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TRANSFER PRICING: AN ANALYSIS OF SOUTH AFRICAN INCOME TAX LEGISLATION

by

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ABSTRACT

TRANSFER PRICING: AN ANALYSIS OF SOUTH AFRICAN INCOME TAX LEGISLATION

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Transfer pricing has become a topical issue in recent years as the number of companies entering into inter-company transactions with connected persons has increased significantly. Transfer pricing has been used by companies as a tax avoidance tool as they shift profits between companies in the same group of companies in an attempt to pay less taxation. This shifting of profits is achieved by transacting with connected persons at prices that are not at arm's length.

The study outlines the basic principles of transfer pricing and how it can be used as a tax avoidance tool in both international and domestic transactions.

As countries around the world have realised the value of taxation revenue losses that have been incurred due to international transfer pricing not occurring at arm's length prices, many have implemented legislation to regulate transfer- pricing transactions.

South Africa has joined in with its international counterparts by implementing legislation in an attempt to regulate transfer pricing. The study aims to analyse South African income tax legislation and compare it to the income tax legislation in the United Kingdom regarding transfer pricing as well as to transfer pricing guidelines of the OECD.

Although research has been performed on transfer pricing in an international context, this study aims to further consider whether South African income tax legislation ensures that domestic transfer pricing transactions occur at arm's length prices. By comparing South African income tax legislation with that of the United Kingdom, the study aims to determine whether South African legislation should include a section dealing specifically with domestic transfer pricing as was done in the United Kingdom.

Key words:
Arm's length
Connected persons
Domestic transfer pricing
Income tax
Transfer pricing

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OPSOMMING

OORDRAG PRYSVASSTELLING:‘N ANALISE VAN SUID-AFRIKAANSE INKOMSTEBELASTINGSWETGEWING

deur

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Oordragprysvasstelling het in die afgelope jare ‘n aktuele saak geword as gevolg daarvan dat die aantal maatskapye wat in inter-maatskappy onderhandelings deelneem grootliks vermeerder het. Oordragprysvasstelling word deur maatskappye gebruik as ‘n wyse om belasting vry te spring en om wins te skuif tussen maatskappye in dieselfde groep van maatskappye, in ‘n poging om minder belasting te betaal. Hierdie proses van die skuif van winste word gedoen deur onderhandelings aan te gaan met verbonde persone en teen pryse wat nie armlengte is nie.

Dié studie skets die basiese beginsels van oordragprysvasstelling en hoe dit gebruik kan word as ‘n wyse om belasting te vermy in beide internasionale en binnelandse onderhandelings.

Aangesien lande dwarsoor die wêreld die waarde van inkomstebelasting verliese besef het, wat as gevolg van internasionale oordragprysvasstelling, wat nie teen armlengte pryse plaasvind nie, het baie van die lande wetgewing ingestel om oordragprysvasstelling onderhandelings te reguleer.

Suid-Afrika het nou by sy internasionale gelykes aangesluit deur wetgewing in te stel in ‘n poging om oordragprysvastelling te reguleer. Die studie poog om die Suid-Afrikaanse inkomstebelasting wetgewing te analiseer om dit te vergelyk met die inkomstebelasting

wetgewing van die Verenigde Koninkryk wat oordragprysvasstelling betref sowel as die van die Organisasie vir Ekonomiese Samewerking en Ontwikkeling.

Alhoewel navorsing reeds op oordragprysvasstelling uitgevoer is in internasionale verband, poog die studie om verdere aandag aan die kwessie te gee of Suid-Afrikaanse inkomstebelasting wetgewing verseker dat binnelandse oordragprysvasstelling plaasvind teen armlengte pryse. Deur Suid-Afrikaanse inkomstebelasting wetgewing met die van die Verenigde Koninkryk te vergelyk, poog die studie om vas te stel of Suid-Afrikaanse wetgewing ‘n afdeling moet hê wat spesifiek met binnelandse oordragprysvasstelling soos in die Verenigde Koninkryk gedoen is.

