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A CRITICAL ANALYSIS OF THE TRANSFER PRICING METHODOLOGY THAT SOUTH AFRICA USES AS COMPARED TO INTERNATIONAL STANDARDS

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ABSTRACT

A CRITICAL ANALYSIS OF THE TRANSFER PRICING METHODOLOGY THAT SOUTH AFRICA USES AS COMPARED TO INTERNATIONAL STANDARDS

by

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Transfer pricing is an important component of international trade. It addresses the pricing of goods or services that falls outside normal commercial guidelines in order to gain some tax advantage. Multinational companies consider transfer pricing in their business dealings as they are continuously affected or impacted by it.

The transfer pricing methodology that South Africa uses to combat tax avoidance together with the methodology used internationally was critically analysed. The results from both studies were compared to identify gaps or areas of improvement in the transfer pricing methodology that South Africa uses.

The results from the analysis of the transfer pricing methodology that South Africa uses to combat tax avoidance indicated that its methodology is modernised; even though there are areas that can be improved in the administration of transfer pricing documentation and the introduction of an Advance Pricing Arrangement. An area for improvement is however to clarify the usage of more than one transfer pricing method in determining the transfer pricing results in South Africa.

Key words: Advance Pricing Arrangement, arm's length price, arm's length principle, comparable analysis, connected persons, multinational company, OECD, transfer pricing.

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OPSOMMING

‘N KRITIESE ONTLEDING VAN DIE OORDRAGSPRYSBEREKENINGSMETODOLOGIE SOOS GEBRUIK IN SUID-AFRIKA IN VERGELYKING MET INTERNASIONALE STANDAARDE

deur

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Oordragsprysberekeningsmetodologie is ‘n belangrike komponent van internasionale handel. Dit het betrekking op die prysberekening van goedere of dienste wat buite die normale handelsriglyne val ten einde ‘n belastingvoordeel tot gevolg te hê. Multinasionale maatskappye oorweeg oordragsprysberekening in hul sake-onderhandelings aangesien hulle voortdurend daardeur geraak word.

Die oordragsprysberekening wat deur Suid-Afrika gebruik word om belastingontduiking teen te werk tesame met die metodologie wat internasionaal gebruik word is krities ontleed. Die resultate van hierdie studies is vergelyk om gapings of areas vir verbetering in die Suid-Afrikaanse oordragsprysmetodologie uit te wys.

‘n Ontleding van die oordragsprysberekeningsmetodologie soos deur Suid-Afrika gebruik om belastingontduiking teen te werk het aangedui dat dit gemoderniseer is. Daar is egter areas in die administrasie van prysberekeningsdokumentasie en die bekendstelling van ‘n gevorderde prysberekeningsooreenkoms wat kan verbeter. Die gebruik van meer as een oordragsprysberekeningsmetode in die vasstelling van dieoordragsprysberekenings-resultate moet egter in Suid-Afrika oorweeg word.

Sleutelwoorde: Gevorderde prysberekeningsooreenkoms, armlengteprys, armlengtebeginsel, vergelykbare ontleding, verbonde persone, multinasionale maatskappy, OESO, oordragprysberekening.

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CHAPTER 1

INTRODUCTION AND MOTIVATION TO THE STUDY

1.1 BACKGROUND

Transfer pricing is the pricing of goods or services outside normal commercial guidelines in order to gain some tax advantage (Olivier & Honiball, 2008:484). If transfer pricing is not handled properly, it will certainly deprive governments of their fair share of taxes from multinational companies and expose these companies to possible double taxation. There is no country, whether poor or rich, that wants its tax base to be eroded because of transfer pricing. Even in a best possible world, there is no tax authority that can assume that controlled transactions of multinational companies set benchmark standards of prises and are conducted in good faith. (Global Financial Intelligence, 2009:1; Olivier & Honiball, 2008:484.)

The effective rate of tax of a multinational company is the sum of taxation paid by the parent company and the connected persons in their host countries. Accordingly multinational companies are encouraged by globalisation, competition or management focus on performance to maximise profits and minimise tax payable. In order to minimise tax payable, profits are more often than not shifted from one country to another. Multinational companies contribute more than 60 percent of world trade transactions. They may manipulate profits by pricing intra-group transactions in such a way that profits are taxed in low tax jurisdiction, while deductions are obtained in high tax jurisdictions. They can also shift profits intra-group to high tax countries which have special tax benefits or where they are able to utilise tax losses. Thus, it is important that the interests of countries are protected to avoid both trade and tax distortions. (Global Financial Intelligence, 2009:1; Olivier & Honiball, 2008:484.)

In South Africa (SA), transfer pricing was previously used not only for commercial or tax reasons but also to circumvent exchange control restrictions. Exchange control restrictions have eased slightly since the introduction of section 31 of the Income Tax Act 58 of 1962. (Olivier & Honiball, 2008:485; Practice Note 7, 1999:6.)

Since SA re-joined the international business community, there has been a marked increase of international trade and commerce, with wide ranging volume of business transactions and complexity. A big portion of these transactions are carried on by multinational companies. The rapid globalisation that followed the dawn of democracy in SA was the realisation of an increase of multinational companies investing in the country. It is important that SA protects its interest, which includes security, wealth and the development of the infrastructure. (Practice Note 7, 1999:5.)

The regulation of transfer pricing between connected persons (connected persons as defined by section 1 of the Income Tax Act) of multinational companies is one of the anti-avoidance measures which tax authorities use internationally. Internationally, multinational companies regard transfer pricing as the most important international tax issue they will have to face. Internationally, most countries follow the Organisation for Economic Co-operation and Development (OECD), Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration, 2001. (Doernberg, 2004:266; Olivier & Honiball, 2008:485.)

A **transfer price** is a price set by a taxpayer when selling to, buying from or sharing resources with a connected person. It is an internal price at which goods or services are exchanged within the same multinational company; where a parent company sell or buy from a subsidiary company or where subsidiary companies of the same parent company sell or buy goods or services between themselves. A transfer price is usually contrasted with a market price, which is the price set in the open market place for the transfer of goods and services between unrelated persons. (Olivier & Honiball, 2008:484.)

1.2 PROBLEM STATEMENT

This study analyse the transfer pricing methodology that SA uses to combat tax avoidance and contrasts these with those adopted by international standards and selected countries. There are currently no reported court cases on transfer pricing in SA. The United States of America (USA) and the United Kingdom (UK) have reported court cases on transfer pricing.

The study endeavours to establish whether the transfer pricing methodology that SA uses is adequate and effective, and whether it requires some development or improvement, when compared to certain international standards.

1.3 PURPOSE STATEMENT

The purpose of this research essay is to analyse the transfer pricing methodology that SA uses to combat tax avoidance and contrasts these with those adopted by international standards and whether it is adequate and effective. Areas of development and improvement in combating tax avoidance were identified in the transfer pricing methodology used in SA. Recommendations from the research findings are included in the research essay, please see chapter seven.

1.4 SPECIFIC RESEARCH OBJECTIVES

The research essay aims to achieve the following specific research objectives:

- to determine whether the transfer pricing methodology that SA uses to combat tax avoidance is adequate and effective as compared to international standards through a review of available literature, regulation and court cases;
- to determine areas for development and improvement in the administration process, for example, the maintenance and filing of transfer pricing documents in SA as compared to international standards through a review of available literature, regulation and court cases;

- to analyse the advanced pricing arrangement technique in resolving transfer pricing disputes. This technique was endorsed and accepted by the OECD, the USA and the UK; and
- to examine the penalty provisions adopted by SA as compared to the penalty provisions adopted by international standards in discouraging non-compliance with transfer pricing provisions by connected persons of multinational companies through a review of available literature and court cases.

1.5 IMPORTANCE AND BENEFITS OF THE RESEARCH ESSAY

According to Global Financial Intelligence (2009:2), globalisation, competition, international trade and free market economy have affected multinational companies; some of them are tempted to shift their profits out of the country that generated those profits. Amounts of profits that are shifted out of SA result in lesser revenue collected by South African Revenue Service (SARS), which will have a negative impact to the wealth, economic growth and the development of the infrastructure and security of SA. In the absence of remedial provisions, the shifting of profits from one country to another might be significant and tax savings achieved by multinational companies by manipulating prices might be material. Hence, it is important that the interest of the state is protected. The study examines whether the transfer pricing methodology used in SA is adequate and effective to protect the interest of SA.

With the rapid increase in globalisation and international trade, multinational companies have also had a commercial, cash flow or business need to shift profits from one country to another. Multinational companies regard transfer pricing as the most important international tax issue they will face in the short term. (Olivier & Honiball, 2008:485.)

The tax revenue estimate for the financial year ended June 2010 was R68,9 billion below the 2009 budget estimate due to the impact of global economic crisis in SA. The gap between government spending and tax revenue is increasing. The government of SA requires more tax revenue and curb government spending. In line with the approach taken by tax authorities across the world, SARS is considering ways to improve tax revenue through broadening the tax base, closing of loopholes and improving tax compliance,

rather than increasing tax rates. The Minister of Finance mentioned in his 2010 budget speech that transfer pricing and cross-border transactions are main areas of concern, hence, the proposed amendment of section 31 of the Income Tax Act as per the Draft Taxation Laws Amendment Bill, 2010. (Brodbeck, 2010:377.)

Even though there is wealth of information on transfer pricing, this academic study contributes mainly on the subject of transfer pricing in SA.

1.6 OVERVIEW OF THE STRUCTURE OF THE RESEARCH ESSAY

This research essay has seven chapters. Chapter two examines the analysis of the transfer pricing methodology. Chapter three critically analyses the transfer pricing methodology that SA uses to combat tax avoidance. Chapter four critically analyses the transfer pricing methodology that is used internationally to combat tax avoidance. Chapter five critically analyses the transfer pricing methodology that is used by the USA to combat tax avoidance. Chapter six examines the analysis of penalties for non-compliance with transfer pricing methodology from a perspective of SA. Chapter seven consider the conclusion on the transfer pricing methodology that is used by SA to combat tax avoidance.

1.7 DELIMITATIONS AND ASSUMPTIONS OF THE STUDY

1.7.1 Delimitations

The research essay is conducted in the SA context, have several delimitations related to the context and constructs of transfer pricing. Transfer pricing in general is a very wide topic, which has evolved with trade, free economy, civilisation and globalisation.

The examination and application of judicial and legislative concepts on thin capitalisation, controlled foreign company legislation, the application of tax treaties and the impacts of exchange control regulation are **not** the focus area of this study.

The background of this research essay illustrates the impact of globalisation, free economy and international trade on multinational companies and transfer pricing. Hence, this research essay analysed the transfer pricing methodology that SA uses to combat tax avoidance when compared to international standards.

According to Mathewson and Quirin (1979:1), the extent of transfer pricing manipulation is not known as the manipulation processes are normally conducted under a veil of secrecy, because the perpetrators fear prosecution by their own governments. Recent relevant international cases were reviewed to identify any gaps in the administration of transfer pricing in SA.

1.7.2 Assumptions

According to Hofstee (2006:88), assumptions are things that are taken to be true without checking whether or not they are actually true.

In examining transfer pricing matters, the study assumed that SARS follow the relevant SA tax treaties, section 31 of the Income Tax Act and Practice Note 7 (1999), which was issued by SARS as a guideline.

1.8 DEFINITION OF KEY TERMS

The meanings of various abbreviations used in this research essay are explained below.

Table 1: The following abbreviations as set out in the table below are used in this research essay:

Abbreviation	Meaning
APA	Advance pricing arrangement
CFC	Controlled foreign company
Income Tax Act	South African Income Tax Act number 58 of 1962 (as amended)
IRC	Internal Revenue Code (USA)
IRS	Internal Revenue Service (USA tax authority)
Practice Note 7	Practice Note 7 (1999), which was issued by the South African Revenue Service in August 1999
OECD	Organisation for Economic Co-operation and Development
SA	South Africa
SARS	South African Revenue Service
STC	Secondary tax on companies
UK	United Kingdom
USA	United States of America

Definitions of key terms or concepts used in this research essay are the following:

In terms of OECD Guidelines (2001:G-1) an "**advance pricing arrangement"** is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria, for example methods, comparables and appropriate adjustments thereto or critical assumptions as to future events, for the determination of the transfer pricing for those transactions over a fixed period of time.

Section 31(1) of the Income Tax Act defines an "**arm's length price"** as the price that goods or services might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's length. The transactions between connected persons should have the substantive financial or commercial characteristics of a transaction between independent parties, where each party will strive to get the utmost possible benefit from the transaction.

In terms of OECD Guidelines (2001:G-1) an "**arm's length principle"** is the international standard that OECD member countries have agreed should be used for determining transfer prices for tax purposes. It is outlined in article 9 of the OECD Model Convention with respect to Taxes on Income and on Capital which deals with **associated enterprises** as follows: where "conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises; then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly" (OECD, 2005:9).

In terms of OECD Guidelines (2001:G-1) the concept "**arm's length range**" is a range of figures that are acceptable for establishing whether the conditions of a controlled transaction are arm's length and that are derived either from applying the same transfer pricing method to multiple comparable data or from applying different transfer pricing methods.

Article 9 of the OECD Model Convention with respect to Taxes on Income and on Capital (2005:9) deals with **associated enterprise,** and defines an "**associated enterprise"** as

where an enterprise of a contracting state participates directly or indirectly in the management, control or capital of an enterprise of the other contracting state **or** the same persons participate directly or indirectly in the management, control or capital of an enterprise of a contracting state and an enterprise of the other contracting state. In either case, where conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises; then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

In terms of OECD Guidelines (2001:G-2) the concept of a "**comparable analysis**" is a comparison of a controlled transaction with an uncontrolled transaction or transactions. Controlled and uncontrolled transactions are comparable if none of the differences between the transactions could materially affect the factor, like price or margin that are being examined in the methodology or if reasonably accurate adjustments can be made to eliminate the material effects of any such differences.

Section 1 of the Income Tax Act and Practice Note 7 (1999:3) defines a "**connected person**", with specific reference to a company as:

- any other company that would be part of the same group of companies as that company;
- any person who individually or jointly with any connected person in relation to himself, holds, directly or indirectly at least 20 per cent of the company's equity share capital or voting rights;
- any other company if at least 20 per cent of the equity share capital of such company is held by such other company; and
- any other company, if such other company is managed or controlled by any person who or which is a connected person in relation to such company.

Practice Note 7 (1999:5) defines a "**controlled transaction"** as any transaction concluded between connected persons of a multinational company. The price of this transaction can be influenced by the multinational company. An "**uncontrolled transaction"** is defined as any transaction concluded at arm's length between companies that are not connected

persons in relation to each other. These transactions form the benchmark against which a multinational company's transfer pricing is appraised in determining whether its prices are arm's length.

In terms of OECD Guidelines (2001:G-5) a "**global formulary apportionment method"** is a method to allocate the global profits of a multinational enterprise group on a consolidated basis among the associated enterprises in different countries on a basis of a predetermined formula.

Section 31(1) of the Income Tax Act defines "**goods**" as to include any corporeal movable thing, fixed property and any real right in such thing or fixed property.
Section 1 of the income Tax Act defines "**group of companies"** as follows,
two or more companies in which one company (hereinafter referred to as the "controlling group company") directly or indirectly holds shares in at least one other company (hereinafter referred to as the "controlled group company"), to the extent that-

- at least 70 per cent of the equity shares of each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof, and
- the controlling group company directly holds at least 70 per cent of the equity shares in at least one controlled group company.

In terms of OECD Guidelines (2001:G-5) the concept of "**independent enterprises"** means two enterprises that are independent with respect to each other when they are not associated enterprises with respect to each other.

In terms of Practice Note 7 (1999:5), a "**multinational company**" means any parent company with connected persons or subsidiaries that operate or conduct business activities in more than one country. These connected persons or subsidiaries have separate legal status. The definition is similar to the one in OECD Guidelines (2001:G-6) for "**multinational enterprises group"**, which defines a multinational enterprises group as a group of associated companies with business establishments in two or more countries.

In terms of Practice Note 7 (1999:5), the **OECD Guidelines** refers to the OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2001.

Article 5 of the OECD Model Convention with respect to Taxes on Income and on Capital (2005:6), deals with a **permanent establishment**, and defines a "**permanent establishment"** as a fixed place of business through which the business of an enterprise is wholly or partly carried on. This will include a place of management, a branch, an office, a factory, a workshop or a mine.

Section 1 of the Income Tax Act defines a "**resident"**, with specific reference to a company, as a person which is incorporated, established or formed in SA or has its place of effective management in SA. A person who is deemed to be a resident of another country for the purpose of a tax treaty between SA and that other country will not qualify to be a SA resident, even though he meets the description of a resident in SA. A "**place of effective management"** is the place where the company is managed on a regular or day-to-day basis by the directors or senior management of the company. (Stiglingh, Koekemoer, van Schalkwyk, Wilcocks, De Swardt & Jordaan, 2010:50-54.)

