009:55.)

The resale price margin can be determined by reference to margins earned by independent enterprises on comparable transactions (OECD, 2009:55). However, the manner in which the enterprises being compared, carry on their respective businesses, will affect the reliability of the resale price method. This is the case with circumstances which affect the resale margin of a product but not necessarily the price. An example of such a scenario would be where one of the enterprises has a lower cost structure due to efficiencies, or due to differences in functions performed. These differences should be adequately considered in analysing whether the uncontrolled transaction is indeed comparable. (OECD, 2009:57.)

Where products are not sourced from both associated and independent enterprises, the resale price margin can be compared to the margin earned by independent enterprises on similar products sourced from other independent enterprises (King: 2009:18).

The above method is most appropriate when applied to marketing operations as the reseller is often a distributor for the associated enterprise. Fewer adjustments are also required when comparing margins as differences between products generally have a lesser effect on product margins than they do on price. By way of illustration, a company selling different products is performing a similar service in relation to each product, in that it is performing a marketing and distribution function. Compensation is therefore expected to be the same across the

functions. However, the products being sold and marketed may differ in nature, for example fridges versus microwave ovens. As the products are not considered to be substitutes for each other, their prices would be different and an adjustment would be required. (OECD, 2009:56.) That being said, the product being compared in an uncontrolled transaction should still be comparable.

Where a reseller is carrying on a substantial business, as opposed to acting merely as a distributor, a significantly larger gross margin is expected. This would be the case where the reseller possessed valuable marketing intangibles for example. The resale margin is most accurate under the following circumstances:

- the product is not substantially modified from the time of purchase;
- the functions undertaken by the reseller are minimal; and
- the margin is realised within a short time, so that no other factors need to be considered due to the time lapse. (OECD, 2009:58.)

As discussed in the previous chapter, when considering comparability, it is important to identify the assets applied and the risks assumed by the parties being compared. Where distribution takes place through an intermediate company, one should consider whether such company takes up risk or performs an economic function in relation to the goods. If this cannot be demonstrated, then an insignificant portion of profits may be attributable to the intermediary company. (OECD, 2009:58.)

In addition, where a reseller has an exclusive right to resell a product, the resale price margin should be expected to vary. The specific circumstances applicable to the exclusive right of resale will influence the value to be placed on such an exclusive right. Such circumstances would include the geographical scope, market for substitutes and competition. These variances should be adjusted for accordingly. (OECD, 2009:58.)

4.2.2.3 *Rationale for the resale price method*

King (2009:19) suggests that the assumptions underlying the resale price model are that, on an arm's length basis, individual distributors would pay similar prices to multiple suppliers and charge the same price to multiple customers.

4.2.2.4 *Analysis of the resale price method*

King (2009:20) points out that from a business perspective, it is unlikely that margins will be similar across entities. It therefore does not make sense to compare margins with those earned by independent enterprises dealing with each other. It is preferable to compare margins earned by the associated enterprises in transactions with independent enterprises.

Where a comparison is performed internally, that is by a single distributor who acquires goods from both independent and associated enterprises, the rationale behind the resale price method would have merit. The reason for this is that distributors would normally purchase from the supplier offering the lowest price, and therefore any other supplier would have to equalise its price, and thus margins would be comparable. As such internal comparisons are not dependent on market equilibrium as is the case for external comparisons, in that, comparisons with independent enterprises distributing similar products. (King, 2009:20.)

King (2009:20) does however note that the circumstances which would allow for such internal comparisons are limited. The reason being that, distributors would likely not source products from both associated and independent enterprises as associated enterprises would likely provide the best price. Distribution to associated and independent enterprises would also undermine the associated enterprise, in that an associated enterprise would likely give preference to another associated enterprise over an independent enterprise.

4.2.2.5 *Circumstances under which the resale price method is applicable*

King (2009:18) provides the following circumstances under which the resale price method and the cost plus method are applicable:

- a single distributor procures comparable products from associated and independent enterprises; and
- two or more distributors procure comparable products, one from associated enterprises, and the other from independent enterprises.

4.2.3 Cost plus method

4.2.3.1 *Definition*

This cost plus method involves the application of an appropriate cost plus mark up to the cost of the goods acquired in a controlled transaction. The method is most appropriate where semi-finished goods are supplied to the associated enterprise, or where the transaction involves the provision of services. The mark up would be most reflective if it were established by reference to comparable uncontrolled transactions. (OECD, 2009:60.)

4.2.3.2 *Practical application of the cost plus method*

As with the resale price method discussed above, the cost plus method requires fewer adjustments as a result of the nature of the product. Factors discussed under the resale price method should also be taken into account in adjusting the cost plus mark up. (OECD, 2009:60-61.)

Difficulties which arise in the application of the cost plus method derive mainly from the difficulty in identifying costs. It often occurs that costs incurred have no discernable link to the profit to be earned. Examples of this would be products which for example have a higher intangible value, as opposed to costs of production, attached thereto, which intangible was developed through minimal

costs incurred. This would be the case where for example a valuable finding was made with minimal research and development costs. (OECD, 2009:61.)

In addition, other aspects of comparability in the cost base should also be considered in applying the cost plus method. An example of this would be where one of the entities being compared leases the premises on which they operate and the other owns the premises. Such lease costs would normally be absorbed into the cost of the product and would therefore lead to a disparity in margins. It is therefore important to analyse the composition of the costs of the product. Any differences should be appropriately adjusted for. (OECD, 2009:61.)

Accounting differences, such as differences in the classification of expenses as operating expenses rather than cost of sales, should also be appropriately adjusted for. These differences affect the cost base of the product, and would therefore result in inaccurate arm's length prices. (OECD, 2009:62.)

Consideration should also be given to scenarios where the purchaser bears some of the supplier's costs. This would often be the case in multinational groups, where the parent company would normally absorb certain costs in an attempt to reduce the subsidiaries cost base. This may also occur where due the nature of the relationship between transacting parties, the purchaser may for example carry the costs of transportation. Where this is the case in only one of the enterprises being compared, appropriate adjustments must be made in order to achieve comparability. (OECD, 2009:64.)

4.2.3.3 *Rationale for the cost plus method*

King (2009:19) suggests that the assumptions underlying the cost plus model are that, on an arm's length basis, individual manufacturers charge the same price to multiple customers and use similar technologies for products for various customers. Where comparisons are made with independent enterprises who manufacture similar products, the only rationale would be that margins and mark-ups will be equalised by market forces.

4.2.3.4 *Analysis of the cost plus method*

Where a comparison is performed internally, that is by a single manufacturer who produces goods from both independent and associated enterprises, the rationale behind the resale price method would have merit. The reason for this is that manufacturers would normally utilise the same facilities in manufacturing goods for various customers, and therefore mark ups would be comparable. As such internal comparisons are not dependent on market equilibrium as is the case for external comparisons, in that, comparisons with independent enterprises manufacturing similar products. (King, 2009:20.)

As with the resale price method discussed above, King (2009:20) notes that the circumstances which would allow for such internal comparisons are limited. Manufacturers would likely not manufacture products for both associated and independent enterprises as this would undermine the associated enterprise. Such circumstance may arise where a manufacturer wants to reach a different target market though, and in this case may distribute to associated and independent enterprises.

4.2.3.5 *Circumstances under which the cost plus method is applicable*

King (2009:18) provides the following circumstances under which the resale price method and the cost plus method are applicable:

- a single manufacturer sells comparable products to associated and independent enterprises;
- a single service provider render comparable services to both associated and independent enterprises, and uses the same intangible in both instances; and
- two or more manufacturers sell comparable products, one to associated enterprises, and the other to independent enterprises.

4.3 CONCLUSION

In this chapter the traditional transaction methods were evaluated.