Sleutelwoorde:

Armlengte

Verbonde persone

Binnelandse oordragprysvasstelling

Inkomstebelasting

Oordrag prysvasstelling

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TRANSFER PRICING:
AN ANALYSIS OF SOUTH AFRICAN INCOME TAX LEGISLATION

CHAPTER 1: INTRODUCTION

1.1 BACKGROUND

Transfer pricing is the biggest tool used in the avoidance of taxation (Sikka, 2009). Transfer pricing is the pricing of inter-company transactions that involve the transfer of goods and services between companies in the same group (Jooste, 2010:36). The South African (RSA) income tax legislation has attempted to regulate the price at which goods or services are transferred between non-resident and resident connected persons. This was done by the introduction of section 31 into the Income Tax Act (as amended) (the act). The section makes provision for the South African Revenue Service (SARS) to make an adjustment to the transfer price in order for it to reflect an arm's length price.

In terms of the act, a non-resident must include receipts and accruals from a source within or deemed to be within the Republic into 'gross income", which would be the income derived from the sale of goods/services to an RSA resident company. One of the many intentions of section 31 of the act is to deter foreign companies from shifting RSA source profits that they would usually be taxed on, to an RSA connected party company that may have an assessed loss. This would be achieved by selling goods to the RSA resident connected party company at a below arm's length sales price. The foreign company would realise a small profit on the sale to the connected party and would thus pay minimal taxation on the minimal RSA-sourced profit that was made. The RSA resident company to whom the goods/services were initially sold would then realise the larger arm's length profit when the good/services are sold to a third party. The larger profit would then be included in the RSA

resident company's gross income and less tax would be levied on that income because the available assessed loss could be used to reduce taxable income.

Section 31 of the act furthermore deals with thin capitalisation, where the amount of interest earned by a non-resident from a loan to a connected resident is disallowed as a deduction from the taxable income of the resident to the extent to which the interest is considered excessive. The purpose of this part of the section is to deter non-residents from providing loans to connected party resident companies and charging excessive interest in order to utilise the section 10(1)(*h*) interest exemption which is available to non-residents and thus reducing their income tax liability on RSA source taxable income.

This legislation deals with international transactions; however, one of the loopholes that are being exploited by RSA companies is the absence of legislation governing domestic transfer pricing (Jooste, 2010:36). In South Africa every legal entity is taxed separately. Two resident companies in the same group could set their transfer price in such a manner that the company with an assessed loss has the majority of the profit from the sale included in its gross income, which would likely not be taxed due to utilisation of the assessed loss.

Much has been researched on international transfer pricing and the measures being implemented to ensure that transfer pricing occurs at arm's length prices. This research will expand further on the research that has been conducted already on transfer pricing and will attempt to resolve problems identified regarding the transfer pricing income tax legislation applicable to companies in RSA.

1.2 PROBLEM STATEMENT

The anti-avoidance provision of section 80A of the act provides for SARS to disallow the set-off of an assessed loss if it is satisfied that the taxpayer entered into a transaction solely or mainly for the purpose of utilising an assessed loss.

The problem arising is that, considering the economic crisis that the world economy recently experienced, it would not prove too difficult for a company to provide evidence that it was legitimately making a loss for the period (Jooste, 2010:36). Those companies wishing to take advantage of the loophole could also provide evidence that in the initial period of trading, they were subject to losses that are usually associated with starting a business. The strength of this evidence would result in SARS allowing the set-off of the assessed loss and thus the companies in the group would use this loophole to avoid paying more tax.

The focus of this research is to analyse South African tax law, as it currently reads, and to determine whether it is structured in a manner that ensures that all transfer pricing transactions between local resident companies in the same group occur at arm's length prices. In the event that legislation is found to be insufficient to meet this objective, what amendments should be made to the income tax legislation to ensure that it is effective in preventing domestic transfer pricing transactions occurring at prices that are not arm's length?

1.3 RESEARCH QUESTION

The research question is: Does the act ensure that domestic transfer pricing transactions between resident connected parties occur at arm's length prices and should the act be amended to include a specific section dealing with legislation on domestic transfer pricing?