Section 31(1) of the Income Tax Act defines **"service"** as to include anything done or to be done, including:

- the granting, assignment or surrender of a right, benefit or advantage (such as the sale of a patent, design or trademark);
- the making available of any facility or advantage;
- the granting of financial assistance (making a loan, security or guarantee);
- the performance of any work;
- an agreement of insurance; and
- the conferring of rights to or the use of incorporeal property (licensing the use of patent or copyright).

In terms of Practice Note 7 (1999:5), **transfer price** is the prices at which an entity transfers goods and services to connected persons. It is a price set by a taxpayer when selling to, buying from or sharing resources with a connected person.

The Draft Taxation Laws Amendment Bill (2010:65) proposes that the definition of the supply of "goods" and "services" in section 31(1) of the Income Tax Act should be deleted. **transfer price** is thus defined as any transaction, operation, scheme, agreement or understanding that has been entered into between a person, resident or non-resident, and a connected person and any term or condition of that transaction, operation, scheme, agreement or understanding which:

- is different from any term or condition that would have existed had those persons been independent persons dealing at arm's length; and
- results or will result in any tax benefit as defined in section 80L of the Income Tax Act being derived by any party to that transaction, operation, scheme, agreement or understanding.

The Commissioner may determine the taxable income of any party to that transaction, operation, scheme, agreement or understanding as if that transaction had been entered into on the terms and conditions that would have existed had the parties to that transaction been independent persons dealing at arm's length. The "**tax benefit**" concept has been defined in section 80L of the Income Tax Act as including any avoidance, postponement or reduction of any liability for tax.

1.9 CONCLUSION

This chapter discussed the importance and benefits of this study, specific research objectives and definition of key terms. An analysis of the transfer pricing methodology will be examined in the next chapter.

CHAPTER 2

AN ANALYSIS OF THE TRANSFER PRICING METHODOLOGY

2.1 INTRODUCTION

In this chapter, an analysis of the transfer pricing methodology will be examined.

Transfer pricing is the pricing of goods or services that falls outside normal commercial guidelines in order to obtain some tax advantage (Olivier & Honiball, 2008:484). The extent of transfer pricing manipulation is not known as the manipulation processes are normally conducted under a veil of secrecy, because the perpetrators fear prosecution by their governments. Generally, tax returns and supporting documentation are confidential. Most of the known cases are revealed to the public due to prosecutions or exposure by tax authorities. Furthermore, transactions within a multinational company contra each other during consolidation, hence, they are not easily detected by external people. (Mathewson & Quirin, 1979:1; Olivier & Honiball, 2008:484.)

Normally, multinational companies set up foreign subsidiaries to protect trade secret or brand name integrity. The details of trade strategies or brand name are not divulged to external companies. Foreign subsidiaries of the multinational companies operate these trade strategies and brand name to ensure confidentiality. Their sensitive strategies and operating tactics are not revealed to external companies, thus comparable data would be difficult to determine. (Avi-Yonah, 2007:104.)

Proper pricing of goods and services within multinational companies is important for decision making purposes by management, in order to avoid trade distortions and to determine entities that yield high return on investment (Global Financial Intelligence, 2009:2).

2.2 TRANSFER PRICING METHODOLOGY OR STANDARDS

Competition by companies to achieve high business performance results may result in manipulation of prises (OECD Guidelines, 2001:VII-1). Many companies have key performance areas or indicators that assist management and staff to focus on improving business performance and maximise profits. Decentralised decision making processes are organised around profit centres, which encourages staff to compete between different segments of multinational companies. Business performance is measured by high profits or high return on investment. These circumstances lead entities to adopt incorrect behaviours to achieve short term goals and rewards by showing high profits in areas that were not supposed to be, if prices were not manipulated, which might be detrimental in the long term. (Levey & Wrappe, 2001:157-162; Olivier & Honiball, 2008:496-501.)

According to the OECD Guidelines (2001:I-4 and VII-1), a multinational company performs a number of inter group transactions like the charging of management fees, royalties in relation to the use of patents, sharing of research and development costs, and the charging of interest on loans. Multinational companies normally price these transactions at different prices, unlike if it was an external sale or transaction. Some of these transactions might not be easy to establish in an open market environment from external entities, especially transactions that involve intangible assets or highly specialised goods or services or internally driven strategic campaigns like safety. These transactions may result in insufficient or inconsistent comparable data. (Levey & Wrappe, 2001:163; Olivier & Honiball, 2008:496-501.)

External entities may not have enough information or they may need some guarantees before they can invest in projects that are not known or are at an infant stage and the profit potential of these projects cannot be adequately determined. Many of the external entities would like to see other entities investing or buying before they commit themselves. Meanwhile connected persons will transact or buy as they know the broader strategy of the company and are privileged to sensitive information, like research studies conducted by the parent company or are compelled by common commercial circumstances. Thus, their prices might not be a true reflection of external market prices. (Levey & Wrappe, 2001:163; Olivier & Honiball, 2008:496-501.)

According to the OECD Guidelines (2001:I-4), connected persons of a multinational company, may for the reason that they are under common control, establish special conditions in their intra group transactions that are different from those that would have been established, had the group member been operating as an independent person in an open market environment.

According to Global Financial Intelligence (2009:2), shifting of profits from the parent to a subsidiary company or from one subsidiary company to another, distorts both profits and trade within a company. These activities may result in double taxation, where the same income might be taxed in more than one country or entity. Double taxation also can arise when different countries use different tax policies, for example residence based and source based methods of tax. A country that uses residence base method might deem profits generated outside the country to be taxable in that country irrespective of the source of that income as long as the taxpayer is a resident of that country. The same income might end up being taxed in the country of source and in the country where the taxpayer is a resident. (OECD Guidelines, 2001:P-2.)

SA applies a **residence-based system** of taxation from January 2001, having changed from a **source-based system** of taxation. The world-wide receipts derived by a SA resident are included in his gross income. Non-residents are taxed on a source-based system of taxation, that is, only receipts derived from sources within or deemed to be within SA are subject to tax in SA, with certain exceptions. (Stiglingh *et al.*, 2010:49.)

Tax authorities and taxpayers may reach different results in evaluating taxable profits of a transaction due to different interpretations of the law or different assumptions used or different evaluation of the facts of the transaction. Multinational companies must be encouraged to invest and trade freely. Double taxation is undesirable and should be avoided, because it discourages international trade and investment flows (OECD Guidelines, 2001:I-1 and IV-1). Thus, tax authorities should implement clear practice notes or guidelines in interpreting some of the complex legislative concepts that can be easily misinterpreted or interpreted in different ways. (Practice Note 7, 1999:6.)

2.3 THIN CAPITALISATION

Section 31 of the Income Tax Act provides special anti-avoidance rules to counter cross-border transactions involving transfer pricing and thin capitalisation (Stiglingh *et al.*, 2010:583).

Section 31(3) of the Income Tax Act defines "**thin capitalisation**" as to the funding of a business with a disproportionate degree of debt in relation to equity. The foreign investor (through a loan) receives interest income which is exempt from tax in terms of section 10(1)(h) of the Income Tax Act, provided that they do not have a permanent establishment in SA, while the local company enjoys the deductions of the interest paid, only if, it is actually incurred to produce income, during the year of assessment. The foreign investor (through equity) receives dividend income which is subject to STC.

Section 31(3) of the Income Tax Act empowers the Commissioner to disallow the interest expense on the portion of the loan that is considered to be excessive in relation to the fixed capital of the SA borrower. The disallowed interest if paid to the non-resident shareholder will be deemed to be a dividend, which will be subject to STC. Thin capitalisation provisions aim to limit the amount of interest deducted on excessive debt funds, thereby, protecting the SA economy against the distortions arising from heavily geared foreign investments made through loans or debt. (Huxham & Haupt, 2010:435.)

The Draft Taxation Laws Amendment Bill (2010:67) proposes the abolishment of the debt to equity ratio and proposes an arm's length test for thin capitalisation. Essentially the SA company which is deemed to be thinly capitalised, that is, where the value of all the financial assistance given exceeds the financial assistance which would have been granted had the non-resident investor and the connected person or a person with a permanent establishment been independent person dealing at arm's length basis. Any interest, finance charge or other consideration payable for or in relation to the financial assistance must to the extent to which it relates to the amount which is excessive, be disallowed as a deduction. Financial assistance includes any loan, advance, debt or the provision of any security or guarantee.

The scope of thin capitalisation rules as contained in section 31(3) has been widened to include financial assistance granted by a non-resident investor to a permanent establishment in SA of any other person who is not a resident (Brodbeck, 2010:379). The arm's length principle, which is well outlined in OECD Guidelines and Practice Note 7 is the basis of the proposed amendment to thin capitalisation.

2.4 CONCLUSION

Section 31 of the Income Tax Act provides special anti-avoidance rules to counter cross-border transactions involving transfer pricing and thin capitalisation (Stiglingh *et al.*, 2010:583).

An analysis of the transfer pricing methodology and thin capitalisation was examined in this chapter. A critical analysis of the transfer pricing methodology that SA uses to combat tax avoidance will be examined in the next chapter.

CHAPTER 3

A CRITICAL ANALYSIS OF THE TRANSFER PRICING METHODOLOGY THAT SOUTH AFRICA USES TO COMBAT TAX AVOIDANCE

3.1 INTRODUCTION

In this chapter, a critical analysis of the transfer pricing methodology that SA uses to combat tax avoidance will be examined.

The provisions in the Income Tax Act and the impact of a tax treaty, if applicable, will determine the SA tax consequences of a cross-border transaction. The purpose of a tax treaty is to avoid a situation whereby the same transaction is taxed twice in more than one tax jurisdiction. (Stiglingh *et al.*, 2010:550.)

Transfer pricing in SA was introduced in July 1995, when a revised section 31 of the Income Tax Act was implemented after the recommendation of the Katz Commission of inquiry. Section 31 of the Income Tax Act was mainly copied from section 770 of the UK Income and Corporation Taxes Act, 1988 (Olivier & Honiball, 2008:485-487). Prior to July 1995, SARS relied mainly on general anti-avoidance provisions as contained in section 103(1) of the Income Tax Act or deemed donation provisions of section 58 of the Income Tax Act to assess transfer prices. Exchange control restrictions also provided some protection against the pricing of goods and services in instances where profits were being shifted from SA to low tax jurisdiction countries. (Olivier & Honiball, 2008:485-487; Practice Note 7, 1999:6.)

Transfer pricing is covered by sections 31(1) and 31(2) of the Income Tax Act. Section 31(2) of the Income Tax Act states that the Commissioner can adjust the incorrect price of a taxpayer for goods or services provided between connected persons in relation to each other or between a resident and a non-resident or between a resident and a permanent establishment of another resident outside SA or between a non- resident and a permanent establishment in SA of another non-resident to an arm’s length price. (Practice Note 7, 1999:6.)

In terms of Practice Note 7 (1999:6), section 31 of the Income Tax Act was revised in 1995 in anticipation of the relaxation of exchange controls and the fear that the tax base will be reduced due to manipulation of transfer prices. Like any other piece of legislation, section 31 of the Income Tax Act is complex and open to different interpretation by the users. SARS issued a comprehensive set of guidelines in the form of Practice Note 7 in August 1999 to assist taxpayers and SARS officials to deal with challenges that are posed by cross border transactions or transfer prices. Since the revision in July 1995 of section 31 of the Income Tax Act, there has been no reported transfer pricing court cases in SA.

Practice Note 7 is based on OECD Guidelines, although SA is not a member country of the OECD, SA has “observer” status from 2004. OECD member countries are bound by an OECD decision if they voted for it. If an OECD member country does not vote that country is not bound by the decision. The OECD is a legal person with no law making powers, unlike the European Union for an example. A regulation of the European Union automatically has the force of law for a member country without having to be implemented by domestic legislation. (Olivier & Honiball, 2008:9-10.)

The OECD Guidelines are acknowledged as an important, influential document that forms an unanimous agreement amongst the OECD member countries, reached after an extensive process of consultation with industry and tax practitioners in many countries (Practice Note 7, 1999:6-8). The OECD Guidelines are followed by many countries that are not members of OECD, thus they have become internationally accepted standards. International usage of OECD Guidelines promote consistency in the international trade, fair allocation of profits from transfer prices and helps prevent double taxation (OECD Guidelines, 2001:P-1).

Practice Note 7 provides a practical guide about procedures to be followed in the determination of arm’s length price. The provisions of section 31 of the Income Tax Act, relevant tax treaties entered into by the government of SA with other countries or OECD Guidelines should be followed in the absence of a specific guidance from Practice Note 7 (1999:6). Thus, taxpayers in SA have a wide scope to refer to for guidance on transfer pricing.

Generally, Practice Notes issued by SARS are not law. However, Practice Note 7 is based on international accepted arm's length principles. Thus, it is assumed that it carry more weight in a court of law than other Practice Notes. However, the problem is that paragraph 3.1 of Practice Note 7, states that it is provided as a practical guide and it is not intended to be prescriptive. (Olivier & Honiball, 2008:492.)

The proposed amendment of transfer pricing regulation as per the Draft Taxation Laws Amendment Bill (2010:65) has considerably widened the scope of the transfer pricing rules contained in section 31(2) of the Income Tax Act. The amendment has been motivated by the 2010 version of OECD Guidelines. This OECD Guidelines (2010) replace the "exceptional" standard for the application of the transactional profit methods, that is, the transactional net margin method and the profit split method, with the requirement that the "most appropriate" method in the circumstances must be used. (Brodbeck, 2010:377-379.)

The current wording of transfer pricing rules is causing structural problems and uncertainty as it focuses on isolated transactions as opposed to economic substance of transactions. In addition, the comparable uncontrolled price method is more preferred than other more practical transfer pricing methods. The emphasis on "price" as opposed to "profit" does not align with the wording in article 9 of the OECD Model Convention with respect to Taxes on Income and on Capital (2005:9), dealing with associated enterprises. (Brodbeck, 2010:377-379.)

The liability of the tax benefit, as defined in section 80L of the Income Tax Act, for the payment of any tax that must be sought to avoid, postpone or reduce is not an accrued or existing liability, but an anticipated liability. The anticipated liability can be avoided by getting out of the way of or escape an anticipated liability. Thus to determine the existence of a tax benefit requires an identification of the income that might have accrued to the taxpayer. SARS would be expected to identify the income that would have accrued to the taxpayer as if the cross border transaction, operation, scheme, agreement or understanding had been entered into with an independent person dealing at arm's length basis. The burden of proof regarding the non-arm's length nature of a cross border

transaction, operation, scheme, agreement or understanding has been effectively shifted to SARS. (Brodbeck, 2010:377-379.)

The shift in focus from adjusting the consideration in respect of a specific transaction to an adjustment of the overall taxable income is to align the SA transfer pricing rules as contained in section 31(2) of the Income Tax Act with the wording of article 9 of the OECD Model Convention with respect to Taxes on Income and on Capital (2005:9). The National Treasury and SARS have announced that the effective date of the amendment of the Draft Taxation Laws Amendment Bill (2010:65) will be 1 October 2011 due to the required changes to the existing SARS Practice Notes. (Brodbeck, 2010:377-379.)

3.2 ARM'S LENGTH PRINCIPLE AND TAX TREATIES FROM A PERSPECTIVE OF SA

A **tax treaty** or **double taxation agreement** is an international agreement concluded between sovereign countries and is governed by international law. A tax treaty is normally enacted into law in the same way as domestic law in most countries. If there is a conflict between a tax treaty and the domestic law, the provisions of the tax treaty normally prevails. Normally tax treaties do not impose tax, they provide tax relief, eliminate double taxation, prevent tax evasion, provide assurance for cross border trade and facilitate investment. (Arnold & McIntyre, 2002:104-106; Olivier & Honiball, 2008:486.)

A tax treaty shift tax revenue, especially passive income, from source country to residence country. Domestic regulation would normally impose tax on source income, thus a tax treaty would provide tax relief in those instances. It assists also in the exchange of information between countries. (Avi-Yonah, 2007:169-172.)

According to Olivier and Honiball (2008:314), international relief from double taxation in a cross border transaction is available either in terms of domestic regulation or bilaterally or multilaterally in terms of tax treaty regulation or both. There are three types of double taxation conflicts which could arise internationally, namely:

- source – source conflict;
- residence – residence conflict; and

- residence – source conflicts.

In SA economic double taxation arises when tax is raised under CFC rules in terms of section 9D of the Income Tax Act, transfer pricing adjustments in terms of sections 31(1) and 31(2) of the Income Tax Act and thin capitalisation adjustment in terms of section 31(3) of the Income Tax Act (Olivier & Honiball, 2008:314).

Olivier and Honiball (2008:317-327) states that domestic tax relief in SA is available in the form of the:

- exemption method, which includes CFC exclusions in terms of section 9D(9) of the Income Tax Act;
- credit method in the form of section 6*quat* rebates of the Income Tax Act; and
- deduction method in the form of section 6*quat*(1C) of the Income Tax Act and the general deduction formula, section 11(a) of the Income Tax Act.