The comparable uncontrolled price method is preferred over the other traditional transaction methods. This method incorporates the most accurate measure of comparability and is likely to result in the most accurate arm's length price. Practical difficulties do arise though, as often few companies may meet the stringent comparability criteria required for the application of this method. Lesser preferred yet effective transactional methods also include the resale price method and the cost plus method, the latter being applicable mainly to manufacturers and the former to distributors. In both instances, the assumptions underlying the models are based on atypical circumstances, however where these circumstances are come upon, these methods will prove simple to apply and will likely yield an accurate result.

In the following chapter, alternative methods of calculating the arm's length price will be considered. These will include the two transactional profit methods, being the profit split method; and the transactional net margin method. The following chapter will also consider the global formulary apportionment method, being a non-arm's length method.

CHAPTER 5
ANALYSIS OF THE ALTERNATIVE METHODS USED IN CALCULATING THE ARM'S LENGTH PRICE

5.1 INTRODUCTION

In the previous chapter, the traditional transaction methods were evaluated. These methods involved the application of the arm's length principle to individual transactions in order to determine an appropriate arm's length price. This chapter will consider the alternative methods suggested by the OECD. These include the transactional profit methods and the global formulary approach. The global formulary approach is a non-arm's-length approach, whereas the transactional profit methods discussed below are arm's length approaches which deal with the apportionment of profits. The methodologies applied, the circumstances in which such methodologies are applicable, a review of the rationale for the methodologies, a critique of the rationale and a review of the practical application of such methodologies will be considered below.

5.2 TRANSACTIONAL PROFIT METHODS

Transactional profit methods are designed to evaluate the profits arising from controlled transactions. The profitability of a transaction may be an indicator that a transaction has been affected by conditions other than those which would have existed had the transaction occurred between independent enterprises. (OECD, 2009:67.)

It is important to note, that the transactional profit methods should only be considered as the primary method for determining an arm's length price, if the traditional transaction methods cannot be applied. Great care must be taken in precluding the use of the traditional transaction methods, and the same factors which lead to the conclusion that these methods are not appropriate, should be considered when assessing the applicability of the transactional profit methods. (OECD, 2009:67.)

The OECD transfer pricing guidelines (2009:67) outline two transaction profit methods. These are:

- the profit split method; and
- the transactional net margin method.

The methods have been discussed in detail below.

5.2.1 Profit split method

5.2.1.1 *Definition*

The objective of the profit split method is to determine a division of profits in a controlled transaction that would be consistent with profits that independent enterprises would realise in a joint venture relationship (OECD, 2009:70).

5.2.1.2 *Practical application of the profit split method*

The application of the profit split method entails the division of profits between associated enterprises as though they were independent enterprises in a joint venture relationship (OECD, 2009:70).

The application of the profit split method is therefore conditioned upon projected profits, as it is unlikely that the taxpayer would know the actual profits at the point at which the conditions in a controlled transaction are set (OECD, 2009:70).

Although there are various methods of determining a profit split, the OECD guidelines on transfer pricing outline two such methods (OECD, 2009:71). These methods are referred to as the contribution analysis and the residual analysis.

- **Contribution analysis**

Under the contribution analysis approach, the total profits earned by the associated enterprises, who are party to the controlled transaction, are divided between the associated enterprises based on the functions performed by each

enterprise. External market data, incorporating independent enterprise considerations, is incorporated where the relative values of each enterprise's contributions cannot be measured directly. (OECD, 2009:72.)

The profit which is being considered for division should be the operating profit. However, in some instances, it would be appropriate to split the gross profit and allocate expenses to the enterprises in order to arrive at the operating profit. An example of such an instance would be where a highly integrated multinational enterprise trades through various associated enterprises. In such an instance, it may be possible to allocate expenses to the various trading entities, though it may not be possible to identify the specific trading activities to which they relate. In such an instance, it would be best to split the gross profit between the entities and then allocate the appropriate expenses. (OECD, 2009:72.)

In practice, the allocation of profits proves to be a complicated endeavour as it is often difficult to value each enterprise's contributions (OECD, 2009:72).

- **Residual analysis**

The residual analysis incorporates a two stage approach to determining an appropriate profit split. Firstly, profits are attributed to each enterprise in order to provide the enterprise with a basic return on assets contributed, dependent on the type of transaction undertaken. The return would be based on independent enterprise assumptions, in that, the return which independent enterprises would have earned on similar transactions. (OECD, 2009:72.)

The first stage essentially represents an extension of the cost plus method, where the associated enterprises are allocated a mark up on the costs incurred by them (King, 2009:29).

The second stage would involve the allocation of the remaining profit to the enterprises taking into account their specific contributions, in the form of intellectual property and intangible assets contributed. Once again this allocation would be based on independent enterprise assumptions. (OECD, 2009:73.)

The allocation serves as compensation based on the relative values of the intangibles contributed by each party, and is made based on profits which are adjusted for the amortisation of intangibles (King, 2009:29).

According to King (2009:29), the process essentially involves the following:

- identification of the expenditure which gives rise to intangibles;
- estimation of the time which elapses between making the investment in intangibles and yielding the return; and
- estimation of the useful lives of such intangibles.

The OECD guidelines on transfer pricing (2009:73) suggest that a possible approach to performing the residual analysis would be to consider the lowest price which an independent seller would willingly accept. This would correspond with the basic return. Any difference between the independent seller's minimum price and the independent buyer's maximum price would represent a negotiation band, which represents any residual profit which to be divided in stage two.

An alternative approach, which in not discussed in detail within the guidelines (2009:74), would be to split profits based on the same return on capital employed. The OECD guidelines on transfer pricing (2009:74) do however point out that this method would not take into account various matters such as conditions in the capital markets. Consequently this approach is not highly recommended (OECD, 2009:74).

5.2.1.3 *Rationale for the profit split method*

The profit split method is based on the premise that operating income is generated through a combination of the application of tangible and intangible assets. The method acknowledges that intangible assets may contribute significantly to the value of a transaction and may be intricately woven into the transaction, such that the profit from the transaction as a whole must be considered. (King, 2009:29.)

The profit split method, specifically when applying the contribution analysis, presumes that division of assets, risks and labour between independent enterprises allows for a reasonable approximation of each companies capital employed (King, 2009:31).

5.2.1.4 *Analysis of the profit split method*

An advantage of the profit split method is that it does not rely directly on closely comparable transactions and can therefore be used where no comparable transactions exist. External data from independent enterprises is used to assess the risks assumed and the assets utilised by the associated enterprises and not to determine the profit split. The method can therefore incorporate unique circumstances, but continues to remain an arm's length approach, as it reflects assumptions that would be applied by independent enterprises. (OECD, 2009:69.)

This does also have a downside, as the data is less closely related to actual transactions than other methods. This may result in varying and subjective profit allocation. (OECD, 2009:69.)

The method encompasses a double sided approach by evaluating both associated enterprises and thereby ensuring an equitable profit result for both parties based on the relevant facts and circumstances. The method consequently also allows for a profit split taking into account efficiencies and benefits due to economies of scale. (OECD, 2009:70.)

Due to the fact that the profit split method makes use of the data of both associated enterprises, one of the difficulties encountered when applying the method is the availability of information of the foreign associated enterprise. In addition it is often difficult to measure the profits of associated enterprises as accounting and foreign currency adjustments required in order to align the results. (OECD, 2009: 69.)

King (2009:30) emphasises that one of the greatest shortcomings of the method, when applying the residual analysis, is that the residual of combined profits less adequate compensation for costs, does not necessarily equate to the value of the intangible assets. Post tax cash flows adjusted for cash flows attributable to the tangible assets would best reflect the intangible value in a transaction.

In addition, when applying the contribution analysis, the likelihood of identifying comparable entities in a joint venture relationship, even one which is simulated, is far removed and as such the method is seldom applied in practice (King, 2009:30).

5.2.1.5 *Circumstances under which the profit split method is applicable*

The profit split method is applied in instances where transactions are so interrelated that they cannot be evaluated in isolation. The method is designed to split profits based on a functional analysis performed. (OECD, 2009:69.)

The profit split method is best applied where the associated enterprises own valuable intangible property and as a result, neither the traditional transaction methods nor the transaction net margin method are appropriate (King, 2009:29).