1.4 RESEARCH OBJECTIVES

The research objectives of this study are:

- To analyse current RSA income tax legislation and case law regarding transfer pricing in comparison with the previous tax legislation on transfer pricing;
- To analyse the income tax legislation of The United Kingdom (UK) regarding transfer pricing; and
- To compare UK and RSA transfer pricing legislation with the OECD model.

1.5 IMPORTANCE AND BENEFITS OF THE STUDY

In light of the shortfall in revenue collections by SARS in the 2009 tax season, the SARS Commissioner and Finance Minister have indicated their intention to implement stricter measures of tax collection in order to curtail the increasing budget deficit (Troskie & Buttrick, 2009).

The findings of this research study could highlight ways in which SARS is forfeiting potential tax that could be collected from South African companies. By possibly amending legislation or applying stricter practical controls, SARS could close off the loophole that is currently being exploited by domestic companies.

The study will entail a review of research that has been conducted on transfer pricing at an international level and how transfer pricing has been used as a mechanism by multinationals to avoid paying income tax. This will be followed by an analysis of the measures that SARS has put in place to ensure the effective administering of the international transfer pricing legislation in order to minimise income tax avoidance by foreign companies. Furthermore, an investigation will be conducted on a country that has implemented domestic transfer pricing tax legislation and the impact of such implementation on the companies that are resident in the said country.

1.6 DELIMITATIONS

Although this study will review international transfer pricing, it will not concentrate on international tax agreements between South Africa and other countries. In the investigation of domestic transfer pricing tax legislation of another country, the study will only focus on the UK. The UK will be used for the reason that various South African tax principles and court cases find their basis from the tax legislation in the UK. The UK recently included domestic transfer pricing in their legislation to ensure arm's length prices between connected UK companies. Therefore the UK would be a good example to assess whether South Africa should include domestic transfer pricing laws in the current income tax legislation.

1.7 DEFINITION OF KEY TERMS

The key terms used in this research proposal are *arm's length, assessed loss, connected persons, domestic transfer pricing, group of companies, Income tax, resident and transfer pricing.* These terms are defined as follows for the purpose of this study:

Arm's length: Choe and Hyde (2007:400) describe *arm's length* as, "the price that would be paid for similar goods in similar circumstances by unrelated parties dealing at arm's length with each other" (see chapter 2.4).

Assessed loss: is defined in section 20 of the act as "any amount by which the deductions admissible under section 11 exceeded the income in respect of which they are so admissible" (see chapter 2.4).

Connected persons: As defined in section 1 of the act in relation to a company,
"any other company that would be part of the same group of companies as that company if the expression 'at least 70 percent' in paragraphs (a) and (b) of the definition 'group of companies' in this section were replaced by the expression 'more than 50 percent'" (see chapter 2.3).

Domestic transfer pricing: this refers to transfer pricing between companies that are residents of the same country. Thus the transfer pricing transactions between the companies are not cross-border and are confined to the countries where both companies are resident (Jooste, 2010:36) (see chapter 2.2).

Group of companies: is defined in section 1 of the act as,
" two or more companies in which one company directly or indirectly holds shares in at least one other company (Herein referred to as the 'controlled group company'), to the extent that

a) At least 70 percent of the equity shares of each controlled company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof; and
b) The controlling group company holds at least 70 percent of the equity shares in at least on controlled group company" (See chapter 2.1)

Income Tax: is defined by SARS (2011) as being, a tax that is levied on all income and profit received by a taxpayer. A taxpayer includes individuals, companies and trusts.

Resident: in the context of this research proposal refers to a person other than a natural person and is defined in par (b) of the definition of resident in section 1 of the act as a "person which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic" (see chapter 2.2).

Transfer pricing: is the value at which one company in a group of companies sells goods, services or intellectual property to another company within the same group (Holland, 1999) (see chapter 2.1).

Table 1 summarises the abbreviations used in this research proposal.