Section 9A of the Income Tax Act provides domestic tax relief for blocked foreign funds. The blocked foreign income will be included in gross income in the year in which it is remitted to SA. The funds are not exempt from tax; they are just deferred for tax purposes (Olivier & Honiball, 2008:327). The blocked foreign income regulation in the USA, which is similar to SA, was introduced after the Supreme Court ruled that the regulation can not be applied in the blocked foreign income situation, hence, it might not survive judicial scrutiny in the USA. (Levey & Wrappe, 2001:140.)

OECD Guidelines provides relief from double taxation under both the exemption method in terms of article 23A and credit method in terms of article 23B of OECD Model Convention with respect to taxes on Income and Capital (2005:14-15). Tax treaties of SA include both exemption and credit methods. USA tax treaties include only the credit method. (Olivier & Honiball, 2008:328.)

In terms of a tax treaty, article 7 of the OECD Model Convention with respect to Taxes on Income and on Capital (2005:8), deals with **business profits,** and provides that the profits of an enterprise of a contracting state shall be taxable only in that state unless the enterprise carries on business in the other contracting state through a permanent

establishment situated therein. The portion of the profits which is attributable to a permanent establishment may be taxed in the state where the permanent establishment is situated. This article provides that allocations between a permanent establishment (for instance a branch) and its head office must be at arm's length as if the branch and its head office are independent persons, even though a branch is not a separate legal person. (Practice Note 7, 1999:7.)

Article 9 of the OECD Model Convention with respect to Taxes on Income and on Capital (2005:9) provides that where a multinational company has a subsidiary that is controlled in the other state, and they enter into a controlled transaction in their commercial and financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not accrued, may be included in the profits of that enterprise and taxed accordingly. The arm's length principle must be applied to commercial and financial relations between associated companies residing in the contracting countries. (Practice Note 7, 1999:8.)

Article 9 of the OECD Model Convention with respect to Taxes on Income and on Capital (2005:9) encourages the Commissioner to follow the spirit used in drafting this article in assessing the policy documents or workings of taxpayers. The arm's length principle provided for in this article forms the framework for bilateral tax treaties between OECD countries, as well as many non OECD countries. These principles are also incorporated in the Model United Nations Double Taxation Convention between developed and developing Nations. (OECD Guidelines, 2001:P-2; Practice Note 7, 1999:8.)

Tax treaties of SA incorporate the principles of the above two articles of OECD Model Convention with respect to Taxes on Income and on Capital. These articles accept the concept of the arm's length principle. The adoption of the international accepted concept of arm's length principle will minimise double taxation of controlled transfer price transactions. (Practice Note 7, 1999:7-9.)

In SA there is no provision for automatic or compulsory adjustments as per the recommendations of article 9 of the OECD Model Convention with respect to Taxes on

Income and on Capital (2005:9). SARS may make any transfer pricing adjustment in terms of section 31(2) of the Income Tax Act, presumably, by means of re-opening the tax assessment and not by applying a credit method in the form of section 6*quat* rebates of the Income Tax Act. Practice Note 7 (1999:7) states that a tax treaty cannot impose a tax liability; it merely allocates existing tax liabilities between countries. (Olivier & Honiball, 2008:509.)

SA has stated its own non-OECD member country position through Practice Note 7 that it reserves the right to replace the word **shall** by **may** in paragraph 2 of article 9 of the OECD Model Convention with respect to Taxes on Income and on Capital (2005:9). Despite this position, SA has many tax treaties that uses the word “shall”, such as tax treaties with the USA and the UK. The wording of a tax treaty depends on the negotiations with that country during the drafting of the tax treaty. (Olivier & Honiball, 2008:509.)

Normally countries develop their own anti-avoidance regulations. Countries may preserve their domestic law requirements in situations governed by tax treaties by specifically stating those provisions in their tax treaties. (Olivier & Honiball, 2008:508.)

3.3 CRITICAL ANALYSIS OF THE ARM’S LENGTH PRINCIPLE IN SA

The principles of section 31 of the Income Tax Act can be applied to cross border transactions between head office and a branch or between branches of the same company in the same way as they are used for cross border transactions in the case of the head office and a subsidiary or connected persons. The **arm’s length price** for this purpose is the price that the goods or services might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm’s length. (Practice Note 7, 1999:8.)

The adjustment made or amounts disallowed by the Commissioner in terms of section 31 of the Income Tax Act will be used by SARS in calculating taxable income of either party to the transaction and may result in STC implications to the recipient. The recipient of the adjusted amount may be any shareholder of the company, relative of such shareholder or trust of the shareholder. Qualifying adjustments or amounts disallowed in terms of section

31 of the Income Tax Act are deemed as a dividend in terms of section 64C(2)(e) of the Income Tax Act, until the implementation of the dividend tax. Tax on the net dividend amount (being dividends received less dividends paid) will be payable irrespective of whether or not the company has made a profit in the current year. (Stiglingh *et al.*, 2010:584.)

According to Stiglingh *et al.* (2010:585), an example of transfer pricing is where a SA resident company Holding Ltd, sold goods to its foreign subsidiary company, Subco for R20 000. These goods had cost Holding Ltd R16 000 and they had a market value of R30 000 at the time of the sale.

Tax implication of Holding Ltd if SARS is of the opinion that R30 000 is an arm's length price is;

Proceeds from sale	R20 000
Section 31(2) adjustment (R30 000-R20 000)	R10 000
Gross income	R30 000
Less: Cost of sales	(R16 000)
Taxable income	R14 000

In terms of section 64(2)(e) of the Income Tax Act, the section 31(2) adjustment of R10 000 will also be considered as a deemed dividend and will be subject to STC at 10%. Holding Ltd and Subco are connected persons.

Section 31 of the Income Tax Act gives SARS the power to adjust transfer prices to prevent taxpayers from shifting income to connected persons in lower tax jurisdictions or high tax jurisdictions with taxable losses. It also gives SARS the power to adjust transfer prices to prevent other countries from obtaining unfair share of tax revenue through overly aggressive enforcement of their rules. In terms of section 31(2) of the Income Tax Act, transfer pricing provisions apply only where goods or services are supplied or acquired in terms of an international agreement. In the absence of remedial provisions, the shifting of profits from one company to another by multinational companies might be significant and tax savings achieved by manipulating prices might be material. (Olivier & Honiball, 2008:484.)

Section 31 of the Income Tax Act provides a way by which the Commissioner adopts the internationally accepted **arm's length principle** for taxation purposes**.** The first and overriding principle of the **arm's length principle** is that transactions between connected persons are to be conducted at arm's length, that is, the transaction should have the substantive financial or commercial characteristics of a transaction between independent persons, where each person will strive to get the utmost possible benefit from the transaction.

The arm's length principle states that the amount charged to a product by one connected person in a multinational company must be the same as if the parties were not related, that is, the price must be an open market price. The price should be the same as if the subsidiaries in the multinational company were independent from each other. Arm's length principle imposes requirements on controlled transactions to connected persons, unlike uncontrolled transaction to independent persons. (Global Financial Intelligence, 2008:2; Practice Note 7, 1999:8.)

3.4 PRINCIPLE OF COMPARABILITY OF DATA

SARS will accept that the local data can be compared with foreign data as some open market data information might not be available in SA. Connected persons should compare the transfer price of their transaction to the price of a comparable transaction between independent persons. Any difference between the two transactions must be identified and adjusted or corrected so that a market related price is charged or paid. The arm's length principle is internationally accepted and is the basis for ensuring that the South African *fiscus* receives their fair share of tax. (Huxham & Haupt, 2010:433-434.)

Multiple year data should be used to obtain a complete understanding of the facts and circumstances surrounding the controlled transactions. These data will give a clear picture and trends of the information. The nature of the information in compiling comparable data is also important, the taxpayer should try to get more information from external parties, open markets, including foreign data and uncontrolled transactions. These information will support the credibility of the information used, thus the results will be more acceptable to external parties, like SARS. (Olivier & Honiball, 2008:495; Practice Note 7, 1999:13-30.)

The principle of comparability is the cornerstone in the application of the arm's length principle. Taxpayers must always look for the highest practical degree of comparing the prices and margins achieved by connected persons in their business dealings to those achieved by independent companies for the same transaction or business dealings. The principles of comparability are covered in OECD Guidelines (2001:I-8) as factors or attributes that determine comparability. (Practice Note 7, 1999:9.)

In terms of Practice Note 7 (1999:9), the principles of comparability are the following:

- characteristics of goods or services;
- functions performed;
- contractual terms, conditions and related risks of the agreements;
- economic and market conditions; and
- business strategy.

3.4.1 Characteristics of goods or services

In terms of Practice Note 7 (1999:9), the following features are relevant in comparing two products and services:

- tangible property: physical fixtures, quality, availability, reliability and volume of supply of the property;
- intangible property: type of property, duration and degree protection; and
- services: nature and extent of services.

3.4.2 Functions performed

According to Practice Note 7 (1999:10), the functions and risks associated to the functions performed by connected persons should be compared to those that are performed by independent persons. Identify and compare the economical significance of the activities and responsibility undertaken. A functional analysis should be prepared by utilising the facts about a business function, assets and associated risks. A taxpayer normally goes through a process which would include some form of functional analysis and information gathering on relevant comparables in determining an arm's length price. The relevant data

will be applied on the appropriate transfer pricing method. Annexure A of Practice Note 7 provides detailed characteristics of a functional analysis.

3.4.3 Economic and market conditions

In terms of Practice Note 7 (1999:11), the taxpayer should determine the size of the market or markets of the product. Examine the geographic location and companies that trade with the product, to determine competition.
The following factors are relevant for comparing markets, namely:

- geographic location of the market;
- size of the markets;
- extent of competition in the markets;
- availability of substitute goods and services;
- transport costs; and
- the level of the market (retail or wholesale).

3.4.4 Business strategy

In terms of Practice Note 7 (1999:11), business strategies consider or examine innovation, degree of diversification and market penetration, risks aversion, assessment of political changes and new product development.

3.5 ACCEPTABLE TRANSFER PRICING METHODS TO DETERMINE ARM'S LENGTH PRICES IN SA

According to Practice Note 7 (1999:13), section 31 of the Income Tax Act does not prescribe any particular transfer pricing methodology. SA endorses the acceptable transfer pricing methods used internationally (OECD Guidelines, 2001:II-1 to III-24). The preferred method is the one that yields the highest degree of comparability, having considered:

- the nature of the activities being examined;
- the availability, quality and reliability of the data;
- the nature and extent of any assumptions; and

- the degree of comparability that exists between the controlled and uncontrolled transactions, where the differences would affect conditions in the arm's length dealings being examined.

Practice Note 7 (1999:26) states that a transfer price can be confirmed through multiple methods. SARS will be convinced that the transfer price of a taxpayer is credible if it is supported by analyses under one or more transfer price methods. However, in line with OECD Guidelines (2001:I-26), , SARS does not, as a rule, require the application of more than one method as this could place a burden on taxpayers. The application of different transfer pricing methods for calculating the transfer price on a transaction, unless in a complex transaction, is a deviation from OECD Guidelines (2001:I-26). (Olivier & Honiball, 2008:495.)

The arm's length range for determining transfer prices is acceptable as the application of the most appropriate method or methods will often result in a range of justifiable transfer prices (Practice Note 7, 1999:25). Practice Note 7 (1999:26) states that SARS may select the mid-point in the range, in the absence of persuasive evidence for the selection of a particular point in that range, which is contrary to the arm's length principle and a deviation from OECD Guidelines. (Olivier & Honiball, 2008:495.)

The results obtained from the transfer pricing methods must be adjusted for the country specific circumstances. Interventions by governments, such as price control, interest control or exchange control should be treated as conditions of the market in that country (Practice Note 7, 1999:30).

3.6 TRANSFER PRICING DOCUMENTATION IN SA

Practice Note 7 (1999:22-25) mainly follows OECD Guidelines (2001:V-1) on transfer pricing documentation. Compilation of transfer pricing documentation should be consistent with the arm's length principle. Companies that have policy documentation on transfer pricing are encouraged to submit them together with their tax returns, if they have transfer pricing transactions in that year. In assessing their tax returns, SARS will use their policy

documentation to establish whether their transactions comply with the requirements of section 31 of the Income Tax Act.

Sections 69, 74, 74A, 74B, 74C, 74D and 75 of the Income Tax Act outlines the information and documentation that should be prepared, as well as documentation that should be submitted with the tax returns by taxpayers. These are general tax regulations that are also applicable to transfer pricing requirements. (Practice Note 7, 1999:22.)

In terms of Practice Note 7 (1999:23), the documentation of setting a transfer price by the taxpayer should address the following:

- details of controlled transactions with connected persons, covering the nature, price and terms of the transactions;
- copies of international agreements entered into with connected persons;
- the method used in determining the price;
- motivation of the method used;
- the information relied on in determining the prices, such as commercial agreements with third parties, financial information, budgets or forecasts;
- the results of the prices that support the arm's length principle; and
- details of any special arrangement or conditions that might have influenced the prices, such as competitors.

In terms of Practice Note 7 (1999:24), the documentation of setting a transfer price by the taxpayer should also outline the following:

- the basis of comparing the goods and services;
- major competitors and those that are considered most comparable; and
- the transfer pricing methods used.

Practice Note no. 7 (1999:31) outlines a four step approach, which is covered in detail under Annexure B of Practice Note 7, to determine arm's length prices, which is in line with the Australian Taxation Office, namely:

- step 1: Understanding the cross border dealings between connected persons in the context of the taxpayer's business and assessing the risk;
- step 2: Selecting the appropriate transfer pricing method;

- step 3: Applying the transfer pricing method; and
- step 4: Calculating the arm's length price in accordance with the selected method.

The addendum to Practice Note 7 dated 29 September 2005, clarifies the submission of transfer pricing policy documents by companies. There is no explicit statutory requirement that taxpayers must prepare and submit transfer pricing policy documents to SARS. SARS acknowledges that the preparation of transfer pricing documentation takes a lot of time and it is expensive. The absence of formal transfer pricing documentation will not be regarded as non-disclosure in the case where a taxpayer has provided full details of the international agreements that were entered into with connected persons.

The addendum to Practice Note 7 (2005:1) confirms that legally, taxpayers are not compelled to prepare the policy document, taxpayers should determine the costs benefits of compiling this documentation. However, taxpayers that have the documents are encouraged to submit them to SARS together with their tax returns. SARS will examine the policy documentation of the taxpayer in assessing their transfer pricing transactions. Adequate documentation is the best way to demonstrate that transfer prices are consistent with the arm's length principle, thus it is in the best interest of taxpayers to submit detail information or documentation to support their workings on transfer prices. Thus, it is advisable for practical reasons that a taxpayer should prepare transfer pricing documents. (Olivier & Honiball, 2008:504.)

The addendum to Practice Note 7 (2005:1), outlined that companies that do not have transfer pricing policy documentation are at risk on two counts. Firstly, they are more likely that SARS will examine a taxpayer's transfer pricing in detail, if the taxpayer has not prepared proper documentation. Secondly, the Commissioner, as a result of this examination, may substitutes an alternative arm's length amount for the one adopted by the taxpayer. The lack of adequate documentation will make it difficult for the taxpayer to rebut that substitution, either directly with SARS or in the courts.

The addendum to Practice Note 7 (2005:2), further illustrates that the process of checking compliance with the arm's length principle becomes more difficult and complex for the

Commissioner if adequate documentations are not kept. The Commissioner might resort to rely on his own judgement, which might be to the disadvantage of the taxpayer.

As from the 2004 tax year, the IT14 form for companies specifically requires taxpayers to submit the information stipulated in the brochure, like transfer pricing policy documents with their tax returns (Olivier & Honiball, 2008:505). This requirement is conflicting with some of the provisions of the addendum to Practice Note 7 (2005:1-2).

The practical considerations in determining transfer prices have been covered in detail in Practice Note 7 (1999:24-31) and OECD Guidelines (2001:I-6) as guidance factors for applying the arm's length principle, please see chapter 4..

3.7 CONCLUSION

Practice Note 7 (1999:13) endorses the acceptable transfer pricing methods that are used internationally, which international methods are considered adequate to determine transfer prices (OECD Guidelines, 2001:II-1 to III-24).

Practice Note 7 should be updated to be in line with the proposed changes to section 31 of the Income Tax Act as per the Draft Taxation Laws Amendment Bill (2010:65) and incorporate latest sections of the Income Tax Act like, for example, sections 80A to 80L.

Practice Note 7 (1999:26) states that SARS may select the mid-point in the range, in the absence of persuasive evidence for the selection of a particular point in that range, which is contrary to the arm's length principle and a deviation from OECD Guidelines. SARS is requested to reconsider this position to the Practice Note 7 in order to be in line with OECD Guidelines. (Olivier & Honiball, 2008:495.)