5.2.2 Transactional net margin method

5.2.2.1 *Definition*

According to the OECD transfer pricing guidelines the transactional net margin method “examines the net profit margin relative to an appropriate base” (OECD, 2009:74). This essentially refers to the application of an appropriate accounting rate of return to the appropriate base in order to calculate each party’s profitability. Examples of such rates of return would be operating profit as a percentage of sales or return on assets. The method is akin to the resale price method and the cost plus method and should therefore be applied in a manner consistent with those methods.

The application of the method presupposes the existence of uncontrolled comparable transactions, be it within the entity or within independent enterprises (OECD, 2009:75).

5.2.2.2 *Practical application of the transactional net margin method*

The comparable profits method is a method similar to the transactional net margin method and is acceptable in the United States of America (King, 2009:12).

King (2009:13) outlines the following steps in the application of the comparable profits method:

- the appropriate accounting rate of return is identified and calculated;
- the above rate of return is applied to the appropriate base;
- a range of arm's length results are identified;
- an interquartile range is determined; and
- a profit contained within the range is selected.

According to King (2009:13), the OECD guidelines essentially apply the same process as above, however the guidelines do not favour the use of an interquartile range, and place significant emphasis on comparability and functional analysis.

The use of the transactional net margin method also requires a higher degree of comparability between enterprises where the comparable uncontrolled transactions are those of independent enterprises (OECD, 2009:77).

All transfer prices are affected in some way by external factors. For example, product differences between comparable entities, would affect the transaction price. Likewise, functional differences would affect margin. Net margins however, lead to volatility in comparison due to the number of factors which affect net margins, such as differences in operating expenditure. (OECD, 2009:78.)

The OECD guidelines on transfer pricing (2009:78) outline the following factors which may affect net margins:

- competitiveness within the market;
- risk of new entrants to the market;
- threat of alternative products;
- efficiencies in management and production;
- specific strategies implemented by management; and
- differences in financing structures.

The OECD guidelines on transfer pricing reiterate that the transaction net margin method should only be used where internal comparable uncontrolled transactions are available or, in instances where only uncontrolled transactions undertaken by independent enterprises are available for comparison, the making of appropriate adjustments should be possible (OECD, 2009:78).

The transactional net margin should not be determined based on a company wide base, but rather applied to margins applicable to the transaction. Therefore, only the profits and expenses applicable to the controlled transaction should be considered in applying the transactional net margin method. (OECD, 2009:79.)

The transactional net margin method should be applied to the associated enterprise for which the most reliable data on comparable transactions is available (OECD, 2009:79).

5.2.2.3 *Rationale for the transactional net margin method*

King (2009:14) outlines the following assumptions upon which the transactional net margin method operates:

- product and markets are competitive and in equilibrium;
- as a result rates of return across various entities are standardised; and
- mark ups on cost are standardised across various entities.

5.2.2.4 *Analysis of the transactional net margin method*

An advantage of the transactional net margin method is that net margins are relatively inelastic in response to transactional differences, unlike prices, which rely to a greater degree on comparable transactions. Net margins, unlike gross margins, may also be affected to a lesser degree by differences in function between controlled and uncontrolled transactions. (OECD, 2009:75.) As such, comparable independent entities need only deal in broadly similar products and perform broadly functions to the associated enterprises involved in a controlled transaction (King, 2009:12).

The converse is also true, where the net margins may incorporate factors which would have little or no bearing on price and gross margins. This would be the case where operating expenses such as depreciation and payroll costs differ between entities being compared and there have a direct impact on the net margin. Such factors would compromise the accuracy and reliability of the arm's length price and would consequently be a downfall of the method. (OECD, 2009:75)

King (2009:15) does however note that, market equilibrium is a condition for a stabilisation in the economic rate of return and not necessarily the accounting rate of return. As a result, the assumption underlying the transactional net margin method is inherently flawed.

Unlike the profit split method, the analysis of functions performed, risks assumed and assets utilised, does not have to be performed for both the associated enterprises. This provides some practical relief from the requirement to align the basis of accounting applied by each associated enterprise. (OECD, 2009:75.)

However, given that there are a number of factors that affect the net margin; this may also prove to be a weakness of the method. A one sided analysis would ignore group profitability and may result in an inappropriate transfer price. (OECD, 2009:76.)

As with the other methods of determining an arm's length price, the accurate and appropriate use of the transactional net margin method is based on the availability of prospective information. This may pose some practical difficulties and the use of estimates may be required. The information required in the application of this method is potentially far more substantial depending on the base used. For example, where operating profit as a percentage of sales is considered to be the most appropriate margin, an estimate would have to be made of the revenue and expenses for both the controlled and uncontrolled transaction. This situation would be compounded where no internal comparable transactions are available and comparison is made between independent enterprises. (OECD, 2009:76.)

As is evident, the degree of estimation involved would be far more than that which is required in the traditional transaction methods and this would impact the accuracy and the reliability of the arm's length price determined. (OECD, 2009:76.)

5.2.2.5 Circumstances under which the transactional net margin method is applicable

According to King (2009:12), the transactional net margin method is applicable to:

- the sale of tangible property;
- the licensing of intangible assets; or
- services performed on behalf of associated enterprises.

King (2009:14) points out that, the transactional net margin method should only be applied where the other methods cannot be applied.

5.2.3 Conclusions on the transactional profit methods

The OECD guidelines on transfer pricing give preference to the traditional transaction methods and discourage the use of the transactional profit methods (OECD, 2009:81). The guidelines recommend that the transactional profit

methods should be used only as a supplement to the traditional transaction methods or, in rare circumstances, where the traditional transaction methods cannot be applied (OECD, 2009:81). The guidelines emphasise that such circumstances generally arise only when there are contingencies regarding the sufficiency or reliability of available information (OECD, 2009:81).

The OECD guidelines on transfer pricing also point out that in most countries the use of the transactional profit methods has been limited to the profit split method, and these situations have been limited. The guidelines therefore caution against the use of these methods and suggest that a tax administration should never allow the use of these methods where the legislative process does not adequately allow for the necessary safeguards (OECD, 2009:82).

The application of these methods also places a substantial burden on the tax administration which asserts the use of these methods, to demonstrate the appropriate use of the method, and to provide evidence that the method does indeed provide the most accurate arm's length price given, the relevant facts and circumstances of the case.

5.3 THE GLOBAL FORMULARY APPORTIONMENT: A NON-ARM'S-LENGTH APPROACH

5.3.1 Definition

The global formulary apportionment method is a non-arm's-length method which seeks to split total profits between associated enterprises based on predetermined formulae (OECD, 2009:84).

5.3.2 Guidance on application of the global formulary apportionment method

The global formulary apportionment method involves a three step approach to determining the profit split outlined as follows:

- firstly, identification of the enterprises which will form part of the global taxable entity;
- secondly, making a determination of the profits for those entities; and
- lastly, determining the formula to be used in allocating the profits (OECD, 2009:84).

The formula applied would generally factor in elements such as employee costs, costs of other inputs, sales, and other assets contributed. The method is advocated as an alternative to the arm's length methods. Potential benefits of this method are seen to be:

- administrative convenience;
- provision of a degree of certainty to the taxpayer;
- a reduction in compliance cost; and
- relief from the application of various methods in varying transactions within a single group (OECD, 2009:84).

5.3.3 Evaluation of the global formulary apportionment method

The OECD guidelines on transfer pricing contend that the global formulary apportionment method is an unacceptable alternative for the following reasons:

- the implementation of the method potentially leads to double taxation, due to the fact that the various tax administrations would likely not reach consensus as there are a number of underlying matters which must be agreed upon;
- the countries would each promote the inclusion of different factors in determining the formula, in order to broaden the tax base of the *fiscus*;
- manipulation of the formula may result in tax avoidance;
- the method would require co-operation by various countries in which the multinational organisation operates, which co-operation is unlikely at such an international scale;
- the allocation of profits is arbitrary and disregards market factors, as such the method could lead to profits being allocated to entities which are otherwise loss making;

- the method is influenced to a greater extent by movements in currency exchange rates and therefore reduces the effectiveness of the profit allocation;
- the method requires alignment of accounting principles across the entire group, thereby increasing documentary and compliance requirements;
- difficulties arise in consistently valuing each entities assets and intangibles;
- the method essentially taxes the group and not the individual entities and would therefore ignore factors specific to the entity and its economic environment; and
- the method may also result in an individual entity being allocated a profit while the group is in a loss position (OECD, 2009:85).