Table 1: Abbreviations used in this document

Abbreviation	Meaning
CUP	Comparable uncontrolled price
OECD	Organisation for Economic Co-operation and Development
RSA	Republic of South Africa
SARS	South African Revenue Services
TNMM	Transactional net margin method
UK	United Kingdom

1.8 RESEARCH DESIGN

The research design will be a qualitative review of literature on transfer pricing at a domestic and international level. The reason for selecting to do non-empirical research is that the nature of the topic requires an analysis of RSA income tax legislation and that can only be achieved through non-empirical research.

The research also includes an analysis of sections and practice notes contained in income tax legislation regarding transfer pricing in South Africa. The analyses are based on a comparison of the old Section 31 and the new transfer pricing section contained in the 2010 Taxation Laws Amendment Bill. This analysis determines whether the changes to legislation assist in ensuring that domestic transfer pricing transactions are conducted at arm's length amounts.

The transfer pricing legislation in the UK is investigated further for the reason that that country has legislation dealing specifically with domestic transfer pricing and many of the South African income tax principles find their origin in UK legislation.

1.9 CONCLUSION

This chapter introduced the background to the research to be conducted on transfer pricing and the analysis to be performed on RSA income tax legislation. The problem statement and research question were introduced in an attempt to identify the gap in

research regarding transfer pricing. The key terms were defined and the delimitations and assumptions of this research were stated. The layout of the research was broadly described and the content of the remainder of this research is discussed below.

Chapter Two provides an explanation of the key concepts related to transfer pricing, thin capitalisation and the arm's length principle. The chapter describes what transfer pricing and thin capitalisation is and how they are used by companies in the avoidance of income tax. The chapter further explains the different accepted methods of determining an arm's length price and the benefits and shortcomings related to each method.

In Chapter Three, a review of the regulation of international transfer pricing in general is conducted. The chapter also provides a description of the role played by the OECD in the regulation of transfer pricing and the guidelines provided by the OECD in this regard.

Chapter Four includes an analysis of UK income tax legislation regarding transfer pricing and what measures the UK income tax legislation has in place to ensure that transactions between connected persons occur at arm's length prices. The chapter also investigates whether the income tax legislation in effect in the UK has been effective in achieving the purpose of ensuring arm's length transfer pricing transactions.

In Chapter Five, the RSA income tax legislation regarding transfer pricing will be analysed and the changes to the legislation assessed to determine whether the changes have been effective in ensuring that transfer pricing transactions between connected persons occur at arm's length prices.

Chapter Six includes a summary of the research conducted and a conclusion that addresses the research question that was posed at the beginning of the research, namely, whether the RSA income tax legislation ensures that domestic transfer pricing transactions occur at arm's length prices.

CHAPTER 2: CONCEPTS REGARDING TRANSFER PRICING

2.1 INTRODUCTION

The previous chapter introduced the background to transfer pricing, the objectives and design of this research and the key terms to be used throughout this paper. This chapter contains an explanation of the key concepts regarding transfer pricing, thin capitalisation and the arm's length principle. The manner in which companies use transfer pricing and thin capitalisation in an attempt to avoid income tax are explained. The arm's length principle is of critical importance in obtaining an understanding of transfer pricing, and this principle is explained with examples of methods that are considered acceptable by SARS.