Application of different transfer pricing methods on a transaction by SARS, unless in a complex transaction, there is a deviation from OECD Guidelines (2001:I-26) which should be clarified in SA (Olivier & Honiball, 2008:495).

A critical analysis of the transfer pricing methodology that SA uses to combat tax avoidance was examined in this chapter. A critical analysis of the transfer pricing methodology that is used internationally to combat tax avoidance will be examined in the next chapter.

CHAPTER 4

A CRITICAL ANALYSIS OF THE TRANSFER PRICING METHODOLOGY THAT IS USED INTERNATIONALLY TO COMBAT TAX AVOIDANCE

4.1 INTRODUCTION

In this chapter, a critical analysis of the transfer pricing methodology that is used internationally to combat tax avoidance will be examined.

According to Levey and Wrappe (2001:141), internationally, most countries follow the OECD Guidelines. The OECD Guidelines give guidance to member states to treat similar transactions in the same way. These will ensure that each and every member country receive their fair share of profits that arises from cross border transactions. The arm's length principle should be applied fairly between member countries to avoid circumstances where the country that have the right to tax profit of a transaction loss that right because the other country has aggressive tax legislation.

The UK has made the OECD Guidelines part of its transfer pricing regulation in terms of section 7708 of the UK Inland Revenue (International Fiscal Association, 1998:29 and 1998:44; Levey & Wrappe, 2001:389).

OECD member countries are amongst the worlds most influential as they produce over two-thirds of the world's goods and services (Levey & Wrappe, 2001:141; Olivier & Honiball, 2008:9). The OECD intends to recruit Brazil, Russia, India and China, the so called "BRIC" countries, even though some OECD member countries do not support these initiatives as it might create a group within a group of OECD member countries. These countries, except Brazil, have OECD observer status like SA. (International Tax Review, 2009:13; Olivier & Honiball, 2008:10.)

According to International Fiscal Association (1998:9), OECD member countries are closely monitored by an OECD working party to ensure that the development of local regulations in the member countries does not conflict with the OECD Guidelines. The

OECD working party number six is a peer review of the transfer pricing practices of OECD member countries. Every effort is made to persuade a country with conflicting local regulations to change or abolish them. Unfortunately non OECD member countries are not being officially monitored, which might lead to global inconsistencies. Negative reports are however, issued on those non OECD countries that are not following the principles of OECD Guidelines. Inconsistencies lead to malfunctions when trying to resolve disputes and forces multinational companies to cater for multiple local solutions which may not make sense, rather than taking a reasonable approach to transfer pricing. (OECD Guidelines, 2001:I-27.)

4.2 CRITICAL ANALYSIS OF THE ARM'S LENGTH PRINCIPLE INTERNATIONALLY

4.2.1 Arm's length principle as used internationally

Article 9 of the OECD Model Convention with respect to Taxes on Income and on Capital (2005:9) does not specifically refer to the term "arm's length". Paragraph 1 of this article commentary refers to arm's length principle and OECD Guidelines. The OECD Guidelines represent internationally agreed principles and provides guidelines for the application of the arm's length principle of which article 9 of the OECD Model Convention with respect to Taxes on Income and on Capital (2005:9) is the authoritative statement. (Levey & Wrappe, 2001:142; Olivier & Honiball, 2008:509.)

The OECD Guidelines (2001:P-1) acknowledge that multinational companies that operate in different countries are faced with a challenge to comply with the various taxation requirements of those countries. Some OECD member countries are faced with a challenge where they loose their share of taxable profits. OECD member countries have adopted the arm's length principle to address the effect of special conditions on the level of profits within multinational companies. Many countries that are not OECD members have also adopted OECD Guidelines (such as SA), thus OECD Guidelines have become internationally accepted standards. The use of OECD Guidelines internationally ensures consistency and reduces double taxation of the same income amounts.

In terms of the OECD Guidelines (2001:I-2), OECD member countries acknowledge that an appropriate adjustment is reached by establishing the conditions of the commercial and financial relations that they would expect to find between independent companies in the same transactions under the same circumstances.

In terms of the OECD Guidelines (2001:I-1), the arm's length principle is the international transfer pricing standards that OECD member countries should use for tax purposes by multinational companies and tax authorities. The arm's length principle is embodied in most tax treaties, especially in OECD member countries. The arm's length principle was adopted by OECD member countries as it provides broad comparison of tax treatment for multinational company and independent companies. It puts connected companies and independent companies on a more equal footing for tax purposes. It avoids the creation of tax advantages and disadvantages that would otherwise distort the relative competitive position of either type of the entity. It further promotes the growth of international trade and investment.

4.2.2 Application of the arm's length principle internationally

The transfer price of controlled transactions of multinational companies should be within the arm's length range. An arm's length range is a range of figures that are acceptable for establishing the conditions of a controlled transaction whether it is arm's length. Thus, tax administrations should avoid making minor taxation adjustments. They are encouraged to consider two implications in their examination practices. Firstly, they are not supposed to be too rigid, unrealistic and unreasonable under the facts and circumstances in their approach. Secondly, they should consider commercial judgement in the application of the arm's length principle of the taxpayer. They must endeavour to view the cross border transaction from the perspective of the taxpayer. (OECD Guidelines, 2001:IV-4.)

The OECD Guidelines endeavour to bring uniformity between member countries. The OECD Guidelines (2001:I-6), outline some factors for guidance when applying the arm's length principle, namely:

- comparability analysis of the transactions;
- recognition of the actual transactions undertaken;

- evaluation of separate and combined transactions;
- use of an arm's length range;
- use of multiple year data;
- losses;
- the effect of government policies;
- intentional set-offs;
- use of customs valuations; and
- use of transfer pricing methods

Practice Note 7 (1999:24-31) covers in detail these guidance factors as the practical considerations in determining transfer prices. The OECD Guidelines discussion of these guidance factors is generally consistent with that of the section 482, 1968 of the Internal Revenue Code (Levey & Wrappe, 2001:143).

4.2.2.1 *Comparability analysis of the transactions*

According to the OECD Guidelines (2001:I-6), the application of the arm's length principle is based on a comparison of the conditions in a controlled transaction with the conditions in a transaction between independent companies. The economic situation of the transactions must be compared. There must be no differences (if any) between the situations being compared that could significantly affect the condition being examined in the methodology.

According to the OECD Guidelines (2001:I-6), independent companies in evaluating a potential transaction will normally compare the terms of the potential transaction to the terms of other options realistically available to them. They will only proceed with the potential transaction if they see no alternative transaction that is clearly more attractive than the one being evaluated. They will consider any economically relevant differences between the options realistically available to them when those options are being valued.

According to the OECD Guidelines (2001:I-6), the comparable uncontrolled price method compares a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price the parties would have agreed to had they resorted directly to a

market alternative to the controlled transaction. The resale price and the cost price methods compare the gross profit margin earned in the controlled transaction to gross profit margin earned in similar uncontrolled transactions. In all these cases, adjustments must be made to account for differences between the controlled and uncontrolled situations that would significantly affect the price charged by independent companies. The profits of a connected person may be adjusted as necessary to correct any distortion to ensure that the arm's length principle is achieved.

According to the OECD Guidelines (2001:I-6), tax authorities should consider the differences (if any) between the situations being compared by the connected persons when establishing whether there is comparability between the situations being compared and what adjustments may be necessary to achieve comparability.

According to the OECD Guidelines (2001:I-6), in order to establish the degree of actual comparability and to make appropriate adjustments to achieve arm's length conditions, the attributes of the company that would affect conditions in an arm's length dealing must be compared. The attributes of the company, that may be important, include the characteristics of the property or services, the functions performed by the parties, taking into account assets used and related risks, the contractual terms, the economic circumstances of the parties and the business strategies pursued by the parties.

The OECD Guidelines (2001:I-8), outlines the factors or attributes of the company that determine comparability that should be analysed. These factors or attributes have been discussed in Chapter three as principles of comparability of data in SA.

4.2.2.2 *Recognition of the actual transactions undertaken*

In terms of the OECD Guidelines (2001:I-14), a tax authority should consider the documents and the standard transfer pricing method used by the taxpayer in examining a controlled transaction of a connected person. Two situations were a tax authority may not accept the work compiled by a taxpayer are if the economic substance of a transaction differs from its form or where the arrangement made in relation to the transaction viewed in their totality is different from those which would have been adopted by independent

companies; as well as when the structure of the transaction prevent the tax authority from determining an appropriate transfer price.

4.2.2.3 *Evaluation of separate and combined transactions*

According to the OECD Guidelines (2001:I-16), the arm's length principle should be used on a transaction by transaction basis to determine the fair market value. However, in some instances, separate transactions that are closely linked or continuous can be used, where it is not possible to isolate them.

4.2.2.4 *Use of an arm's length range*

The OECD Guidelines (2001:I-18) illustrates that in practice, it is possible to apply the arm's length principle and arrive at a single figure that is more reliable to establish that the figures of a transaction are arm's length. There are instances were the standard transfer pricing method or methods might yield a number of different results, range of figures that are relatively reliable. The taxpayer should use good judgement to identify the range of the arm's length price. The range of figures would be easily acceptable to tax authority, if the relevant conditions of the controlled transactions are within the arm's length range, no adjustment would be necessary.

4.2.2.5 *Use of multiple year data*

The OECD Guidelines (2001:I-19) outlines that the taxpayer must examine data from both the year under examination and prior years to establish both the business and product life cycle trends, to obtain full understanding of the facts and circumstances of the data that is being compared.

4.2.2.6 *Losses*

According to the OECD Guidelines (2001:I-20), tax authority will scrutinize a subsidiary company that consistently realises losses meanwhile the multinational company as a whole is profitable. An independent company would not be prepared to tolerate losses that

continue indefinitely, unless, the operations of the subsidiary company are driven by other ulterior motives.

4.2.2.7 *The effect of government policies*

In terms of the OECD Guidelines (2001:I-21), government interventions on price control, such as price cuts, exchange controls, exchange rate policy, anti-dumping duties, interest rate controls, and controls over payments for services or management fees should be considered as conditions of the market in the particular country. They should be taken into account, in considering the arm's length price in that market. Government interventions apply equally for connected persons and independent persons, under normal circumstances as a general rule, for example, blocked income in a foreign country would be blocked in the same way for both connected and independent persons.

It becomes complicated where the government intervention applies only to transactions between connected persons. Arm's length principle can be used by considering the interventions as a condition affecting the terms of the transaction. Tax treaties should be considered as well. A difficult with this analysis in this circumstance is that an independent person simply would not enter into a transaction in which payments were blocked, unless the government interventions were imposed subsequently after the transaction was entered into. (OECD Guidelines, 2001:I-22.)

In SA, section 9A of the Income Tax Act provides domestic tax relief for blocked foreign funds.

4.2.2.8 *Intentional set-offs*

An associated entity may perform some functions or benefits on behalf of another associated entity in anticipation of a reduced price or a certain benefit in return. These entities may claim that the benefit each has received should be subtracted from the benefit each has provided as part payment for those benefits so that only the net gain or loss on the controlled transactions needs to be considered for purpose of assessing tax liability. These transactions are similar to barter transactions. The arm's length principle should be

applied in the same way as though they were independent companies. (OECD Guidelines, 2001:I-23.)

4.2.2.9 *Use of customs valuations*

The import value used by an associated company is compared to the value for similar goods imported by an independent company. This principle is used by customs administrations as well. (OECD Guidelines, 2001:I-26.)

4.2.2.10 *Use of transfer pricing methods*

In terms of the OECD Guidelines (2001:I-26), the traditional transaction methods or transactional profit methods establish whether the conditions imposed in the commercial and financial relations between connected persons are consistent with the arm's length price. These conditions are similar to the ones that are found in article 9 of the OECD Model Convention with respect to Taxes on Income and on Capital (2005:9). Tax administrators should hesitate from making minor adjustments as no single method is suitable in every possible situation. The arm's length principle does not require the application of more than one method per transaction, unless it is a difficult transaction.

4.3 ACCEPTABLE TRANSFER PRICING METHODS THAT ARE USED INTERNATIONALLY

Different methods can be used in complex cross border transactions even though the arm's length principle does not require the application of more than one method (OECD Guidelines, 2001:II-1).

Standard transfer pricing methods recognised by the OECD Guidelines (2001:II-1 to III-24) and endorsed by the Practice Note 7 (1999:13) are:

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

- transaction net margin method; and
- profit split method.

4.3.1 Comparable uncontrolled price method (CUP method)

The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. Significant differences determined indicate that the controlled transactions might not be arm's length. (OECD Guidelines, 2001:II-1 to III-24.)

4.3.2 Resale price method (RP method)

The RP method compares the price of a product, for example a car, which is sold to an external entity versus the price that was initially sold to a connected person. The selling costs are taken out of the resale price margin; the resale price margin, being the difference of the two prices (resale price to external entities less the price to connected persons).
What is left after subtracting the gross margin and indirect costs is an arm's length price. (OECD Guidelines, 2001:II-1 to III-24.)

4.3.3 Cost plus method (CP method)

An appropriate cost plus mark up is added to the costs incurred by the supplier of property or services in a controlled transaction for property transferred to a connected person. The sum of these costs will be the arm's length price of the original controlled transaction. This method is used for half finished goods in a production line. (OECD Guidelines, 2001:II-1 to III-24.)

4.3.4 Transaction net margin method (TNMM)

TNMM examines the net profit margin relative to an appropriate base that a taxpayer realises from a controlled transaction. TNMM operates in a manner similar to the cost plus

and resale price methods, thus it is used to collaborate their results. (OECD Guidelines, 2001:II-1 to III-24.)

4.3.5 Profit split method

The profit split method identifies the profit to be split for the associated company from the controlled transactions in which the connected persons are engaged. Those profits are split between the connected persons on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length. (OECD Guidelines, 2001:II-1 to III-24.)

In terms of the OECD Guidelines (2001:II-7), traditional transaction methods are the most direct means of establishing whether conditions in the commercial and financial relations between connected persons are at arm's length, hence, they are preferable as compared to other methods. They require a high degree of comparability. A reliable method is the one that provides fewer and more reliable adjustments. The taxpayer should use a method which they have the most data. The most preferred method internationally is the CUP method, followed by RP and CP methods, which are the traditional transaction methods.

The complexities of real life business and lack of adequate data or information may compel taxpayers to use other methods, like transactional profit methods. These methods are normally classified as alternative methods to traditional transaction methods. TNMM and the profit split methods are transactional profit methods. They examine the profits that arise from certain transactions among connected persons. (OECD Guidelines, 2001:II-7.)

The application of the most appropriate method or methods will often result in a range of justifiable transfer prices. The use of more than one method will be justified in the case of complicated controlled transactions (OECD Guidelines, 2001:III-1). The applicability of any particular method must not be disproved as there is no one method that is suitable for every possible situation. Arm's length principle does not require the application of more than one method as that would not be practical and would create a significant burden for taxpayers. (OECD Guidelines, 2001:I-26.)

4.4 TRANSFER PRICING DOCUMENTATION

Taxpayers should maintain and be able to provide documentation on how they have determined their cross border prices with connected persons in accordance with the arm's length principle. They should refer to written materials, which indicate the factors, basis and methods used to determine the prices. (OECD Guidelines, 2001:V-1.)

The rules under the burden of proof in some countries may affect the requirement of documentation. Depending on the complexity of cross border transactions, a taxpayer should use the same prudent business management principles to determine whether the documentation is adequate for tax purposes. (OECD Guidelines, 2001:V-1.)

Tax administration should consider the costs and administrative burden of the taxpayer of creating and submitting the documentation. They should not expect taxpayers to prepare or obtain documentation beyond the minimum needed to make a reasonable assessment of whether or not they have complied with the arm's length principle. The OECD Guidelines do not prescribe specific penalties for non-compliance with documentation disclosure with tax authorities unlike the USA. (OECD Guidelines, 2001: V-1 to V-3.)

4.5 PRACTICAL CHALLENGES OF TRANSFER PRICES INTERNATIONALLY

The OECD Guidelines acknowledges that there are practical difficulties in applying the arm's length principle as taxpayers may not be able to obtain the required information on transactions between independent companies; which is comparable to the controlled transactions of connected persons (Levey & Wrappe, 2001:143).

In terms of the OECD Guidelines (2001:I-5), the arm's length principle illustrates that the taxpayer and tax authority should evaluate uncontrolled transactions and the business activities of independent companies and compare them with the transactions and activities of connected persons. This process can demand a substantial amount of data. Gathering data has its own challenges. The available information might be incomplete or difficult to

interpret or the information might be difficult to obtain due to logistical challenges or confidentiality concerns.

Even though, some countries view the arm's length principle to be flawed. The reasons that they advance are that the arm's length approach may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses. The counter argument is that there are no common accepted criteria for allocating the economies of scale or benefits of integration between connected persons. (OECD Guidelines, 2001:I-4.)