The global formulary apportionment method is viewed as ultimately undermining the arm's length principle under which the transfer pricing framework is designed. The OECD is firm in its dismissal of the approach, as is apparent from the criticism raised above (OECD, 2009:85).

5.4 CONCLUSION

In this chapter transactional profit methods and the global formulary apportionment method were discussed. These methods are alternative methods to the traditional transaction methods, suggested by the OECD. The OECD has repeatedly emphasised that the transactional profit method should only be applied where the application of the traditional transaction methods is not possible. All the factors which were considered in concluding that the traditional transactions methods were not applicable should be considered again in evaluating the applicability of the transactional profit methods.

The OECD does not support the use of the global formulary apportionment method as it is seen to undermine the arm's length principle. The OECD views the allocation derived under this method to be arbitrary as it ignores a number of factual elements of the transaction.

In the following chapter, transfer pricing will be considered in the context of developing and developed economies. The chapter will consider the guidance issued by the national tax authorities, including the preference for specific methods of determining the arm's length price, and how such guidance compares to the OECD guidelines.

CHAPTER 6
EVALUATION OF TRANSFER PRICING PRACTICES IN DEVELOPING AND DEVELOPED COUNTRIES

6.1 INTRODUCTION

In the previous chapter, the transactional profit methods, as well as the global formulary apportionment method of determining a transfer price, were evaluated. In this chapter, transfer pricing will be considered in the context of developed countries being Japan and the United States of America, as well as developing countries, being India and South Africa. As the fundamental principles of transfer pricing, as well as the various methods of determining arm's length prices have been discussed at great length in the preceding chapters, this chapter will consider aspects where differing or additional guidance is given over and above that provided in the OECD guidelines on transfer pricing.

The following aspects of transfer pricing in the above mentioned countries will be considered:

- the history of transfer pricing;
- the practice of transfer pricing, including whether such practices are embodied in legislation, and whether any additional guidance has been provided by the national tax authorities;
- definitions which are critical to the practice of transfer pricing;
- aspects of the practical application of transfer pricing, including the methods prescribed by the national tax authorities, and any relevant guidance thereto;
- comparison of the arm's length methods applied, to those outlined by the OECD guidelines; and
- the documentation requirements or any guidance provided by the national tax authorities.

6.2 TRANSFER PRICING IN SOUTH AFRICA

6.2.1 History of transfer pricing in South Africa

According to Mazansky (2005:2), transfer pricing and thin capitalisation rules were introduced into the Income Tax Act in 1995. The South African Revenue Service (SARS) subsequently issued the Practice Note 7 "Determination of Taxable Income of Certain Persons from International Transactions: Transfer Pricing" in 2009. The Practice Note contains comprehensive guidance on acceptable transfer pricing methods as well as documentation requirements. The Practice Note is based largely on the OECD guidelines on transfer pricing.

6.2.2 Practice of transfer pricing in South Africa

The transfer pricing provisions in South Africa are embodied within section 31 of the Income Tax Act. Section 31 is titled "Determination of taxable income of certain persons in respect of international transactions".

In addition, South African Practice Note 7 was also issued by the SARS. Sections 31(1) and 31(2) of the Income Tax Act deals with transfer pricing, and section 31(3) deals with thin capitalisation.

Section 31(2) of the Income Tax Act outlines three requirements in order for the provisions on the section to apply to a transaction. These are that:

- there must be a supply of goods and services between a resident and a non-resident;
- the parties should be connected persons; and
- the transaction should be at a price above or below the arm's length price.

Where the above conditions are met, section 31(2) provides that the Commissioner for the SARS may adjust the consideration to reflect the arm's length price.

6.2.3 Key definitions related to transfer pricing in South Africa

6.2.3.1 *Arm's length price*

Section 31 of the Income Tax Act does not provide a definition for the arm's length price, however; its meaning can be inferred from the wording of section 31(2)(c)(i). Section 31(2)(c)(i) makes reference to a price that such goods and services would have fetched in a transaction between independent persons dealing at arm's length. The key element of the definition is that the transaction should be between independent persons.

6.2.3.2 *Connected person*

The connected person definition is embodied in section 1 of the Income Tax Act. The definition is not specific to transfer pricing and is referred to in many other sections of the Income Tax Act. The definition therefore deals with various persons, including all forms of natural and juristic persons.

For the purposes of this transfer pricing analysis, only persons regarded as connected persons in relation to companies have been considered. It is noteworthy however, that the wording of section 31(2) makes room for a much broader application of the law as it refers to transactions between residents and non-residents.

Section 1(d) of the Income Tax Act states that two companies are considered to be connected if:

- one company is the holding company of the other company;
- one company is the subsidiary of the other company;
- both companies are subsidiaries of the same holding company;
- one company holds at least 20% of the other company and no other shareholder has majority voting rights; or
- both companies are managed or controlled by the same person or a person connected to such person.

The Income Tax Act makes reference to the South African Companies Act, 61 of 1963 in order to clarify the definition of holding company and subsidiary company.

According to section 1 of the Companies Act ,a company ("B") is a subsidiary of a holding company ("A") if "A" is a member of "B" and

- "A" holds the majority voting rights in "B";
- "A" has the right to appoint or remove a majority of the directors of "B"; or
- "A" has control over majority voting rights in "B", either through agreement with other shareholder or otherwise.

6.2.4 Practical application of the arm's length principle in South Africa

The practical guidance on the application of the arm's length principle is embodied in Practice Note 7 of the Income Tax Act.

Although South Africa is not a member of the OECD (OECD, 2009), Practice Note 7 outlines the guidance provided within the OECD guidelines on transfer pricing and paragraph 3.2 of the Practice Note states that these guidelines should be referred to in the absence of specific guidance. The Practice Note discusses the arm's length principle, the principles of comparability, acceptable methods for the determination of the arm's length price, aspects of practical application of such methods, as well as examples of the application of the various methods.

Paragraph 9.2.4 of the Practice Note states that the commissioner endorses the traditional transaction methods, being the comparable uncontrolled price method; the resale price method; and the cost plus method, as well as the transactional profit methods, being the transactional net margin method and the profit split method. No other methods have been specified in the Practice Note.

6.2.5 Comparison of the arm's length methods applied in South Africa to those prescribed by the OECD

Paragraph 3 of Practice Note 7 states that the guidance the OECD guidelines are acknowledged as an important document, and therefore the Practice Note is based mainly on the OECD guidelines on transfer pricing. The Practice Note therefore endorses the application of the methods outlined by the OECD guidelines on transfer pricing.

The Practice Note states that no hierarchy is specified with regards to the most appropriate method however, the traditional transaction methods are preferred. This is consistent with the OECD transfer pricing guidelines (2009:43).

6.2.6 Documentation requirements in South Africa

In an addendum to Practice Note 7, published on 29 September 2005, the SARS clarified the requirements of paragraph 10.2.1 by reiterating that there are no legislative requirements for the preparation and maintenance of transfer pricing documents.

General legislative guidance, with regards to documents to be maintained and furnished by the tax payer to the SARS, are contained in sections 74, 74A, 74B, 74C, 74D and 75. These requirements relate to all documentation which can be requested by the SARS. The requirements are not specifically designed for transfer pricing transactions.

Paragraph 10.3 of the Practice Note provides that the documentation guidance provided within the Practice Note largely resembles chapter V of the OECD guidelines on transfer pricing.