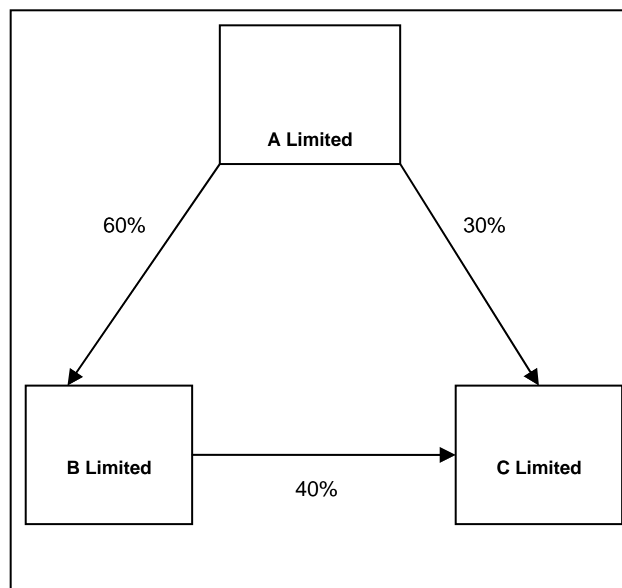
2.2 THE CONCEPT OF TRANSFER PRICING

Globalisation has enabled companies to conduct their business operations in various countries throughout the world. The more technologically advanced the world has become, the easier it has become for companies to do business anywhere in the world. As companies seek to maximise shareholder's wealth and remain on the competitive edge of their respective industries, they have sought to expand the scope of their operations through the acquisition of investments in other companies. With investments in other companies, holding companies have the right to exercise control of the acquired company due to the acquisition of equity shares therein.

As the scope of business has expanded, more and more companies transfer goods, services and intellectual property to other companies in the same group of companies. The transfer of goods and services between companies within the same group has left companies with the discretion of the value at which the goods or services should be transferred. Each company, in an effort to maximise their profits would want to transfer the goods and services at the best possible price. All multi-national entities use transfer pricing to shift profits between countries around the world. (Baker, 2005:30.)

A group of companies, as defined in section 1 of the act includes two or more companies where at least one company in the group holds a controlling interest in another company in the group. Figure 1 includes a diagram that represents a basic group structure. A Limited is a controlling group company that owns 60% of the shares of B Limited. A Limited also owns 30% of the shares in C Limited and B Limited owns 40% of the shares in C Limited. B Limited and C Limited are both controlled companies and all three companies in the diagram form a group of companies and are therefore connected persons.

Figure 1: A group of companies



A distinction between domestic transfer pricing transactions and international transfer pricing transactions should be made to understand the concepts used in this research. Domestic transfer pricing transactions would refer to those transactions between companies that are resident in the same country whereas international transfer pricing transactions refer to transactions between companies that are residents in different countries. In both instances mentioned, the transactions are between companies that are in the same group.

a) International transfer pricing

Each country in the world is subject to its own taxation legislation. A Multinational is described as "an enterprise operating in several countries but managed in one country" (Business Dictionary, 2011). Multinationals have used loopholes in the legislation of various countries to shift their profits to companies within their group that are situated in countries that levy a lower rate of tax on income (Sikka, 2009). Companies that are in the same group of companies are considered to be connected persons, however not all connected persons are necessarily in the same group of companies. According to Clark (2007:1), companies use aggressive transfer pricing methods that include conducting inter-group transactions at non-arm's length prices and providing inter-group loans at interest rates that are not arm's length interest rates; all in an effort to move taxable income to entities that are taxed at a lower rate or are not taxed at all. Due to the fact that each individual company is subject to tax and the companies do not pay group taxation, multinationals have been able to shift profits from within the different companies in their group through transfer pricing techniques. Group tax allows for the profits and losses within a group of companies to be assigned to the parent company and are then taxed in the parent company (Niemann & Treisch, 2005: 1).

An example of shifting profits would be a holding company in Australia selling goods to a group company resident in Mauritius at a below market-related price. The company in Mauritius will then sell the goods at a market-related price to third parties resulting in higher profits. Assuming Mauritius has a lower tax rate than Australia, the tax levied on the profits from the sale of goods would be lower than if the Australian holding company had sold it at market-related prices. The effect would thus be that the group as a whole pays a lower tax amount. What would be of concern to the Australian tax authority, is that the various companies are under the same common control, which means that transfers are not necessarily subject to full market forces. (Neighbour, 2002:230.)

Refer to case A and case B below as well as figure 2 that contains an example that further illustrates the principle of how two companies within the same group who are located in different countries can use transfer pricing to their benefit.