The arm's length principle provides the closest approximation of sound theoretical basis of the open market figures where connected persons sells and buys goods or services within themselves. In fact, there is no legitimate or realistic alternative method that is known than the arm's length principle. The OECD Guidelines reject the global formulary apportionment approach, which is sometimes mentioned as a possible alternative by some advocates, as it is arbitrary and does not reflect differing rates of return in different jurisdictions. The method is not practical, although some tax administrations, like in Canada and California, have applied this method to maximise their revenue. (Arnold & McIntyre, 2002:80; OECD Guidelines, 2001:I-5 and III-19.)

In terms of International Tax Review (2009:14), the global formulary apportionment method, which might be the contender as a replacement system of the arm's length principle is not practical. The League of Nations fiscal committee studied the global formulary apportionment method in the early 1930s, in the same way that OECD fiscal committee did when they came out with the OECD Guidelines (2001:III-21), they found that even though it might be better, it would be very political and difficult to get international agreement from countries to agree to a universal formula. The League of Nations was replaced by the United Nations in 1945 after the World war two. The UK, as well, is not in favour of the global formulary apportionment method.

The International Tax Review (2009:12-14) looked at what could threaten the arm's length principle. The European Union is exploring the possibility of adopting some type of global formulary apportionment method in order to address the complex problems that are faced

by their multinational companies. The European Commission working group, which is a working group of the European Union, during the discussions about moving to a common consolidated corporate tax base, supported the global formulary apportionment method. They raised concerns that the arm's length principle is complicated, time consuming, resource intensive, expensive to comply with and administer and leaves room for profit shifting strategies. In the USA, where global formulary apportionment method is used by some states like California, there are signs that a wider conversion is emerging that support this method. (Arnold & McIntyre, 2002:80.)

The advocates of the global formulary apportionment method claim that it would provide greater administrative convenience and certainty for taxpayers. They argue that it reduces the resources and costs of taxpayers to comply, since in principle only one set of tax accounts would be prepared by multinational companies. (OECD Guidelines, 2001:III-20.)

In terms of International Tax Review (2009:12), the advocates against the arm's length principle argue that the whole point of international corporate groups is that they have economies of scale or integration advantages that make them different from companies dealing at arm's length. Thus, trying to apply the arm's length principle, it is seen as trying to recreate a situation which in principle, does not exist. It is becoming difficult to demonstrate to the increasing high standard of proof needed to comply with arm's length.

4.6 ADVANCE PRICING ARRANGEMENT

The USA was the first country to develop the advanced pricing arrangement (APA) in the beginning of 1990 in an effort to ensure compliance with section 482 of the IRC and to provide taxpayers with some certainty in planning their business transactions (Avi-Yonah, 2007:118-119; Doernberg, 2004:329).

An APA is a binding and confidential arrangement that determines, in advance, an appropriate set of criteria, for example, transfer pricing method, critical assumptions, comparables or appropriate adjustment thereto, which would be used to determine acceptable transfer prices over a fixed period of time. The APA procedure attempts to prevent tax disputes by determining criteria to be used by taxpayers to meet the

acceptable transfer prices in advance before those cross border transactions are entered into. It makes it easier for multinational companies to evaluate whether to undertake a particular transaction or not and for taxpayers to freely conduct their business without fear of being attacked later by tax authorities. (Avi-Yonah, 2007:118-119; Doernberg, 2004:329; OECD Guidelines, 2001:IV-41 to IV-51.)

The APA procedure offers the certainty of pre-clearance, immunity from penalties, avoid prolonged legal cases and reduce double taxation. It applies on an agreed upfront transfer pricing methodology for agreed cross border transactions. The period of an APA is about three to five years, depending on the type of a transaction and industry of the taxpayer. In order for APA to be comfortable with the transfer pricing work performed by a taxpayer; APA would recommend an expert, who is approved by the tax authority, at the expense of a taxpayer, to independently review the work of the taxpayer. (Avi-Yonah, 2007:118; Doernberg, 2004:329.)

In terms of Levey and Wrappe (2001:316), an APA may either be:

- a unilateral APA- an agreement between the taxpayer and tax authority; or
- a bilateral or multilateral APA- an agreement that includes the taxpayer, the local tax authority and one or more foreign competent tax authority under applicable tax treaty.

In terms of Levey and Wrappe (2001:329), a taxpayer should file an APA annual report to the tax authority APA office on a certain date (90 days in the USA) after the due date. The APA annual report should indicate that the taxpayer is complying with:

- the good faith compliance by the taxpayer with the terms and conditions of the APA;
- the calculations of compensating adjustments that should be within the agreed upon transfer price range; and
- compliance with any critical assumptions.

Tax authorities should limit the amount of information that is submitted with the tax returns. Useful information to determine the arm's length principle should be kept confidential by tax authorities, unless compelled by regulation or a court of law. The useful information include information about the associated companies involved in controlled transactions,

details of controlled transactions, functions performed, comparable data obtained in relation to the controlled transaction. (OECD Guidelines, 2001:V-5.)

The only major problem with the APA in the USA was confidentiality as companies submit their useful information that include price sensitive data and business strategies in advance. Some companies attempted to compel Inland Revenue Services (IRS) to release that information in terms of the USA Freedom of Information regulation. However, the regulation was amended to protect the privacy of the APA. (Avi-Yonah, 2007:119.)

4.7 CONCLUSION

The OECD Guidelines provide adequate guidelines to administer and apply the arm's length principles of which article 9 of the OECD Model Convention with respect to Taxes on Income and on Capital (2005:9) is the authoritative statement (Levey & Wrappe, 2001:142; Olivier & Honiball, 2008:508).

The examination practices in the OECD Guidelines (2001:IV-3) are not part of Practice Note 7, although they provide excellent guidance to assist tax authority and taxpayers. Taxpayers can use them to defend or justify their transfer pricing results.

A critical analysis of the transfer pricing methodology that is used internationally to combat tax avoidance was examined in this chapter. A critical analysis of the transfer pricing methodology that is used by the USA to combat tax avoidance will be examined in the next chapter.

CHAPTER 5

A CRITICAL ANALYSIS OF THE TRANSFER PRICING METHODOLOGY THAT IS USED BY THE USA TO COMBAT TAX AVOIDANCE

5.1 INTRODUCTION

In this chapter, a critical analysis of the transfer pricing methodology that is used by the USA to combat tax avoidance will be examined.

The USA is covered in this research essay as it is the first country to modernize and enforce transfer pricing laws. USA is a significant market for a number of multinational companies and is a leader in transfer pricing. Its activities create an infrastructure of multinational companies that can easily manipulate transfer prices. In April 1999, IRS estimated that the annual tax loss resulting from non-compliance with transfer pricing was $2.8 billion, which is a significant amount. Transfer price regulations in the USA were strengthened over the years as IRS was unable to obtain information from the taxpayers, the inherent subjectivity in the application of the transfer pricing regulation and IRS did not have adequate resources to enforce the law. (Levey & Wrappe, 2001:164-169.)

5.2 CRITICAL ANALYSIS OF THE ARM'S LENGTH PRINCIPLE IN THE USA

The USA applies section 482 of the IRC in assessing transfer prices. Section 482 of the IRC states that in any case of two or more organisations, trade or businesses (whether or not organised in the USA) owned or controlled directly or indirectly by the same interests. The Internal Revenue Secretary may distribute, apportion or allocate gross income, deductions, credits or allowances between or among such organisations, trade or businesses, if he determines that such distribution, apportionment or allocation is necessary in order to prevent evasion of taxes or to reflect the income of any such organisations, trade or businesses. (Avi-Yonah, 2007:103.)

The USA Congress added the first amendment sentence to this section since its inception in 1986, which states that in the case of any transfer or license of intangible property, the

income with respect to such a license shall be commensurate with the income attributable to the intangible. This provision established the super royalty rule in the USA. (Avi-Yonah, 2007:110; Levey & Wrappe, 2001:4.)

Section 482 of the IRC is an umbrella like provision that is available to IRS, if a number of narrower provisions addressing certain specific transactions prove to be inadequate. The section is not prescriptive; it is backed by a string of penalties that can be imposed for non-compliance with transfer pricing regulations. It is the most general section and the most sweeping grant of power to the IRS of any section of the IRC. The section does not have the definition of control. IRS has the flexibility of trying to find informal control in various ways, which might lead to abuse of power. (Avi-Yonah, 2007:103; Doernberg, 2004:267.)

Section 482 of the IRC authorises IRS to allocate gross income and taxation expenses between connected persons to the extent necessary to prevent evasion of taxes or clearly to reflect income of a connected person. The allocation of gross income and taxation expenses is a weapon which is only available to IRS, these provisions cannot be invoked by a taxpayer. (Doernberg, 2004:264.)

Section 482 of the IRC is based on the principle that transactions between connected persons should be evaluated on an arm's length basis. This section is basically in line with the principles of article 9 of the OECD Model Convention with respect to Taxes on Income and on Capital (2005:9).

The development of OECD Guidelines was influenced to a great extent by the regulations of the USA. The OECD Guidelines are generally consistent with the USA transfer pricing regulations. There are two areas were they differ significantly, namely:

- the relationship between the comparable profit method and the OECD's transactional net margin method; and
- commensurate with income standard for intangible transactions in the USA, the super royalty rule, which is not available under the OECD Guidelines. (Doernberg, 2004:265; Levey & Wrappe, 2001:142.)

The arm's length principle of a transaction between connected persons is best tested by comparing the results of unrelated parties engaged in comparable transactions under comparable circumstances with the results of the transaction of connected persons as per an USA context. Comparable circumstances, if two transactions can be achieved by comparing the following factors: functions, risks of the transactions, contractual terms of the transactions, economic conditions, nature and volume of property transferred or services rendered. A controlled transaction meets the arm's length provisions if the results of the transaction are consistent with the results that would have been achieved if it was an uncontrolled transaction under the same circumstances. (Doernberg, 2004:268.)

The prices set between connected persons need not be a specific point in that range. As long as the results of the taxpayer fall within the price range derived from two or more applications of the same pricing method to different uncontrolled comparable transactions. The arm's length range is a price range of figures that are relatively equally reliable in terms of OECD Guidelines. (Levey & Wrappe, 2001:27-28.)

The USA regulations distinguish between two possible price ranges. One being of equally reliable results and the other one is based on comparables but of a different quality. The price range results of the latter must be shortened by cutting off the results that are falling in the first and last quarter of the range. The common factor between the two rules is that no adjustment should be made if the price range falls within the arm's length price range. (International Fiscal Association, 1999:2; Levey & Wrappe, 2001:8.)

Section 482 of the IRC allows a taxpayer to elect a deferred income method of accounting if a foreign legal restriction prevents the payment or receipt of a blocked income. The blocked income regulation was introduced after both cases of the *First Security Bank of Utah* (405 U.S. 394 (1972)) and *Procter and Gamble company* (961 F 2d 1255 (6th Cir. 1992)). It will not survive judicial scrutiny because IRS overstepped their authority under the statute. IRS is trying to overrule the opinion of the Sixth Circuit court in regards to the case of Procter and Gamble company, where it was held that section 482 of the IRC can not be applied in the blocked income situation. (Levey & Wrappe, 2001:133-140.) The case of Procter and Gamble company is covered in detail later under the application

challenges of the arm's length principle in the USA. The blocked income regulation in the USA is similar to section 9A of the Income Tax Act.

A related party (which is similar to connected person) in terms of section 482 of the IRC is:

- any 25% foreign shareholder of the reporting company;
- any person related to the reporting company or a 25% foreign shareholder; or
- any person who is related to the reporting company under section 482 of the IRC. (Doenberg, 2004:313; Levey & Wrappe, 2001:177.)

5.3 ACCEPTABLE TRANSFER PRICING METHODS UNDER THE ARM'S LENGTH PRINCIPLE IN THE USA

A transaction may be comparable to another transaction even if it is not identical, although adjustments may be required. The adjustment must be based on commercial practices or economic principles in the same way in which they are prescribed by OECD Guidelines. (Doernberg, 2004:264-271.)

Section 482 of the IRC offers a variety of different methods that can be used to determine the arm's length price of a transaction between connected persons. In recognising that different methods may yield different results, IRS uses a best method rule, rather than imposing a hierarchy of methods, that is, the best method under the facts and circumstances that provides the most reliable measure of an arm's length result is used. (Doernberg, 2004:264-271; Levey & Wrappe, 2001:8-13.)

The best method rule looks at the quality of the data, that is, the completeness and accuracy of available data and assumptions used in the analysis; the degree of comparability between the controlled transaction and the uncontrolled comparable transaction; and the extent of adjustments required in applying a particular method. The best method rule provides that if two methods provide inconsistent results, a third method should be considered, that would provide consistent results with the results of either of the two methods. The best method rule was modified in 1994 to provide that taxpayers were to use the "most reliable" method instead of the "most accurate" method. (Levey & Wrappe, 2001:8-13.)

According to Doernberg (2004:272), sections 482 of the IRC covers the following five categories of cross border transactions as conducted by connected persons:

- the sale of tangible assets;
- the licence of intangible assets;
- the provision of management services;
- loans; and
- leases of property

5.3.1 The sale of tangible assets

The sale of tangible assets can be assessed under the following pricing methods; being the comparable uncontrolled price method (CUP), the resale price method, the comparable profits method and the profit split method.

Arm's length results are determined from the price charged in comparable uncontrolled transaction for comparable goods in the case of CUP or from the gross profit margins of comparable uncontrolled resellers in the case of resale price methods or gross margin of comparable procedures in the case of cost plus method. The cost of services plus method evaluates whether the amount charged in a controlled services transaction is arm's length by reference to the gross services profit mark-up realised in comparable uncontrolled transaction. (Doernberg, 2004:264-272; Levey & Wrappe, 2001:31.)

5.3.2 The licence of intangible assets

The licence of intangible assets uses the CUP, comparable profits method and the profit split method (Doernberg, 2004:264-272; Levey & Wrappe, 2001:51).

5.3.3 The provision of management services

The transfer price for the provision of management services may use the services cost method (SCM). Costs from shared or centralised services are allocated through shared services arrangement provision. (Doernberg, 2004:264-272; Levey & Wrappe, 2001:87.)

5.3.4 Loans and leases of property

The terms of the loan and the rental amount must be set at arm's length (Doernberg, 2004:264-272; Levey & Wrappe, 2001:111).

Section 482 of the IRC provides that other unspecified methods, as long as they satisfy the best method rule like the specified methods, may be used to evaluate transfer prices (Levey & Wrappe, 2001:50).

5.4 REPORTING REQUIREMENTS UNDER SECTION 482 OF THE IRC

In terms of section 6038A of the IRC, a reporting company is generally a USA company that has at least one 25% foreign shareholder or a foreign company which is engaged in a trade or business in the USA (Doernberg, 2004:313; Levey & Wrappe, 2001:177).

According to Doernberg (2004:312-318), section 6038A of the IRC, which was introduced in 1989, imposes information reporting and record keeping on any USA company (reporting company) that is owned to a significant extent by a foreign shareholder, which is engaged on transactions with connected persons.

According to Levey and Wrappe (2001:14), section 6038A of the IRC has two complete exceptions and two partial exceptions. Complete exceptions are for reporting requirements where a foreign company:

- with no USA permanent establishment under the applicable tax treaty; and
- whose gross income is exempt from USA under section 883 of the IRC (qualified shipping income).

Partial exceptions apply where the company;

- has less than $10 million in USA gross receipts for the taxable year; and
- has related party transactions that are not more than $5 million and less than 10 percent of its USA gross income.

Section 6038C of the IRC, which was introduced in 1989, imposes similar requirements on a foreign company or a branch operations of foreign company, which is engaged in a trade or business in the USA; as valuable information to determine arm's length requirements may be held by this connected persons of multinational companies in foreign tax jurisdictions of the USA (Levey and Wrappe, 2001:14).

*ASAT Inc (*108 T.C*.* 147 (1947)) illustrated circumstances of non-compliance with section 6038A of the IRC. IRS would sometimes request the reporting company to act as an agent of a foreign related person, that is, an authorised agent, for a limited period to disclose the necessary information or documents to IRS. If a reporting company fails to respond to summons or act as an agent of a foreign related party as requested by IRS, then IRS has broad powers to use their discretion to determine an arm's length amount attributable to the transfer price of a connected person. (Levey & Wrappe, 2001:175-181.)

ASAT Inc, which was a wholly owned USA subsidiary of ASAT Ltd, a Hong Kong company. Worltek International Ltd, an independent company, acquired 95 percent of ASAT Ltd in July 1992. IRS performed a tax audit of ASAT Inc after the acquisition, for the years prior July 1992. IRS requested that ASAT Inc obtain the authorisation of agent from ASAT Ltd under section 6038A of the IRC. ASAT Inc failed to significantly comply with the request and summons. ASAT Inc argued that it was impossible to obtain the required information from ASAT Ltd as ASAT Ltd was acquired by Worltek International before the investigation was initiated by IRS. Hence, they were not subject to section 6038A of the IRC with respect to ASAT Ltd. (Levey & Wrappe, 2001:182.)