Paragraph 10.3 of Practice Note outlines the following documentary requirements:

- an detailed description of the process followed by an entity in determining transfer prices;
- details of the functional analysis performed;
- identification of controlled transactions;
- copies of the international agreements related to controlled transactions;
- a description of the nature and terms (including prices) of all the relevant transactions;
- the method applied in deriving the nature and terms of the transactions;
- justification and support for the method applied given the specific circumstances of the transaction;
- an explanation of the process applied in selecting the most appropriate method of calculating an arm's length price;
- justification and support for the method applied, specifically, the reason why the method is believed to yield an accurate arm's length price;
- any other information used in determining arm's length terms; and
- details of any special circumstances that have influenced the price.

6.3 TRANSFER PRICING IN INDIA

6.3.1 History of transfer pricing in India

In 2001, the Indian tax administration introduced a comprehensive code on transfer pricing into the Indian Income Tax Act, 43 of 1961. The code dealt with administrative and documentary requirements related to transfer pricing, as well as outlining the costs of non-compliance. Since then, a task force of transfer pricing officers, having performed numerous audits, carried out transfer pricing adjustments in approximately 250 cases. (Mukherjee, 2005:314.)

6.3.2 Practice of transfer pricing in India

The transfer pricing provisions in India are embodied within the Indian Income Tax Act and the Indian Income Tax Rules of 1962. The tables below outline the relevant sections and rules applicable to transfer pricing guidance.

Table 10: Relevant transfer pricing sections embodied in the Indian Income Tax Act

Section	Title
92	Computation of income from international transaction having regard to arm's length price
92A	Meaning of associated enterprise
92B	Meaning of international transaction
92C	Computation of arm's length price
92CA	Reference to transfer pricing officer
92CB	Power of Board to make safe harbour rules
92D	Maintenance and keeping of information and document by persons entering into an international transaction
92E	Report from an accountant to be furnished by persons entering into international transaction
92F	Definitions of certain terms relevant to computation of arm's length price, etc
93	Avoidance of income-tax by transactions resulting in transfer of income to non-residents

Table 11: Relevant transfer pricing rules embodied in the Indian income tax rules

Rule	Title
10A	Meaning of expressions used in computation of arm's length price
10B	Determination of arm's length price under section 92C
10C	Most appropriate method
10D	Information and documents to be kept and maintained under section 92D
10E	Report from an accountant to be furnished under section 92E

6.3.3 Key definitions related to transfer pricing in India

The Indian Income Tax Act contains a number of definitions applicable to the transfer pricing legislation. Two such definitions which are pertinent in the context of this study are the definition of the arm's length price, and the definition of an associated enterprise. These definitions have been analysed below.

6.3.3.1 *Arm's length price*

Section 92F (ii) of the Indian Income Tax Act defines the arm's length price as a price applied in an uncontrolled transaction between persons other than associated enterprises.

6.3.3.2 *Associated enterprises*

Section 92A (1) of the Indian Income Tax Act provides a general definition of associated enterprises. Section 92A (2) of the Indian Income Tax Act provides specific scenarios under which enterprises would be considered to be associated.

Section 92A (1) of the Indian Income Tax Act provides that, an enterprise is an associated enterprise in relation to another enterprise,

- where one enterprise participates in the management, control or capital of the other enterprise; or
- where one or more persons participate in the management, control or capital of both enterprises.

Sections 92A (2) (a)-(m) of the Indian Income Tax Act provide specific clarification of the above definition and have been explained below. For the sake of simplicity the first enterprise will be referred to as "A" and the second, as "B".

"A" and "B" are associated enterprises where:

- "A" holds at least 26% of the voting power in "B";
- any person holds at least 26% of the voting power in both "A" and "B";
- a loan advanced by "A" to "B" constitutes at least 51% of the book value of "Bs" total assets;
- "A" guarantees at least 10% of the total borrowings of "B";
- more than 50% of "Bs" board of directors are appointed by "A";
- one or more executive directors of "Bs" board of directors are appointed by "B";

- the same person may appoint more than 50% of the board of directors of both "A" and "B";
- the same person may appoint one or more executive directors of both "A" and "B";
- the manufacture of goods by "B" is wholly dependent on the use of intangible assets of which "A" is the owner, or to which "A" has exclusive rights;
- at least 90% of the raw materials required in the manufacture of goods by "B" are supplied by "A"; or by a person specified by "A", and the price and other conditions are specified by "A";
- goods manufactured by "B" are sold to "A"; or to persons specified by "A", and the pricing of such goods is controlled by "A";
- both "A" and "B" are controlled by the same individual or his relative;
- both "A" and "B" are controlled by a Hindu undivided family, or a member thereof, or a relative of a member of a Hindu undivided family;
- "A" owns at least 10% of "B", and "B" is a firm, association of persons or body of individuals; or
- "A" and "B" have a relationship of interest which may be prescribed.

For the definition above, it should be noted that:

- a holding refers to both direct or indirect holding through intermediaries;
- board of directors may also refer to a governing board;
- person may also refer to persons; and
- "A" and "B" can be considered interchangeably.

6.3.4 Practical application of the arm's length principle in India

Specific requirements with regards to the computation of the arm's length price have been included in section 92C of the Indian Income Tax Act. The section mandates the use of one of the following methods as is most appropriate:

- comparable uncontrolled price method;
- resale price method;
- cost plus method;
- profit split method;

- transactional net margin method; or
- any other method prescribed by the Central Board of Direct Taxes.

Section 92C of the Indian Income Tax Act also provides for the following:

- where more than one price is determined by the most appropriate method, the arithmetic mean shall be the arm's length price; and
- where the difference between the actual price and the calculated arm's length price is 5% or less, the actual price will be considered to be the arm's length price.

Further guidance on the computation of the arm's length price is provided in rule 10B of the Indian Income Tax Rules. The rule provides guidance for application for each method. The rule also outlines the criteria for comparability which are consistent with those in the OECD guidelines on transfer pricing.

Rule 10B of the Indian Income Tax Rules provides an additional requirement as regards the data which should be used in the computation of the arm's length price. The rule requires that the data used in the comparability analysis should be data related to the current financial year or, data of two years prior to the financial year may be used, where the data may reveal facts which may influence the transfer price.

6.3.5 Comparison of the arm's length methods applied in India to those prescribed by the OECD

The methods prescribed by the Indian Income Tax Act, and the guidance provided by the Indian Income Tax Rules are similar to the guidance provided by the OECD guidelines on transfer pricing. The OECD guidelines also outline the use of the methods detailed by the Indian Income Tax Act.

There are two main differences noted between the requirements of the Indian Income Tax Act and the OECD guidelines. These are that section 92C of the Indian Income Tax Act allows for a 5% margin of error from the arm's length price

determined and, where multiple prices are determined by a method, an arithmetic mean can be considered to the be the arm's length price.

The guidance in rule 10B of the Indian Income Tax Rules are however not as detailed or prescriptive as the OECD guidelines, as the guidelines provide various considerations and examples.

6.3.6 Documentation requirements in India

The legislative requirement to keep and maintain documents in respect of international transactions is embodied in section 92D of the Indian Income Tax Act. The section requires that appropriate information should be maintained, and that such information may be called upon for inspection.

Rule 10D of the Indian Income Tax Rules provides specific guidelines as to the documentation which should be kept and maintained by every person who has entered into an international transaction. An enterprise which has entered into an international transaction with an affected enterprise should maintain the following documentation:

- a detailed ownership structure;
- a profile of the multinational group to which the enterprise belongs including the name, address, legal status and country of tax residence of each of the associated enterprises with whom international transactions have been effected, and ownership linkages among them;
- a broad description of its business and the industry in which it operates, and of the business of the associated enterprises with whom it has transacted;
- the nature and terms of international transactions;
- details of property transferred or services provided;
- the value of each such transaction or class of such transaction;
- a description of the functions performed, risks assumed and assets employed or to be employed by both the associated enterprises;
- a record of the economic and market analyses;

- where pertinent to the international transaction, forecasts, budgets or any other financial estimates for the business and for each division or product separately;
- a record of comparable uncontrolled transactions evaluated in assessing comparability of the transactions,
- a record of the nature, terms and conditions relating to any uncontrolled transaction with third parties which may be of relevance to the pricing of the international transactions;
- a record of the functional and comparability analyses performed;
- a description of the methods considered for determining the arm's length price in relation to each international transaction or class of transaction;
- a description of the method selected and motivation for such selection; and
- a description of the manner in which the method was applied.