- **Case A:** A subsidiary is located in Mauritius where the rate of taxation is 15% and the parent company is situated in Australia where the rate of tax is 30%. The parent manufactures a motor vehicle at a cost of R100 000 and exports the car to the subsidiary at a transfer-selling price of R280 000. The subsidiary sells the motor vehicle to an external third party for R300 000. Therefore both the subsidiary and parent company each earn a profit before tax of R20 000 and R180 000 respectively on the motor vehicle. The group's consolidated after tax profit would be R143 000;and

- **Case B:** The parent company transfers the motor vehicle to the subsidiary for R200 000 and the subsidiary sells the motor vehicle to an external third party for R300 000. Therefore both the subsidiary and parent company each earn a profit before tax of R100 000 on the motor vehicle and the group's consolidated after tax profit is R155 000.

Figure 2: Transfer pricing cases

	Case A		Subsidiary	Parent	Consolidated
			Mauritius	Australia	
		Selling price	300,000	280,000	580,000
		Cost of goods sold	280,000	100,000	380,000
		Profit before tax	20,000	180,000	200,000
		Tax	3,000	54,000	57,000
		Profit after tax	17,000	126,000	143,000
	Case B		Subsidiary	Parent	Consolidated
			Mauritius	Australia	
		Selling price	300,000	200,000	500,000
		Cost of goods sold	200,000	100,000	300,000
		Profit before tax	100,000	100,000	200,000
		Tax	15,000	30,000	45,000
		Profit after tax	85,000	70,000	155,000

Source: (Dean,Feucht &Smith,2008:12)

The example illustrates that by charging a lower transfer price as in case B and using the different tax rates of the companies to their benefit, the group as a whole could make a higher profit after tax. Thus the group is using transfer pricing to maximise its profits. It further illustrates that in case B, Australia would be forfeiting tax revenues due to an adjustment in the transfer price by the group.

In a survey conducted on developing and developed countries (Borkowski, 1997:321-336), it was evident that developing countries were concerned about their losses in tax revenue because of their lack of sufficient transfer pricing regulations. The recommendations that came from the countries that were surveyed can be summarised in two points. The first was "... to develop standardised transfer pricing policy and procedures to be implemented globally" and the second suggestion was "...to mandate increased disclosures about the magnitude and effects of transfer pricing on subsidiary income and tax liabilities in the financial reports of corporations engaging in cross-border transactions" (Borkowski, 1997:1). The survey, which was conducted more than ten years ago, indicates the concerns that countries had regarding transfer pricing. A discussion of the manner in which transfer pricing is being regulated and the developments in transfer pricing are discussed in Chapter Three of this research.

The discretion afforded to companies in setting their transfer prices can allow them to maximise, as much as possible, the profits that will eventually be taxed in jurisdictions with low rates of taxation (Sikka & Willmott, 2010:342). This practice is not the evasion of tax. According to Hickey (2005), tax avoidance is "using legal means to reduce tax burdens" whereas Sharkey (2008:45) describes the evasion of tax to involve a taxpayer concealing a transaction or activity so that they will not have to pay any taxation that would be related to the transaction or activity. Transfer pricing is not the hiding of a transaction in an attempt not to pay tax altogether. It is merely a tool used by companies to exploit the differences in tax rates in the tax legislation to ensure that most of the tax is paid in the lower tax jurisdiction.

b) Domestic transfer pricing

Transfer pricing is not only applicable to foreign companies that have a shareholding in companies that are residents of a different country. It is also is a common concept within the domestic business environment. This is the practice whereby companies in the same country transfer goods, services and intellectual property amongst each other at a value determined at their discretion or determined at the discretion of the company with a controlling interest in the other companies within the group (Agrawal, 2011:2).

Although much has been published on multinational companies adjusting transfer prices to shift profits to companies in countries with lower tax rates, the issue of domestic transfer pricing in South Africa is a new topic for which there has been minimal research. The point of interest with domestic transfer pricing is not the avoidance of tax through the shifting of profits between different countries. The issue on a domestic front as identified in the problem statement above is that companies within the same group are shifting profits to companies (also resident in South Africa) with assessed losses or other tax benefits. This is done to ensure that the group as a whole effectively pays less or no tax. If the company with the assessed loss or more favourable tax benefit makes most of the profit in their records, the assessed loss they have can be set-off against those high profits generated. This results in the group paying less tax.