The Tax Court upheld the actions of the IRS and rejected ASAT Inc argument based on section 6038A of the IRC. IRS issued a proposed adjustment based on information in its possession and further charged ASAT Inc 20 percent negligence penalty for failing to comply with section 6038A. (Levey & Wrappe, 2001:182.)

Section 6662 of the IRC has effectively shifted the burden of providing transfer pricing documentation from the IRS to the taxpayer. The purpose of this penalty regulation is to encourage taxpayers to make a serious effort to comply with the arm's length principles. Taxpayers in the USA must report arm's length results on their tax returns and document

their transfer pricing analysis in a formal report. They must be prepared to provide this documentation within 30 days upon request by IRS. (Doernberg, 2004:317; Levey & Wrappe, 2001:14.)

In terms of sections 6038A and 6038C of the IRC, a reporting company must file a Form 5472 for each foreign related party with which it has a reportable transaction during the tax year. Form 5472 is filed with the tax return of the taxpayer. A reportable transaction includes sales and purchases of inventory or other tangible property, rents and royalties paid or received, amounts paid or received in respect of intangible property, commissions paid or received amounts loaned or borrowed, insurance premiums or interest paid or received and other amounts paid or received that affect a reporting company's taxable income. The reporting requirements are significant and will be relied upon by the IRS in assessing the arm's length requirements. The increase in transfer pricing information has made it easier for IRS to examine transfer pricing decision of taxpayers. (Doernberg, 2004:312-314; Levey & Wrappe, 2001:164 and 2001:382.)

According to Levey and Wrappe (2001:178), the taxpayer must disclose the number of Forms 5472 filed for the tax year and the total value of payments made with respect to all foreign related party transactions reported on all the forms. A reporting company must include the following on Form 5472:

- the reference number, the name and address of the taxpayer;
- countries in which the taxpayer conducts trade and files an income tax return;
- country of incorporation;
- total assets; and
- principal business activities.

In terms of Doenberg (2004:312-314), a reporting company must submit detailed annual information concerning transactions with connected persons and maintain books or records. Categories of books or records that must be maintained are the general ledger, sales journals, accounting manuals, profit and loss statements, pricing documents including invoices and correspondence, foreign country filings, ownership and capital structure records, records of loans, security agreements, litigation and other risk shifting

mechanisms documents. These documents must generally be maintained in the USA, unless they can be produced quickly when they are required.

In terms of Doernberg (2004:318), the penalty regulation, section 6662 of the IRC lists ten principal documents that must be prepared by a taxpayer to fulfil the full maintenance requirements:

- business overview;
- description of organisational structure;
- documentation required under section 482 of the IRC;
- description of best method selected;
- description of methods not selected;
- description of controlled transactions;
- description of comparables selected;
- explanation of economic analysis;
- description of post year end relevant data; and
- index of principal and background documents.

Several countries have differing requirements for maintaining documentation and disclosure of cross border transactions between connected persons. One country may strongly suggest a copy of the transfer pricing documentation to be submitted with the tax return while another country may require completion of a form that lists the volume of each reportable transaction. Recent trends indicate that foreign countries do not only require documentation but also requires invoices and legal agreements to permit deductibility of inter group cross border payments. (Doernberg, 2004:312-315.)

The USA, unlike SA, imposes monetary penalties for non-compliance with the requirements of transfer pricing documentation. In terms of section 6038A, a reporting company is subject to a penalty of $10 000 for each year it fails to maintain records multiplied by the number of related parties for which records are not kept; unless the taxpayer can indicate that non compliance was due to reasonable care, which is an exception to the penalty. There is also a $10 000 penalty for each failure to file an adequate Form 5472. If a failure to maintain records or file an adequate Form 5472 continues for 90 days after notification, the penalty increases by $10 000 for each failure

and may be increased again for each subsequent 30 days period. (Doernberg, 2004:312-314; Levey & Wrappe, 2001:14.)

In terms of section 6662 of the IRC, if an adjustment made by IRS in terms of section 482 of the IRC demonstrates a “substantial valuation misstatement”, a penalty which is equal to 20 percent of the adjustment is imposed by IRS. The penalty rate doubles to 40 percent for a gross valuation misstatement which occurs if the consideration is 400 percent or more or 25 percent or less of the arm’s length determination or the net transfer price adjustment under section 482 of the IRC for the year exceeds the lesser of $20 million or 20 percent of the taxpayer’s gross receipts. (Doernberg, 2004:312-314.)

A substantial valuation misstatement occurs where the consideration reflected on the transaction in question is 200 percent or more or 50 percent or less of what is determined to be the arm’s length price or the net transfer price adjustment in terms of section 482 of the IRC for the year exceeds the lesser of $5 million or 10 percent of the taxpayers gross receipts (Doernberg, 2004:312-314).

In terms of section 6662 of the IRC, there are situations where an increase in taxable income resulting from a section 482 of the IRC adjustment of transfer pricing transactions is excluded in determining any applicable penalty; for example, where prices were determined in good faith and the misstatement was caused by a reasonable cause. Factors that are used in determining a reasonable cause include reliance on the advice of an expert by a taxpayer. The net adjustment penalty will not be applied if the taxpayer has reasonable cause though incorrectly followed one of the stipulated transfer pricing methods under the principle of the best method rule, which would be evidenced by supporting documentation.

Section 1059A of the IRC, which was introduced in 1986, prevents a USA purchaser from inflating the price paid for customs duties to a related foreign company in order to minimise the gain on eventual resale, the transaction price used for customs duties should be used (Levey & Wrappe, 2001:117).

The transfer pricing oversight committee was established by the IRS in 1996 to monitor and enforce consistency in the application of the documentation standards under section 6662 of the IRC. The committee reviews and determines the penalty of all cases in a District office of IRS. (Levey & Wrappe, 2001:175-181.)

DHL Corporation v IRS (76 T.C.M. (CCH) 1122 (1998), the dispute was in regards to the ownership of the DHL Corporation (DHL) trademark and the amount of royalty payable in its usage. DHL challenged IRS's presumption of correctness. DHL argued that it should be held to a lesser standard of showing that the prices were at arm's length. DHL further argued that it has reasonably relied on an appraisal that was performed by an independent person, a foreign shareholder. The court established that the appraiser was prepared to meet the value set by DHL, thus, DHL could not use that defence.

The court held that DHL owned the trademark, which was registered and used by its foreign connected company. The trademark was valued at $100 million. The court upheld the IRS's imposition of the 40 percent valuation misstatement penalty under section 6662(h) of the IRC as well as the 20 percent penalty under section 6662(b) of the IRC.
The court rejected the argument of DHL because it found out that the difference in the IRS's position was because DHL refused to share information with the IRS during the audit; this would encourage taxpayers to withhold information from the IRS and later criticise IRS. (Levey & Wrappe, 2001:175-176.)

5.5 ADMINISTRATION CHALLENGES OF THE ARM'S LENGTH PRINCIPLE IN THE USA

The administration challenges of the arm's length principle in this study are analysed under both the enforcement and practical challenges in the USA.

5.5.1 Enforcement challenges of the arm's length principle

The USA and other governments have strengthened their transfer pricing regulations and increased enforcement to protect their tax revenues from being shifted away by multinational companies (Levey & Wrappe, 2001:163).

In terms of Levey and Wrappe (2001:170), IRS identified the following factors that have hindered the effective enforcement of section 482 of the IRC:

- no contemporaneous evaluation of transfer prices;
- priority of transfer pricing methodologies;
- limited access to taxpayer information; and
- protracted disputes

5.5.1.1 *No contemporaneous evaluation of transfer prices*

Multinational companies do not consider the arm's length principle when setting their prices. Transfer pricing is only considered once they are being audited. The prices are not determined when the cross border transactions are concluded; they are based on hindsight, after the actual controlled transactions were concluded. (Levey and Wrappe, 2001:170.)

5.5.1.2 *Priority of transfer pricing methodologies*

Section 482 of the IRC contained a hierarchy of transfer pricing methods, which results in disputes between the taxpayer and IRS if one method is not identified as the best method by either (Levey and Wrappe, 2001:170).

5.5.1.3 *Limited access to taxpayer information*

IRS Inspectors are always faced by situations were there is inadequate information, especially information from a foreign country. They are forced to conclude their audits without adjustments or make adjustments based on limited information or estimations. (Levey and Wrappe, 2001:170.)

5.5.1.4_*Protracted disputes*

Transfer pricing disputes often became very difficult and protracted due to the fact that IRS did not have facts and taxpayers took unwarranted defence positions (Levey and Wrappe, 2001:170).

In terms of Levey and Wrappe (2001:171), the USA introduced five part strategies in 1992 to improve enforcement, namely:

- strengthened section 482 of the IRC in 1994;
- improved documentation requirements by adopting stringent penalty regime in section 6662(e) of the IRC in 1996;
- the USA built a worldwide consensus behind the arm's length principle, which culminated in OECD Guidelines;
- the usage of APA to proactively resolve transfer prices disputes was extensively promoted; and
- IRS developed technical and litigation support for prosecuting cross border transactions.

5.5.2 Application challenges of the arm's length principle

Section 482 of the IRC has a general rule that an allocation in terms of this section may be made, notwithstanding a foreign legal restriction. This provision of the regulation has attracted a number of court cases in the USA.

The *Procter and Gamble company v IRS* (961 F 2d 1255 (6th Cir. 1992)) involved blocked income, that is, income earned in a foreign country but cannot be transferred due to foreign government regulation. Procter and Gamble A.G. (AG) was a wholly owned subsidiary of Procter and Gamble company, parent USA company. Procter and Gamble manufactures household products such as detergents and disposable diapers. AG a Swiss company was engaged in marketing the products of Procter and Gamble in countries where Procter and Gamble was not performing marketing services. AG licensed and paid royalties to Procter and Gamble for the use of patents and trademarks of Procter and Gamble.

AG in turn sublicensed the patents and trademarks to its subsidiaries throughout Europe and the Middle East countries. The income generated by AG from the marketing activities of its subsidiaries was taxable directly by IRS to Procter and Gamble. Gamble Espana, a subsidiary of AG was operating in Spain. Spain prohibited the payments of royalties from Gamble Espana to AG. In determining the taxable income of Procter and Gamble, IRS allocated a royalty of two percent of Gamble Espana's net sales to be included in the taxable income of Procter and Gamble. IRS reasoned that no taxpayer would give away the right to use property in an arm's length transaction, that is, there is no royalty-free licence in an open market. AG was willing to forego a royalty payment from Gamble Espana because AG would reap the benefits from the marketing activities of Gamble Espana in Spain. A non shareholder licensor would not agree to license the use of its property unless it received royalty payments in exchange. (Levey & Wrappe, 2001:135.)

The court ruled that IRS could not allocate income between related companies where the purported misallocation was caused by foreign law. AG did not have deemed royalty income from Gamble Espana, which would be included in the taxable income of Procter and Gamble. The court agreed that foreign law should prevail even though the royalty was regulated in the USA. On appeal by IRS, the Sixth Circuit court rejected the IRS's notion that Procter and Gamble could have reported the royalty income on a deferral income method basis and then paid the tax due once the foreign regulation restriction was lifted. Section 482 of the IRC could not be applied in the circumstances of the blocked income. The company and the court relied on the Supreme Court case of First Security Bank of Utah, which was based on a well accepted American domestic law unlike the case of Procter and Gamble. (Avi-Yonah, 2007:121-123; Doernberg, 2004:319-322.)

Texaco Inc v IRS (98 F 3d 825 (5th Cir. 1996)), Texaco Inc (defendant), parent company was engaged in the production, refining, transportation and marketing of crude oil and refined oil products in the USA and around the world. Texaco International Trader Inc (Textrad), subsidiary company of Texaco Inc acquired Saudi Arabian crude oil by way of the Arabian American oil company (Aramco). This multinational company was established after the USA asked Saudi Arabia to help in stabilising oil prices in the 1970s. The Saudi Arabian government established the official selling price at a certain price per barrel for

Saudi Arabian crude oil below the market price and the government prohibited Aramco members from reselling Saudi Arabian oil at prices higher than the official selling price.

Textrad sold about 80% of the Saudi Arabian crude oil to Texaco Inc's refining companies in Indonesia below market price and 20% was sold to unrelated parties at the official selling price. Texaco Inc's refining companies earned huge profits when they sold their refined products at the world price to Texaco Inc and the rest of the major oil companies. Major oil companies sold the refined oil to their customers at the world price as well. The income of the refining companies in Indonesia was foreign source income and fell outside the USA taxing jurisdiction. IRS alleged that Textrad had unduly shifted profits to its foreign refining companies by selling the Saudi Arabian crude oil at prices below the market prices and applied section 482 of the IRC to increase the taxable income of Textrad by including the deemed difference of the market prices and actual prices received. The difference of about $9 billion was the biggest tax deficiency ever litigated in the American courts. IRS argued that the market prices are the prices to be used in determining the transfer price. (Avi-Yonah, 2007:122; Doernberg, 2004:322-324.)

The Tax Court decided in favour of Texaco Inc, noting that the price restrictions were equivalent to law in Saudi Arabia, which Texaco Inc was required to obey and that the IRS was thereby precluded from re-allocating income to Texaco Inc under section 482 of the IRC. Texaco Inc did not have the power to control the selling price of the Saudi Arabian crude oil and was dependent on the Saudi Arabian government for the rights to get the crude oil. (Avi-Yonah, 2007:122; Doernberg, 2004:322-324.)

The court concluded that "the complete power" referred to in the regulations hardly includes the power to force a subsidiary to violate the laws in a foreign country in which it operates. IRS could not allocate income between connected persons where the purported misallocation was caused by a foreign law. There is no allocation of income under section 482 of the IRC where the taxpayer does not have the complete power to shift income among its subsidiaries. (Avi-Yonah, 2007:122; Doernberg, 2004:322-324.)

The court relied on the case of *Procter and Gamble* as precedent. There were many similar cases because each of the multinational companies under Aramco like Exxon Mobil

had their own cases. IRS lost in those cases as well. The case of *Procter and Gamble* created a precedent even though the case was based on a Spanish regulation, which blocked the income, unlike the original USA Supreme Court case of *First Security Bank of Utah* (405 U.S. 394 (1972)), which was based on USA regulation. (Avi-Yonah, 2007:123.)

The simple application of precedent of this nature might create gaps especially with foreign regulation as some of the multinational companies might contribute or influence the drafting of those foreign regulations. In principle, the precedent is enough to eliminate the super royalty rule in the USA. Section 482(e) of the IRC was enacted to address blocked income, which states that a taxpayer, if he has a blocked income, must file a return stating the blocked income (even though the taxpayer does not have to report it for tax purposes while it is blocked) and pay the royalty and the tax with interest if the income should become unblocked in the future. This regulation is contrary to all the legal authorities as it was introduced after both cases of the *First Security Bank of Utah* and *Procter and Gamble.* (Avi-Yonah, 2007:123.)

Bausch and Lomb Inc vs IRS (933 F.2d 1084 (2nd Cir 1991)) illustrates the challenges of attempting to find a true comparable price. Bausch and Lomb was based in the USA and had a subsidiary in Ireland. Ireland has preferential tax rates to attract investment. Bausch and Lomb transferred some very valuable contact lenses manufacturing process information to the Irish subsidiary that allowed them to manufacture contact lenses at a cost of $2.50 per lens; meanwhile competitors in Ireland were manufacturing the same at $7.50 per lens.

The Irish subsidiary sold the contact lenses to the USA parent company at $10 per lens, where they were resold to consumers at their retail prices. The competitors in Ireland also sold the lenses to other distributors at $10 per lens. The Irish subsidiary made huge profits, which were subject to preferential tax rates in Ireland. IRS wanted these profits to be taxed in the USA as the research and development belonged to the company in the USA. Bausch and Lomb argued in court that the manufacturing process was performed in Ireland and other manufacturers represented a perfect comparable, as they were selling the same product in the same market at the same price. The court agreed with the argument of *Bausch and Lomb.* (Avi-Yonah, 2007:108; Levey & Wrappe, 2001:35.)

Bausch and Lomb as compared to unrelated parties made huge profits from the sale of the same contact lenses. The profit of comparable unrelated party per lens was ($10-$7.50) $2.50 as compared to ($10-$2.50) $7.50 of Bausch and Lomb. These unrelated parties will not be able to compete with Bausch and Lomb in the long term. In reality, the profit should probably have been divided between USA and Ireland as the huge profits in the Irish subsidiary was as a result of the research and development of the parent company. IRS attempted to divide the additional profit by using comparable data, however, it failed as these comparable data never fully represent the circumstances as the comparable unrelated parties did not have the same arrangements as in Bausch and Lomb. (Avi-Yonah, 2007:108.)