In addition section 92E of the Indian Income Tax Act requires that any company, which has undertaken a transaction with an associated enterprise, should obtain a report from an accountant and submit such report to the tax authorities.

6.4 TRANSFER PRICING IN JAPAN

6.4.1 History of transfer pricing in Japan

In 1986, Japan enacted the Special Measures Concerning Tax Act, 26 of 1957. This remains the basis of transfer pricing legislation in Japan. Japan is a member country of the OECD and therefore uses the guidelines issued by the OECD as the basis for determination of the arm's length price. (OECD, 2009:1.)

In addition to the specific legislation contained in the Special Measures Concerning Tax Act, the National Tax Agency of Japan has also issued administrative guidelines, for the practical application of the legislation. The administrative guidelines were revised in October 2008 to provide guidance on transactions treated as deemed contributions, the treatment of intra-group services, and the deadline for submitting advanced pricing arrangements. The

administrative rules were further amended in June 2010 to include further guidance on documentation. (Transfer Pricing Associates, 2010:1.)

6.4.2 Practice of transfer pricing in Japan

Transfer pricing legislation in Japan is embedded in Article 66-4 of the Act on Special Measures concerning Taxation. The section, entitled “Special Taxation Measures of Transactions between Corporations and Foreign-related Persons”, is supplemented by the commissioner’s directive on the operation of transfer pricing. A supplement thereto, containing case studies on the application of the arm’s length price under certain predetermined conditions has also been issued by the National Tax Agency of Japan. (OECD, 2009:1.)

6.4.3 Key definitions related to transfer pricing in Japan

6.4.3.1 *Foreign-related person*

Article 66-4(1) of the act, defines a foreign-related person as a foreign corporation having an associated relationship with another corporation.

6.4.3.2 *Associated relationship*

According to article 66-4(1) of the act, a corporation is treated as associated with another corporation if it holds 50 percent or more of the total number of issued stocks or the amount of investment of such other corporation.

6.4.4 Practical application of the arm’s length principle in Japan

Article 66-4(2) of the act provides that the arm’s length price is calculated by the use of one of the following methods:

- the comparable uncontrolled pricing method;
- the resale price method;
- the cost plus method; or

- methods equivalent to the above methods

Article 66-4(2) also provides that other methods such as the profit split method and transactional net margin method may be used. Such equivalent methods, profit split method, or transactional net margin method may only be applied if the first three methods cannot be applied.

6.4.5 Comparison of the arm's length methods applied in Japan to those prescribed by the OECD

Japan is a member of the OECD. The Commissioner's directive (NTA, 2005:4) on the operation of transfer pricing makes reference to the OECD guidelines on transfer pricing and requires that these guidelines should be referred to in the examination of a transaction by a tax authority. In addition, the guidelines provided on the application of the arm's length price are similar to those of the OECD.

The Commissioner's directive on the operation of transfer pricing does however provide for some differences between the OECD guidelines on transfer pricing. One such difference is that the directive allows for the use of an average price where a range of arm's length prices is determined. (NTA, 2005:17.)

The Commissioner's directive (NTA, 2005:17) on the operation of transfer pricing also provides specific guidelines in addition to those generally provided by the OECD. Among these, adjustments are required for the following:

- where products are shipped under different shipping terms, adjustments must be made for insurance and freight where applicable;
- where there is a time lag between the date of purchase and the date of calculating a transfer price, an appropriate adjustment should be made for interest; and
- volume rebates should be adjusted for.

6.4.6 Documentation requirements in Japan

The National Tax Administration amended the act and the Enforcement Regulation 22-10 on 1 April 2010. As a consequence of the amendment, documentation requirements have been introduced into legislation. The requirements outline information which must be maintained for intercompany transactions as well as documentation which must be maintained in calculating the arm's length price. The specific documentary requirements are as discussed below. (Transfer Pricing Associates, 2010:2.)

6.4.6.1 *Documentation related to the relationship and business of the related entities*

The Commissioner's directive (NTA, 2005:5-6) on the operation of transfer pricing lists the following documents which should be maintained to demonstrate the relationship and type of business which the parties undertake:

- details of the capital and business relationship between the corporations;
- details of current, as well as any major changes to, shareholders of the corporations;
- financial statements and reports on the details of business for each corporation;
- details of the major product lines of the corporations;
- details of the transaction price of each product;
- details of the selling markets of each product;
- details of the market size of each product;
- details of the results and characteristics of each business; and
- any other details of business of the corporations.

6.4.6.2 *Documentation related to intercompany transactions*

The Commissioner's directive (NTA, 2005:6-7) on the operation of transfer pricing lists the following documents which should be maintained for intercompany transactions:

- details of assets utilised and the services provided;
- risks assumed and functions undertaken by each related party;
- details of any intangible assets used;
- any intercompany contracts entered into;
- pricing policies or negotiations;
- profits earned or losses incurred by each related party;
- a detailed market analysis;
- the business strategies of the parties; and
- if applicable, details of other closely related transactions.

6.4.6.3 *Documentation related to the computation of the arm's length price*

According to the Commissioner's directive (NTA, 2005:7) on the operation of transfer pricing, the following documents should be maintained with regards to the arm's length price calculated:

- the transfer pricing method selected and the rationale therefore;
- the process applied in selecting comparable transactions and details of selected comparables;
- calculation of profit attributable to each related party where the profit-split method or transaction net margin method is applied;
- where multiple transactions are aggregated, a suitable justification and details of the individual transactions;
- details of adjustments made.

6.4.6.4 *Other documentation*

According to the Commissioner's directive (NTA, 2005:8) on the operation of transfer pricing, the following general documents should be maintained:

- accounting standards' manual of the corporations;
- details of any transfer pricing examinations conducted by foreign tax authorities;

- any documents prepared by the related party in terms of the requirements of its tax jurisdiction; and
- any other documents.

6.5 TRANSFER PRICING IN THE UNITED STATES OF AMERICA

6.5.1 History of transfer pricing in the United States of America

Section 482 was introduced as part of the Internal Revenue Code of 1954 in 1968. The Internal Revenue Code of 1954 was redesignated as the Internal Revenue Code of 1986. The section was subsequently amended to include transfer pricing provisions on intangible assets. In 1995 regulation 1.482 was introduced in the Code of Federal Regulations to provide further clarification on the application of section 482. (Miller & Oats, 2009:307.)

6.5.2 Practice of transfer pricing in the United States of America

The principle section governing transfer pricing in the United States of America is section 482 of the Internal Revenue Code of 1954. Section 482 provides that the secretary of the treasury may apportion gross income, deductions, credits, or allowances in transactions between entities owned or controlled by the same interests.

Section 482 of the Internal Revenue Code of 1954 is further clarified through corresponding regulation 1.482 embedded in the Code of Federal Regulations in 1995. Regulation 1.482 is effective for taxable years beginning after October 6, 1994. The regulation provides comprehensive guidance on the application of the arm's length principle, supplemented by examples and other practical considerations. The sub-regulations contained within regulation 1.482 have been considered below.

Table 12: Relevant transfer pricing rules embodied in regulation 1.482

Sub-regulation	Title and content
1.482-1	**"Allocation of income and deductions among taxpayers"** The sub-regulation provides comprehensive guidance on the general aspects of transfer pricing. Key guidance included in the sub-regulation is: the purpose and scope of section 482 of the Internal Revenue Code; the arm's length standard and methods allowed; guidance on determining of the best method to apply; guidance on comparability; and guidance on the arm's length range.
1.482-2	**"Determination of taxable income in specific situations"** The sub-regulation provides guidance with regards to transfer pricing considerations when loans or advances are provided.
1.482-3	**"Methods to determine taxable income in connection with a transfer of tangible property"** The sub-regulation provides guidance on the application of the comparable uncontrolled price method, the resale price method and the cost plus method.
1.482-4	**"Methods to determine taxable income in connection with a transfer of intangible property"** The sub-regulation outlines considerations specific to determining arm's length prices for the transfer of intangible property.
1.482-5	**"Comparable profits method"** The sub-regulation provides guidance on the application of the comparable profits method.
1.482-6	**"Profit split method"** The sub-regulation provides guidance on the application of the profit split method.
1.482-7	**"Sharing of costs"** The sub-regulation provides guidance on the sharing of costs between entities with a group.

Sub-regulation	Title and content
1.482-8	**"Examples of the best method rule"** The sub-regulation provides examples on applying the best method rule, which outlines the manner in which the best method should be selected.

6.5.3 Key definitions related to transfer pricing in the United States of America

6.5.3.1 *Arm's length price*

Neither the Internal Revenue Code nor the Code on Federal Regulations provide a definition of an arm's length price. The meaning may however be inferred from sub-regulation 1.482-1(b). The sub-regulation provides that a controlled transaction meets the arm's length standard "if the results of the transaction are consistent with the results that would have been realised if uncontrolled taxpayers had engaged in the same transaction under the same circumstances".

6.5.3.2 *Controlled company*

Section 482 of Internal Revenue Code makes reference to two or more entities "owned or controlled" by the same interest. It is therefore important to understand what is meant by "controlled". The definition of control is included in regulation 1.482 of the Code of Federal Regulations.

Regulation 1.482 defines control as "any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise." An important inclusion to the definition of control is that control is presumed if income or deductions have been arbitrarily shifted.

It is evident from the above that the definition of control is very broad and is not limited by specific circumstances, such as proportion of interest and voting rights.

6.5.4 Practical application of the arm's length principle in the United States of America

Although the United States is a member nation of the OECD (OECD, 2009), no reference is made to the OECD in section 482 of the Internal Revenue Code or regulation 1.482 of the Code of Federal Regulations. Regulation 1.482 provides comprehensive guidance on the application of the arm's length principle, supplemented by examples and other practical considerations.

Regulation 1.482 of the Code of Federal Regulations provides a comprehensive discussion on comparability. The factors considered are similar to those highlighted to in the OECD guidelines on transfer pricing, however, the regulation provides additional examples of circumstances which should be considered in assessing comparability. The regulation also provides additional examples.

In determining an arm's length price, regulation 1.482-1 allows for an arm's length range to be used. The arm's length range will consist of the results of all of the uncontrolled comparables that meet the following conditions:

- the information on the controlled and uncontrolled is sufficiently complete such that all material differences have been identified; and
- the identified differences have a reasonably ascertainable effect on price or profit which can be eliminated through adjustments performed.

The regulation also allows for the use of an interquartile range where the use of such range would improve accuracy of the arm's length price.

Regulation 1.482-3(a) provides that the arm's length price should be calculated in line with the six methods listed below. These methods are:

- the comparable uncontrolled price method;
- the resale price method;

- the cost plus method;
- the comparable profits method;
- the profit split method; and
- unspecified methods.

The regulation provides comprehensive guidance on the application of the above methods as well as various examples. The information provided is far more comprehensive than that provided in the OECD guidelines on transfer pricing.

The regulation provide for the use of other unspecified methods as long as these methods comply with the guiding principles of comparability and the arm's length standard.

Hawkins (2008:205) notes that the comparable profits method is a transfer pricing method which relies on the principle that taxpayers' with similar locations earn similar returns over a given time period. The comparable profits method therefore determines transfer prices by comparing operating results of the related entities with those of unrelated taxpayers engaged in activities of a similar nature and form of reference. This method is essentially the same as the transactional net margin method prescribed by the OECD.

6.5.5 Comparison of the arm's length methods applied in the United States of America to those prescribed by the OECD

The methods described in regulation 1.482-3 are similar to those described in the OECD guidelines on transfer pricing. The regulation provides additional considerations and examples to facilitate application. The regulation does however allow unspecified methods. These methods should however be in line with the principles of comparability and the arm's length principle.

6.5.6 Documentation requirements in the United States of America

The requirements with regards to the maintenance of appropriate documentation for controlled transactions, is embodied within section 6662 of the Internal Revenue Code. The section does not provide specific guidance. Such specific guidance is embodied within regulation 1.6662-6(d)(2) of the Code of Federal Regulations.

The regulation divides the documentary requirements into principal documents and background documents. The principal documents required are as follows:

- an overview of the taxpayer's business,
- an analysis of factors affecting prices, such as economic and legal factors;
- a description of the taxpayer's organizational structure, including an organization chart covering all related parties engaged in transactions potentially relevant under section 482, including foreign affiliates whose transactions directly or indirectly affect the pricing of property or services in the United States;
- a description of the method selected and rationale therefore;
- a description of the alternative methods considered and support for their exclusion;
- a description of the controlled transactions and any internal data used to analyse those transactions;
- a description of comparables;
- a comparability analysis;
- details of any adjustments made; and
- a summary of any relevant data obtained between the end of the tax year and the date of filing the return which would support that the method was applied in a reasonable manner.

According to the regulation, the background documents include documents which support the assumptions and conclusions within the principal documents. Such documents should be appropriately maintained.

6.6 CONCLUSION

It is evident that various countries have various practices in terms of transfer pricing. However, a majority of the guidance provided by the various tax authorities largely resembles the guidance provided by the OECD in terms of the OECD guidelines on transfer pricing. A clear difference between the various countries relates to the definition of associated enterprises, as this is a determinant of the scope of the legislation. The discussion above has been summarised in the table below.

Table 13: Comparison of aspects of transfer pricing in the countries evaluated

Criteria	Developed countries		Developing countries	
	South Africa	India	Japan	America
Member of OECD	No	No	Yes	Yes
Practice of transfer pricing	Transfer pricing provisions are embodied in legislation. The legislation is supported by further guidance on the application provided by a Practice Note.	Transfer pricing provisions are embodied in legislation. The legislation is supported by further guidance on the application provided by the income tax rules.	Transfer pricing provisions are embodied in legislation. The legislation is supported by further guidance on the application provided by a directive issued by the commissioner.	Transfer pricing provisions are embodied in legislation. The legislation is supported by further guidance on the application provided by regulations issued.
Definition of associated enterprise	The definition of connected person refers mainly to relationship through shareholding and voting rights. No other specific relationships have been provided for. This limits the scope of transfer pricing provisions.	The definition of associated enterprise is comprehensive, including a number of specific scenarios. This has the effect of broadening the scope of the legislation.	The definition of associated relationship is limited to a simple majority shareholding. This limits the scope of the legislation.	The definition of controlled company does not specify any quantitative thresholds and therefore the scope of the legislation is substantially broadened.

Criteria	Developed countries		Developing countries	
	South Africa	India	Japan	America
Practical application of the arm's length principle	The guidance outlines the five methods of determining the arm's length price which are consistent with the methods described by the OECD guidelines on transfer pricing.	The guidance outlines the five methods of determining the arm's length price which are consistent with the methods described by the OECD guidelines on transfer pricing. Primary differences include the use of 5% margin of error, and the use of an arithmetic mean where various prices have been calculated.	The guidance outlines the five methods of determining the arm's length price which are consistent with the methods described by the OECD guidelines on transfer pricing. Primary difference includes the use an arithmetic mean where various prices have been calculated.	The guidance outlines the five methods of determining the arm's length price which are consistent with the methods described by the OECD guidelines on transfer pricing. Additional methods may be applied for so long as they comply with the basic principles of comparability and the arm's length standard.
Reference to OECD guidelines	Reference is made to the OECD guidelines in Practice Note 7.	None.	Commissioner's directive on the operation of transfer pricing makes reference to the OECD guidelines.	None.
Documentation requirements	General documentary requirements embodied in the tax legislation. Specific requirements are included in Practice Note 7 of the Income Tax Act.	General documentary requirements embodied in the tax legislation. Specific requirements are included in rule 10D of the Income Tax Rules.	Documentary requirements are specifically embodied in legislation and further clarified in the commissioner's directive.	General documentary requirements embodied in the tax legislation. Specific requirements are included in regulation 1.6662 of the Code on Federal Regulations.