In order to avoid these circumstances, mainly as a result of the case of Bausch and Lomb, section 482 of IRS was amended in 1986, that the profits of a transferred intangible property should be commensurate with the income of the intangible property, super royalty rule. The USA Congress also asked the USA Treasury to determine whether there was another way to solve these problems. The amendment covers all transfers of intangible property like licences of patents, copyright, which are used by related parties or connected persons. The USA Treasury proposed the global formulary apportionment method, which was the opposite extreme to arm's length principle. (Avi-Yonah, 2007:111.)

Taxpayers in the USA can mitigate the effect of the amended section 482 by conducting research and development in a tax haven country or transfer the research and development of a product, especially at an early stage of product development, when their potential is unknown, to a country that has preferential tax rates as compared to the USA. Royalty would be set early at a very low amount. Royalty from these initiatives would be very minimal in the USA, if any, as most of the research and development of the product was performed in a foreign country. (Avi-Yonah, 2007:111.)

Glaxo SmithKlime Holdings Inc v IRS (117 U.S.T.C. number 1 (2001)) illustrates the practical challenges of the arm's length principle. Glaxo SmithKlime Holdings (GSK), a large United Kingdom based pharmaceutical giant faced a proposed $7.8 billion adjustment, which equates to $2.7 billion in tax deficiencies in the USA Tax court. The

protracted case was amongst the largest tax dispute in the history of IRS, was settled out of court. In terms of the settlement agreement, Glaxo USA (USA subsidiary company of GSK) paid $3.4 billion (which include interest) and abandon the discrimination refund claim of $1.8 billion. Glaxo USA claimed the discrimination refund amount because IRS rejected their APA request in 1994, meanwhile the APA request of their competitor was granted in 1993. (Gustafsson & Hallback, 2008:33-64.)

The main issue in the case dealt with the amount of profit to be attributable to Glaxo USA, which was operating, marketing and distributing the Zantac pharmaceutical product in the USA. The research and development was conducted by the parent company in the UK (Glaxo UK). Glaxo USA purchased the active ingredients from Glaxo UK. Glaxo USA used a resale-minus method in determining the transfer prices and kept 55 percent of the gross profit margin. (Gustafsson & Hallback, 2008:33-64.)

IRS claimed that the Zantac product was not a pioneer drug, the increase in sales was mainly attributable to the increase in marketing activities in the USA. The marketing activities should be more than the patent. IRS applied the profit split method, which allocated about 80 percent of the profit to Glaxo USA and the balance to Glaxo UK. The resale-minus method allocated about 70 percent of the profit to Glaxo UK and 30 percent of the profit to Glaxo USA. IRS argued that a taxpayer that has contributed to the development of intangible property should not be entitled to deduct royalties paid to the developer of the intangible property. Glaxo USA had provided assistance to the development and enhancement of the Zantac drug in the USA. (Gustafsson & Hallback, 2008:33-64.)

The settlement agreement resolved a transfer pricing dispute that has been running for about fifteen years. Under the settlement agreement, Glaxo USA conceded over 60 percent of the total amount put in issue by IRS. (Gustafsson & Hallback, 2008:33-64.)

The Commissioner of IRS commented after the settlement agreement that they have consistently said that transfer pricing is one of the most significant challenges they are faced with in the area of corporate tax administration. They are committed to resolve transfer pricing disputes through responsible and innovative agreements that embody the

arm's length standard for related party transactions, provided that their ultimate goal of compliance was not compromised or through litigation when necessary. (IRS Newswire, IR-2006-142.)

The USA took advantage of the areas of uncertainty regarding intangible property and marketing intangibles to serve its own purpose of increasing tax revenue. Marketing intangibles can neither sustain the large profits once patent protection is lost nor sustain the large market share of a high priced drug. Several scholars claimed that the transfer pricing set by GSK was in accordance with the arm's length principle. The GSK case is described as a battle between the tax authorities over the right to tax transfer price transactions. Both tax authorities in the USA and the UK could not reach a mutual agreement regarding the allocation of income despite the fact that both countries claim that they apply the arm's length principle. The mutual agreement procedures and APA are the existing means to solve transfer prices disputes. GSK suffered from double taxation as a result of this case. (Gustafsson & Hallback, 2008:54-64.)

In terms of International Tax Review (2009:13), the arm's length principle was dealt a heavy blow in the case of *Xilinx Inc and consolidated subsidiaries v* IRS (567 F 3d 482, 2009, U.S. App Lexis 11118 (9th Cir. 2009)). Xilinx Inc was the world's largest supplier of programmable logic devices. The inclusion of stock based compensation in the charges of a cost sharing agreement and whether the arm's length standard applied to the determination of appropriate cost allocations was the subject matter of contention in the case.

It was held that the "all costs methodology" prescribed in section 482.7(d) of IRC was irreconcilable with the arm's length standard in section 482.1 of the IRC. It was decided that section 482.1 was more specific and must prevail, thereby circumventing the arm's length standard.

The court's decision ignored the arm's length principle, which is enshrined in the US treaty law. Diane Hay, former chairwoman of Her Majesty's Revenue and Customs transfer pricing board said that either the court got it wrong or the court meant to rule that the

domestic law in the USA could override the treaty and the arm's length principle. Ireland raised their concerns with the USA about this case. (International Tax Review, 2009:13.)

The Ninth Circuit Court of Appeal reversed the decision in an unusual way. It agreed that Xilinx Inc did not have to contribute to the costs of employee share options in a cost sharing agreement with its Irish subsidiary as it would not have done so if it was an independent transaction. (International Tax Review, 2010.)

5.6 ARM'S LENGTH PRINCIPLE AND TAX TREATIES IN THE USA

The USA goal in negotiating tax treaties is that active income should be taxed in the country of source if it is attributable to a permanent establishment. The passive income should mainly be taxed in the country of residence. This negotiation stance, favours developed countries as they have more multinational companies. A tax treaty in the USA may not increase the amount of tax; it may reduce applicable amount of tax because tax laws are passed by the USA Congress as a whole, whereas tax treaties are ratified only by the USA Senate. An amount of tax that is increased through a tax treaty would be unconstitutional as it would never have been ratified by the USA House of Representative. (Avi-Yonah, 2007:169-172.)

Most USA tax treaties provide that if the USA makes a reallocation to the taxable income of one connected person, the other country agrees to make a corresponding correlative adjustment to the income of the other connected person; provided that it agrees with the allocation. If the other country does not agree, both countries agree to reach a compromise under the mutual agreement procedures of the treaty is in line with article 25 of OECD Model Convention with respect to Taxes on Income and on Capital (2005:16). If both countries fail to reach a compromise, the taxpayer will face international double taxation. (Doernberg, 2004:327-329.)

All USA bilateral tax treaties include provisions of a mutual agreement procedure that provides assistance to a taxpayer when faced with a double tax situation (Levey & Wrappe, 2001:305).

In an international context, the USA does not have tax jurisdiction over the other connected persons resident in a foreign country. However, to the extent that the income of a foreign company is relevant for USA tax purposes, for example, for purposes of determining the indirect foreign tax credit, the earnings of the foreign connected person should reflect the correlative adjustments. USA tax treaties include only the credit method. (Doernberg, 2004:327-329; Olivier & Honiball, 2008:328.)

Multinational companies in some states of the USA are subjected to the global formulary apportionment method as they trade in those states. These companies rely on applicable tax treaties for relief if they trade in other countries. Where tax treaties are not available and there are no mutual agreement procedures, these multinational companies might be subjected to double taxation of the same income amount. (Doernberg, 2004:327-329.)

5.7 GLOBAL FORMULARY APPORTIONMENT METHOD

The Global formulary apportionment method determines that the amount of income taxable within a jurisdiction is determined by multiplying the combined income from connected persons both in and outside the jurisdiction by a factor based on total payroll, properties and sales within the jurisdiction compared to overall payroll, properties and sales (Avi-Yonah, 2007:108-114; Doernberg, 2004:266).

The Global formulary apportionment method begins with the assumption that the multinational company is a single unit. This method ignores parent and subsidiary companies of the same multinational company, even though they operate in a foreign country, which is very controversial. The method then calculates the profit and net profit for the group as a whole. The figures are distributed in terms of the business situated in a country. The percentage of profit that belongs to say country A is determined based on the proportion of the company's business in country A. This is determined by calculating the percentage of worldwide assets that are in country A (intangible assets are ignored, as it is assumed that the tangible assets contributed to them), then the percentage of worldwide payroll in country A is calculated in the same way as worldwide assets, then the percentage of worldwide sales in country A is calculated in the same way. The three percentages are then averaged, if say 20 percent of each factor is in country A. The

average of the three is 20 percent. This average of 20 percent is then multiplied by the total profit or net profit to allocate the portion of country A. The method is easy and straight forward at first glance. The information to be used is more often than not readily available from the multinational company. (Avi-Yonah, 2007:108-114.)

The OECD Guidelines (2001:III-21) has rejected this methodology as it is arbitrary and does not reflect differing rates of return in different jurisdictions, it violates tax treaties (Avi-Yonah, 2007:108-114; Doernberg, 2004:266).

A USA company in the 1980s and Barclays Bank, an UK company, in the 1990s tried to challenge the global formulary apportionment method before the USA Supreme Court. The USA company based its argument on the grounds of international law and tax treaty. The Barclays Bank based its argument on the grounds of the USA constitution that this method violates the USA constitution. In both cases, the USA Supreme Court upheld this method and ruled in favour of the state of California. Thus, it is not clear whether a forum exists within the USA to hear this argument. (Avi-Jonah, 2007:108-114.)

5.8 SUMMARY OF TRANSFER PRICING TREND IN LATIN AMERICA

According to International Tax Review (2009:48), a significant number of countries in Latin America have transformed their economies by adopting transfer pricing regulations for cross border transactions. The adoption of the international arm's length principle will contribute in encouraging foreign investment in those countries and make it easy for multinational companies to trade in those countries.

In terms of International Tax Review (2009:48), the status of the economies in Latin America is as follows:

- transfer pricing is modernised for arm's length compliance in Mexico;
- the countries that are in the process of modernising their economies to transfer pricing are Argentina, Chile, Colombia, Ecuador, Peru, Uruguay and Venezuela. Chile requires taxpayers to comply only with the arm's length principle, meanwhile others require multinational companies to file information of their controlled transactions, prepare and keep transfer pricing documentation as well; and

- the country that has not transformed its economy to transfer pricing is Brazil. The transfer pricing rules adopted determine the maximum amounts of deductible expenses and minimum amounts of taxable income for Brazilian entities that are engaged in cross border transactions with connected persons. The Brazilian economy is viewed as a safe harbour regime.

5.9 CONCLUSION

The five part strategies provide valuable lessons for SA to improve enforcement of transfer prices. The USA has developed transfer pricing regulations as it is the first country to modernise transfer pricing laws despite the administration challenges they faced. (Levey & Wrappe, 2001:164.)

In contrast to the OECD Guidelines (2001:I-26), section 482 of the IRC requires the best method rule, where the taxpayer performs analysis under more than one method to prove that a particular method yields the best transfer pricing results. The best method rule was modified in 1994 to provide that taxpayers were to use the “most reliable” method instead of the “most accurate” method. (Levey & Wrappe, 2001:8-13 and 2001:140.)

The 2010 version of OECD Guidelines replaces the “exceptional” standard for the application of the transactional profit methods with the requirement that the “most appropriate” method in the circumstances must be used (Brodbeck, 2010:377-379). The application of the most appropriate method or methods will often result in a range of justifiable transfer prices in SA (Practice Note 7, 1999:25).

The blocked income regulation in the USA is contrary to all the legal authorities, it is still subject to judicial scrutiny (Avi-Young, 2007:123).

The Glaxo SmithKline case is described as a battle between the tax authorities over the right to tax transfer price transactions. It is disappointing that both tax authorities in the USA and the UK could not reach a mutual agreement regarding the allocation of income despite the fact that both countries claim that they apply the arm’s length principle. The mutual agreement procedures and APA are the existing means to solve transfer prices

disputes. Glaxo SmithKline suffered from double taxation as a result of this case. (Gustafsson & Hallback, 2008:54-64.)

A critical analysis of the transfer pricing methodology that is used by the USA to combat tax avoidance was examined in this chapter. An analysis of the penalties for non-compliance with transfer pricing methodology from a perspective of SA will be considered in the next chapter.

CHAPTER 6

AN ANALYSIS OF PENALTIES FOR NON-COMPLIANCE WITH TRANSFER PRICING METHODOLOGY FROM A PERSPECTIVE OF SA

6.1 INTRODUCTION

In this chapter, an analysis of the penalties for non-compliance with transfer pricing methodology from a perspective of SA will be examined.

Internationally, there is no consistency in charging penalties for non-compliance with transfer pricing (Olivier & Honiball, 2008:507).

Failure to observe transfer pricing rules and requirements can lead to time consuming audits, significant taxable income adjustments, imposition of interest and penalties and possible double taxation of the same income. Adequate transfer pricing regulation and penalties for non-compliance encourage compliance by taxpayers. (Levey & Wrappe, 2001:169.)

6.2 AN ANALYSIS OF PENALTIES FOR NON-COMPLIANCE WITH TRANSFER PRICING REGULATION

Swenson (2000:1) studied reported product prices by country and determined that income shifting costs, penalties and the fear of detection may all reduce the degree of non-compliance with transfer pricing by companies. Her study indicated that reported customs values of USA, imports from Canada and the UK were consistent with the pricing incentives created by taxes and tariffs. Multinational companies that have their head offices in high tax territorial countries face reverse incentives, they may decide to report artificially low transfer prices as a means of shifting income into the USA. When these companies manipulate their transfer prices on products shipped to the USA, they may potentially reduce home country tax payments, but they did not deprive their customs officials of tariff revenue. Reported prices rose when the combined effect of taxes and tariffs provided an incentive for companies to overstate their prices.

The OECD Guidelines do not recommended specific penalties for non-compliance with the arm's length principle. However, they acknowledge that the appropriate application of penalties may play a role in addressing transfer pricing compliance. The OECD Guidelines advocate fair and reasonable penalties, not unduly onerous penalties, as they can promote unevenness. Multinational companies may record non-arm's length prices in low penalty jurisdictions in order to avoid harsh penalties in high penalty jurisdictions. (International Fiscal Association, 1998:44; OECD Guidelines, 2001: V-26.)

The national tax compliance by taxpayers in a country depends on the overall tax system. Most OECD member countries use civil or administrative penalties instead of criminal penalties for non-compliance with transfer pricing principles. In terms of the OECD Guidelines (2001:IV-7), a penalty is often imposed to encourage compliance. It is designed to make tax underpayment and non-compliance more costly than compliance. Penalties of procedural compliance are normally not significant as compared to penalties of understatement of tax liability. Penalties of tax understatement are calculated as a percentage of the understated amount. The OECD Guidelines encourage fairness and reasonableness of the penalty system by improving taxpayer compliance and discourages minor adjustments by tax authorities. (OECD Guidelines, 2001:IV-7 to 9.)

According to International Financial Association (1998:44), penalties should take account of the uncertain nature of the transfer prices facts and problems. Penalties should be proportionate to the offence.

Section 31(2) of the Income Tax Act imposes price adjustments for non-compliance with transfer pricing principles. Practice Note 7 (1999:31-32) states that the Commissioner will follow the Practice Note 7 guidelines in conducting reviews, audits and investigations. The Commissioner can also apply the General Anti-Avoidance Rules contained in sections 80A to 80L of the Income Tax Act. The Commissioner is likely to pay more attention to multinational companies that conducts business with entities resident in a country with low tax jurisdictions than SA. Since the perception exists that such transactions might be motivated by tax, rather than strictly commercial or financial reasons.

The discretion to adjust the consideration in respect of a transaction rests with the Commissioner. The penalty, additional tax and offence provisions in terms of sections 75, 76 and 104 of the Income Tax Act will apply to default, evasion or omission relating to transfer prices. Section 89*bis* of the Income Tax Act and 89*quat* of the Income Tax Act provide for interest to be paid by the taxpayer if there is underpayment of tax. These provisions will also apply if there is underpayment of tax in terms of section 31 of the Income Tax Act in line with OECD Guidelines (2001:IV-8). In terms of section 82 of the Income Tax Act, the burden of proof regarding exemptions, non liability for tax, deductions or set-offs on the taxpayer rests with the taxpayer. The taxpayer should present reasonable argument and evidence to suggest that its transfer pricing was arm's length, where requested to do so by SARS. SARS may use the General Anti Avoidance Rules as contained in sections 80A to 80L of the Income Tax Act in combating tax abuses. Section 103(1) of the Income Tax Act was replaced by sections 80A to 80L of the Income Tax Act. (Practice Note 7, 1999:31-33.)

The burden of proof regarding the non-arm's length nature of a cross border transaction, operation, scheme, agreement or understanding has been effectively shifted to SARS as per the proposed changes by the Draft Taxation Laws Amendment Bill (2010:65) (Brodbeck, 2010:377-379).

According to Olivier and Honiball (2008:507), the UK has specific transfer pricing penalties. Ordinary provisions for self assessment apply for up to 100 percent of unpaid tax through fraud or negligent conduct. There is no penalty if a taxpayer has made an honest and reasonable attempt to comply and has evidence of the work performed. (Levey & Wrappe, 2001:398.)

The USA imposes progressive monetary penalties for non-compliance with transfer pricing documentation. The USA has two types of penalties that can be applied in the transfer pricing context, that is, valuation misstatement penalties and reporting penalties. In addition to these penalties, general civil and criminal tax penalties and interest charges may be assessed. The reporting requirements under sections 6038A and 6038C of the IRC have increased transfer pricing information and made it easier for IRS. These

reporting requirements have created a lot of reporting requirements for multinational companies. (Levey & Wrappe, 2001:164-183.)

In terms of Practice Note 7 (1999:31), tax authority can obtain tax information about a taxpayer through a number of ways, such as;

- directly from the taxpayer through enquiries into its transfer pricing practices,
- other taxpayer in the same industry or business,
- financial databases, publicly available industry information or the internet; or
- other jurisdictions, through the exchange of information as contained in the tax treaties.

6.2.1 Secrecy provisions

There are procedural problems, such as evidence in court due to the secrecy provisions in terms of section 4 of the Income Tax Act for the Commissioner to use publicly undisclosed information. The Commissioner will therefore, as a matter of course, not use publicly undisclosed information in an attempt to substitute an alternative measure of the arm's length figures in SA. The OECD Guidelines emphasise that information of the taxpayers is confidential, thus information obtained by tax authorities during a tax audit which may not be disclosed to other taxpayers because of secrecy provisions may not be used in court. The USA is in line with the OECD Guidelines that such information may not be used against a taxpayer in court. (International Financial Association, 1998:3.)

The tax administrator should consider the potential implications of the legislation and administrative procedures of transfer pricing to other tax jurisdictions, and endeavour to promote the equitable allocation of taxes between jurisdictions and the prevention of double taxation for taxpayers. The Commissioner must apply the legislation and administrative procedures in a fair and equitable manner. The provisions of article 9 of the OECD Model Convention with respect to Taxes on Income and on Capital (2005:9) should be followed in good faith. (International Fiscal Association, 1998:44.)

6.2.2 Administration practices by tax administrators

Tax administrators are encouraged to be reasonable and flexible in their approach, they should undertake to begin their analyses of transfer pricing from the perspective of the method that the taxpayer has chosen in setting its arm's length price. Tax administrators should hesitate from making minor or marginal adjustments as the taxpayers are allowed to use a price range in determining their arm's length prices. Transfer pricing workings are normally very complex, even the best intentioned taxpayer can make an honest mistake or come to a wrong conclusion from the facts. (OECD Guidelines, 2001:I-18 and IV-3.)

In terms of the OECD Guidelines (2001:IV-4), in most tax jurisdictions internationally, the tax administrator bears the burden of proof, that is, assessment and appeals, in the normal internal dealing with taxpayers and in litigation. The taxpayer may not have any legal obligation to prove the correctness of its transfer pricing unless the tax administrator makes a prima facie case that the prices are not consistent with the arm's length principle. The taxpayer should be prepared to provide its workings in good faith, showing that its determination of transfer pricing is consistent with the arm's length principle. The tax administrator should likewise make good faith showing that their assessment of transfer pricing is consistent with the arm's length principle even though the burden of proof is on the taxpayer. The tax administrator should not misuse the burden of proof as a justification for making groundless or unverifiable assertions about transfer pricing. (OECD Guidelines, 2001:IV-6.)

In terms of Levey and Wrappe (2001:3), in the USA, the burden of proof is shifted to the taxpayer in terms of section 6662 of the IRC. A taxpayer may satisfy its burden of proof in one of two ways:

- establish that they followed section 482 of the IRC in determining their prices; or
- establish that the IRS determination was arbitrary or unreasonable, in other words IRS abused their discretion. The case of DHL Corporation tried unsuccessfully to outline this principle, please see chapter five.

In the USA, in terms of section 6662 of the IRC, the taxpayer can only escape a penalty where an adjustment is made by tax authorities and the taxpayer can prove that he did his utmost to follow one of the recognised transfer pricing methods in the case concerned

6.3 CONCLUSION

Penalties that are applied in SA are adequate, proportionate to the offence and are in line with the OECD Guidelines (2001:IV-8) to discourage non-compliance.

In addition to section 31(2) of the Income Tax Act adjustment, SA rely on regulations like sections 75 and 76 of the Income Tax Act, penalty and additional tax for failing to submit documentation and section 104 of the Income Tax Act, offence provisions. The General Anti-Avoidance Rules contained in sections 80A to 80L of the Income Tax Act are used by SARS to combat tax avoidance. Section 103(1) of the Income Tax Act was replaced by sections 80A to 80L of the Income Tax Act. (Practice Note 7, 1999:31.)

The OECD Guidelines (2001:IV-3) provides additional information under compliance practices, on examination practices and the burden of proof, that is not available in the Practice Note 7. The examination practices provide guidance to taxpayers on how to prepare their transfer pricing results, which can be used to justify the transfer pricing results.

An analysis of the penalties for non-compliance with transfer pricing methodology from a perspective of SA was examined in this chapter. In the next chapter, conclusion on the critical analysis of the transfer pricing methodology that is used by SA to combat tax avoidance will be examined.

CHAPTER 7

CONCLUSION AND RECOMMENDATIONS

7.1 INTRODUCTION

In this chapter, the conclusions on the analysis of the transfer pricing methodology that is used by SA to combat tax avoidance will be examined.

The analysis of the transfer pricing methodology that SA uses to combat tax avoidance as examined in Chapter three was contrasted with those adopted by international standards and the USA as discussed in Chapters four and five.

7.2 SPECIFIC RESEARCH OBJECTIVES

The research essay critically analysed the following specific research objectives:

- to determine whether the transfer pricing methodology that SA uses to combat tax avoidance is adequate and effective as compared to international standards through a review of available literature, regulation and court cases. This research objective was examined in chapters three, four and five;
- to determine areas for development and improvement in the administration process, for example, the maintenance and filing of transfer pricing documents in SA as compared to international standards through a review of available literature, regulation and court cases. This research objective was examined in chapters three, four and five;
- to analyse the advanced pricing arrangement technique in resolving transfer pricing disputes. This technique was endorsed and accepted by the OECD, the USA and the UK. This research objective was examined in chapter four; and
- to examine the penalty provisions adopted by SA as compared to the penalty provisions adopted by international standards in discouraging non-compliance with transfer pricing provisions by connected persons of multinational companies through a

review of available literature and court cases. This research objective was examined in chapter six.

The results from the critical analysis of the transfer pricing methodologies identified the following gaps or areas of improvement that should be addressed in SA.

7.3 RESEARCH FINDINGS AND RECOMMENDATIONS

7.3.1 Transfer pricing methodology

The findings and recommendations on whether the transfer pricing methodology that SA uses is adequate; are discussed under transfer pricing regulations, determination of the arm's length range and transfer prices methods.

7.3.1.1 *Transfer pricing regulations*

SA must continue to embrace the internationally accepted arm's length principle to make it easier for multinational companies to comply, which would contribute in encouraging foreign investment in the country. The arm's length principle is enshrined in the tax treaties of SA. The arm's length principle is internationally accepted and is the basis for ensuring that the South African *fiscus* receives their fair share of tax. (Doernberg, 2004:266; Huxham & Haupt, 2010:433-434.)

Practice Note 7 (1999:13) endorses the acceptable transfer pricing methods that are used internationally, which international methods are considered adequate to determine transfer prices (OECD Guidelines, 2001:II-1 to III-24).

In the USA, transfer pricing disputes often became very difficult and protracted due to the fact that IRS did not have facts and taxpayers took unwarranted defence positions. The five part strategies adopted by the USA in 1992, please see the discussion on protracted disputes in chapter five; provide valuable lessons for SA to follow in strengthening its transfer pricing regulations so that they can be able to enforce transfer pricing regulations

more effectively (Levey & Wrappe, 2001:164-170). The strategies that should be considered in SA are:

- strengthen section 31 of the Income Tax Act. The proposed amendment of section 31 of the Income Tax Act per the Draft Taxation Laws Amendment Bill (2010:65) will address this weakness;
- improve documentation requirements by implementing clear documentation requirements;
- SARS to consider a more advanced system by developing technical and litigation support for prosecuting cross border transactions; and
- develop APA to proactively resolve transfer prices disputes.

The fifth strategy of the USA resulted in the development of OECD Guidelines.

The current wording of transfer pricing rules is causing structural problems and uncertainty as it focuses on isolated transactions as opposed to economic substance of transactions. The proposed amendment of transfer pricing regulation as per the Draft Taxation Laws Amendment Bill (2010:65) has considerably widened the scope of the transfer pricing regulation. SARS would be expected to focus on the economic substance of a transaction with a connected person, benchmarking the overall profitability of a taxpayer rather than focusing only on the arm's length nature of a specific cross-border transaction with a connected person. (Brodbeck, 2010:377-379.)

Practice Note 7 should be updated to be in line with the proposed changes to section 31 of the Income Tax Act as per the Draft Taxation Laws Amendment Bill (2010:65) and incorporate latest sections or amendment of the Income Tax Act like, for example, sections 80A to 80L.

SA should create technical capacity to effectively enforce the transfer pricing regulation to protect its tax revenue from being shifted away by multinational companies through transfer pricing. SARS should undertake to estimate the amount that they are loosing from taxpayers who are not complying with transfer pricing regulation in the same way that IRS established in April 1999 that the USA was loosing $2.8 billion annually from non-compliance by taxpayers. (Levey & Wrappe, 2001:164-169.)

It would be interesting to see how the courts will conclude if the blocked foreign income, section 9A of the Income Tax Act is challenged in SA considering the precedence that was set by the Procter and Gamble case in the USA. The blocked foreign income regulation in the USA is contrary to all the legal authorities. It will not survive judicial scrutiny in the USA. (Avi-Yonah, 2007:123.)

7.3.1.2 *Determination of an arm's length range*

Practice Note 7 (1999:26) states that SARS may select the mid-point in the range, in the absence of persuasive evidence for the selection of a particular point in that range, which is contrary to the arm's length principle and a deviation from OECD Guidelines.

SARS is requested to reconsider this position in their update of the Practice Note 7 so that SA can be in line with OECD Guidelines. OECD Guidelines (2001:I-18) illustrates that it is possible to apply the arm's length principle and arrive at a single number or amount that is more reliable to establish that the numbers or amounts of a transaction are arm's length. There are instances were the use of the most appropriate method or methods produce a range of numbers or amounts that are relatively equally reliable as well. Each separate range could be used to define an acceptable range of arm's length figures as good judgement is used. (Olivier & Honiball, 2008:495.)

7.3.1.3 *Transfer prices methods*

Practice Note 7 (1999:13) states that credible results will be determined from applying a transfer pricing method to multiple comparable data or from applying different transfer pricing methods. However, in line with OECD Guidelines (2001:I-26), SARS acknowledges that the application of more than one method could place a significant burden on taxpayers.

Practice Note 7 (1999:26) should be clarified to be in line with OECD Guidelines (2001:I-26) that the arm's length principle does not require the application of more than one method per transaction, unless it is a complex transaction (Olivier & Honiball, 2008:495).

7.3.2 Administration process on transfer pricing methodology

The finding and recommendation on whether there are gaps or areas of improvement in the administration process on transfer pricing methodology in SA are discussed under transfer pricing documentation.

The OECD Guidelines states that tax authorities should take great care to balance their requirements for the transfer pricing documents against the cost and administrative burden to the taxpayer of obtaining them. The requirements of the arm's length principle must be made flexible to accommodate the concerns raised by the European Commission working group and other countries in the USA that the arm's length standard is complicated, resource intensive, time consuming and expensive to comply with and administer. (International Tax Review, 2009:12-14.)

Levey and Wrappe (2001:170) established that in many instances multinational companies did not take arm's length standard into account in setting their controlled transactions with connected persons. Transfer prices were only considered when they were audited or assessed. There was no contemporaneous evaluation of transfer prices. Thus the preparation of the relevant and applicable information for purpose of transfer pricing documentation can not be left at the discretion of a taxpayer.

In terms of the addendum to the Practice Note 7 (2005:1-2), there is no explicit statutory requirement that multinational companies in SA must prepare and submit transfer pricing documents. The extent of compliance rests with an individual taxpayer after they have determined the costs benefits of compiling the documents. Some organisations in compiling transfer prices documentation may purposefully omit valuable information that could incriminate them.

As from the 2004 tax year, the IT14 form for companies specifically requires taxpayers to submit the information stipulated in the brochure, like transfer pricing policy documents with their tax returns (Olivier & Honiball, 2008:505). This requirement conflicts some of the provisions of the addendum to the Practice Note 7 (2005:1-2) as mentioned above. This

position should be clarified as taxpayers may use this loophole in defending their actions in court.

SA should introduce minimum requirements for maintaining transfer pricing policy documentation and disclosure of reportable transactions by connected persons to improve the effectiveness of the regulation to make it clearer for taxpayers. SA should introduce partial exemptions of disclosure of reportable controlled transactions like the one in the USA in terms of section 6038A of the IRC, for example, where small companies with revenue of say, less than R50 million, do not have to submit detailed transfer pricing policy documentation.

The increase in transfer pricing information in the USA has made it easier for tax authority to examine transfer pricing results of taxpayers and enforce transfer pricing regulations (Levey & Wrappe, 2001:164).

This recommendation is flexible to address the concerns that were raised by European Union working group (International Tax Review, 2009:12-14). It will contribute in effectively enforcing transfer pricing regulations. It supports the addendum to Practice Note 7 (2005:2); that the process of checking compliance with the arm's length principle becomes more difficult and complex for SARS if adequate documentation is not kept. It is further endorsed by Olivier and Honiball (2008:504) that it is advisable for practical reasons that a taxpayer should prepare transfer pricing documents.

7.3.3 Advance pricing arrangement

The finding and recommendation on whether there are gaps or areas of improvement in resolving transfer pricing disputes in SA are discussed under APA process.

The OECD Guidelines and USA regulations provide an APA process to create certainty for cross border transactions of multinational companies between connected persons and tax authority to reduce transfer pricing disputes. Unfortunately SA does not have an APA process. SA should consider the introduction of an APA to assist multinational companies

to be certain about their cross border transactions with connected persons. SARS should develop enough technical and litigation capacity to administer APA.

The useful information that is submitted in advance to the APA consists of price sensitive and business strategies of multinational companies, which must be kept confidential. Taxpayers might use section 3 or 4 of the Promotion of Administrative Justice Act to obtain information held by the APA. SA will have to pass regulations to protect this information unless if it is required by regulation or a court of law, otherwise the future of the APA will be threatened. (Avi-Yonah, 2007:119.)

The mutual agreement procedures and APA are the existing means to solve transfer prices disputes (Gustafsson & Hallback, 2008:54-64).

7.3.4 Penalty provisions from a perspective of SA

The finding and recommendation on whether the penalty provisions from a perspective of SA discourage non-compliance are discussed below.

In addition to the adjustment in terms of section 31(2) of the Income Tax Act, SA rely on regulations like the penalty, additional tax and offence provisions in terms of sections 75, 76 and 104 of the Income Tax Act. General Anti-Avoidance Rules contained in sections 80A to 80L of the Income Tax Act are used by SARS to combat tax avoidance. (Practice Note 7, 1999:31.)

Penalties that are applied in SA are adequate, are proportionate to the offence and are in line with the OECD Guidelines (2001:IV-8) to discourage non-compliance by taxpayers. The research essay does not recommend specific and harsher penalties for non-compliance with transfer pricing requirements like the ones in the USA as it might encourage inconsistencies and promote unevenness. (Doernberg, 2004:309; OECD Guidelines, 2001:V-26.)

7.4 SUGGESTIONS FOR FUTURE RESEARCH

Since the revision in July 1995 of section 31 of the Income Tax Act, there has been no reported transfer pricing court cases in SA. It would be worthwhile to determine the reasons so as to establish the practical challenges of the enforcement of the arm's length principle in SA. The practical challenges would assist in determining whether:

- the taxpayers are complying with the transfer pricing regulations;
- the inherent subjectivity in the application of the transfer pricing regulation makes it possible for SARS to accept the transfer prices; or
- whether SARS does not have adequate resources and capacity to enforce transfer pricing regulation. (Levey & Wrappe, 2001:164-169.)

7.5 CONCLUSION

In considering the above research findings and implementing the proposed recommendations, SA should note that a country needs to protect its tax base against erosion, but on the other hand, it must know that companies can easily relocate in response to tax avoidance measures and rigid tax regime. The government of SA must ensure that its policies are globally competitive, even though global competitiveness is often in direct conflict with domestic tax policies. (Olivier & Honiball, 2008:428.)

In this chapter, conclusion on the critical analysis on the transfer pricing methodology that is used by SA to combat tax avoidance was examined. The list of references used in this research essay will be covered in the next part.

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