CHAPTER 7
SUMMARY AND CONCLUSIONS

7.1 INTRODUCTION

In chapter 6, the transfer pricing practices in developing and developed countries were evaluated. This chapter will clarify the findings presented in previous chapters.

The study was governed by three primary research objectives. These are:

- to evaluate the fundamentals underlying the arm's length principle;
- to critically evaluate the methods applied in calculating an arm's length price and the shortcomings of such methods; and
- to perform a comparison of transfer pricing practices between developing and developed countries.

  These were discussed as indicated below.

7.2 THE CONCEPT OF TRANSFER PRICING AND THE ARM'S LENGTH PRINCIPLE

The arm's length principle is defined differently in various countries. However, as discussed in chapter 3 the crux of these definitions is that, an arm's length price is a price determined between independent enterprises under open market conditions.

Although some may regard the principle as flawed, all countries examined have based their legislation on the arm's length principle.

As discussed in chapter 3, in South African practice note 7, the Commissioner acknowledges the importance of the OECD guidelines and has based the practice note *inter alia* on the guidance of the OECD on transfer pricing. Therefore the above guidelines should be appropriately considered by South African companies involved in controlled transactions.

7.3 METHODS OF DETERMINING THE ARM'S LENGTH PRICE

The OECD (2009:48) makes mention that there may be various methods of determining an arm's length price. The OECD outlines five such arm's length methods. These methods are divided into the traditional transaction methods and the transactional profit methods. These methods were discussed in chapters 4 and 5.

The traditional transaction methods include:

- the comparable uncontrolled price method;
- the resale price method; and
- the cost plus method.

The transactional profit methods include:

- the profit split method; and
- the transactional net margin method.

The comparable uncontrolled price method involves the comparison of prices in a controlled transaction to prices in comparable uncontrolled transactions. A high degree of comparability is required between the enterprises being compared.

The resale price method reduces the selling price of goods purchased under a controlled transaction by an appropriate comparable margin. The calculated cost represents the arm's length price of the goods purchased under a comparable transaction. The method is most applicable in a distribution environment, where the associated enterprise acquires goods and distributes them to third parties.

The cost plus method is based on similar principles as the resale price method however, the cost plus method is most appropriate where semi-finished goods are acquired from an associated enterprise and further processed before resale to third parties. The method is most applicable in a manufacturing or servicing environment.

The profit split method involves the division of profits between the associated enterprises based on independent enterprise assumptions. The method is most applicable where the

transactions between the associated enterprises are so interrelated that evaluating the transactions separately would not be practically feasible.

Under the transactional net margin method, profits are attributed based on an arm's length accounting rate of return. The method requires a high degree of comparability and of the accounting bases.

Each of the above methods poses unique challenges to practical application. The principle of comparability should always be kept in mind. And a method of application should be based on the facts and circumstances most pertinent to the controlled transaction and the associated enterprises.

7.4 APPLICATION OF TRANSFER PRICING PROVISIONS IN DEVELOPING AND DEVELOPED COUNTRIES

Examination of legislation and other guidance issued by tax authorities of South Africa, India, Japan and the United States of America revealed a variety of practice as discussed in chapter 5. However, the differences are not considered to fundamental in nature. Most countries showed some deviations from the OECD guidelines however, the principles have remained consistent:

- comparability is key in the application of the arm's length principle;
- a detailed risk and functional analysis should be performed;
- non-arm's length method should not be applied; and
- contemporaneous and sufficiently detailed documentation supporting the company's decisions should be maintained.

7.5 IMPLICATIONS OF FINDINGS ON THE SOUTH AFRICAN TAX AUTHORITY

The objective of the study was to compare the design and practice of transfer pricing provisions between developing and developed countries. This was envisaged as a manner of assessing South Africa's legislation in relation to its peers. Based on the findings, South African tax authorities should consider the matters outlined below.

7.5.1 The size of the net cast by the "connected persons" definition

It was noted that the definition of associated enterprise, referred to as "connected person" in South Africa, differs significantly between all countries compared. SARS should consider the scope created by this definition and whether it is appropriate in light of its fiscal policy. An analysis should be performed in order to evaluate the number of taxpayers caught in the net as a result of the definition. SARS should also consider whether a specific definition of connected persons should be developed for the purposes of transfer pricing.

7.5.2 The geography of transfer pricing provisions

Japan and India have detailed transfer pricing provisions embodied directly in legislation. This has the effect of giving the requirements direct enforceability. SARS should consider expanding the legislation on transfer pricing, and embodying certain basic principles in legislation. Some aspects, such as basic documentation requirements and adherence to the arm's length principle should be included directly in legislation, and supplemented by guidance in the form of practice notes.

7.5.3 Extended aspects of practical application

Both Japanese and American guidance provide a number of practical examples with regards to most aspects of the transfer pricing provisions. Specifically, a number of relevant examples are provided with regards to the application of the various arm's length methods.

The South African Practice Note provides one example for each method. Additional examples would likely be useful for taxpayers, and the SARS should therefore consider extending practical guidance embodied in Practice Note 7.

7.6 IMPLICATION OF FINDINGS ON SOUTH AFRICAN COMPANIES ENGAGED IN CONTROLLED TRANSACTIONS

7.6.1 Maintaining contemporaneous and sufficiently detailed documentation

As far as South African companies are concerned, the primary obligation from a tax perspective remains the maintenance of appropriate documentation. There are no specific legislated requirements with regards to documentation pertaining to transfer pricing transactions. South African companies should however consider guidance provided by countries such as the United States of America and Japan, as this guidance is extensive.

The level of detail at which documentation is maintained is dependent on the company's ability to justify its decisions with regards to transfer prices determined. It is therefore best for a company to maintain contemporaneous documentation.

7.6.2 Supporting results

Although the application of more than one method is not required, where possible, maintaining the balance between cost and benefit, taxpayers should endeavour to support their results by the application of more than one arm's length method.

7.7 LIMITATIONS OF THE RESEARCH AND FUTURE RESEARCH DIRECTIONS

The research conducted was based on three primary sources. These are the OECD guidelines on transfer pricing, national legislation in the countries examined, and any practice guidance published by the countries examined. The reason for this limitation is that the research is governed by broad objectives. Future research may take a view on practical issues identified in relevant court cases, and other practical measures which revenue authorities are willing to accept and form part of the country's undocumented practice.

The research was also limited to the four countries selected. The countries comprised two developing and two developed countries. In addition the developed countries were both

members of the OECD, whereas the developing countries were not. Therefore, bearing in mind the general geographic limitations of the study, other countries may provide further guidance and insight.

The research focussed primarily on the application of the arm's length methods outlined by the OECD guidelines on transfer pricing and used this as a basis for comparison. This was considered to be the most appropriate starting point as the OECD has a large number of developed member countries and the guidelines are broadly acknowledged in all countries examined save for the United States of America. Future studies may focus on matters which may specifically be relevant to South Africa.

The research did not explore the effects of the differences in the definition of associated enterprises. Such differences may potentially lead to a wider tax net in certain countries. Future research may focus on such differences in analysing the taxpayers affected by the definition.

The research was primarily focussed on transfer pricing provisions and practices as they relate to sale of goods. Future research may consider transfer pricing as related to the provision of services, and the transfer of intangible assets between associated enterprises.

7.8 CONCLUSION

From the research performed, it is evident that the calculation of an arm's length price involves a significant level of judgement. Facts and circumstances must be carefully considered and evaluated in depth. Companies should maintain adequate documentation to outline the thought process followed and the application thereof in determining transfer prices.

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