The following section entails an explanation of thin capitalisation, which is a type of transfer pricing, and how this method may be used by companies in the avoidance of tax.

2.3 THE CONCEPT OF THIN CAPITALISATION

Thin capitalisation is often regarded as a category of transfer pricing and refers to the financing of a business with a disproportionate amount of debt in comparison with the business's equity (Stiglingh, Koekemoer, Van Schalkwyk, Wilcocks, De Swart &, Jordan, 2009:585).

The term thin capitalisation is usually used in reference to situations where high levels of debt financing are obtained from companies that are connected persons in the same group of companies. This is a form of transfer pricing as the service being transferred from one entity to another is the loan of capital and the income that could be shifted from one entity to another is the interest payable on the loan amount (Stiglingh *et al*, 2009:585-586).

As a part of intergroup transactions, multinational companies would usually provide a loan to a company within the same group of companies. This loan would bear interest at a rate that is abnormally high. The interest received by the foreign company granting the loan would normally be subject to an exemption in the country where the receiving company is situated. In South African income tax legislation this exemption is contained in section 10(1)(*h*) of the act. The interest amount would then also be allowed as a deduction in the hands of the company paying the interest in terms of section 24J (Stiglingh *et al*, 2009:585-586). This would save the loan recipient company from having to pay a dividends tax if the financing were rather obtained by the issue of equity instruments that would be entitled to a dividend payment.

The aim of this method of transfer pricing is the avoidance of tax by shifting the loan capital to a tax jurisdiction where the rate of tax is high, thus ensuring the tax is avoided at the highest possible rate on the interest that would be levied on the loan.

Having examined the concept of thin capitalisation as a form of transfer pricing, it is important to investigate how this method (transfer pricing) of avoiding tax is being regulated in an international context. Refer to chapter three.

2.4 THE ARM'S LENGTH PRINCIPLE

According to the Owens (2004), considering the international scope of transfer pricing and the controversy that has surrounded this issue, it is vital to create principles that are accepted internationally to help each country combat the trends by

multi-national companies of shifting profits abroad in an attempt to avoid taxation. The arm's length principle was adopted by the OECD to ensure that all transactions within multinational entities be reflected at prices that would normally be used if the transaction was between independent entities that were not under the control of the same controlling company (Owens: 2004).

An arm's length transaction is one in which independent parties to the transaction attempt to derive the best possible benefit from the transaction (SARS: 1999:8).

The arm's length principle is found in the OECD Model Tax Convention Treaty. Paragraph 2 of article 9 of the OECD Model Tax Convention Treaty provides that, "[when] conditions are made or imposed between... two [associated] enterprises in their commercial or financial relations which differ from those which would have been made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly." (OECD, 2008:30.)

The OECD has accepted, amongst others, the following five methods that can be used to determine an arm's length value for a transaction (OECD, 2009:52):

- Comparable uncontrolled price;
- Resale price method;
- Cost plus method;
- Transactional net margin method; and
- Profit split method.

These methods are discussed below. In the discussion of the methods, an uncontrolled transaction refers to one in which the parties to the transaction are not connected persons as defined in Chapter One.

For all the methods recommended by the OECD, the most important principle is that controlled transactions should be compared to uncontrolled transactions, in determining an arm's length price. For transactions to be considered comparable,

the differences between the transactions should not materially affect the condition that is being compared in the transactions. It is also important to note that the arm's length prices may vary across different markets. Therefore to ensure comparability it is important that the markets in which the parties transact are comparable. (SARS, 1999:9.)

2.4.1 <u>Comparable uncontrolled price method</u>

The comparable uncontrolled price (CUP) method is the preferred method above all transfer pricing methods. This method compares the value at which goods are transferred in a controlled transaction to the value charged in a comparable transaction that is uncontrolled. This method is not always practical to apply, as companies do not always have access to detail on comparable transactions (Pricewaterhousecoopers, 2009:25).

Two transactions can only be comparable where there are no differences that have a material effect on the price being compared. In certain instances, adjustments should be made to the price to eliminate such material effects; however it is often difficult to accurately quantify such adjustments (SARS, 1999:14).

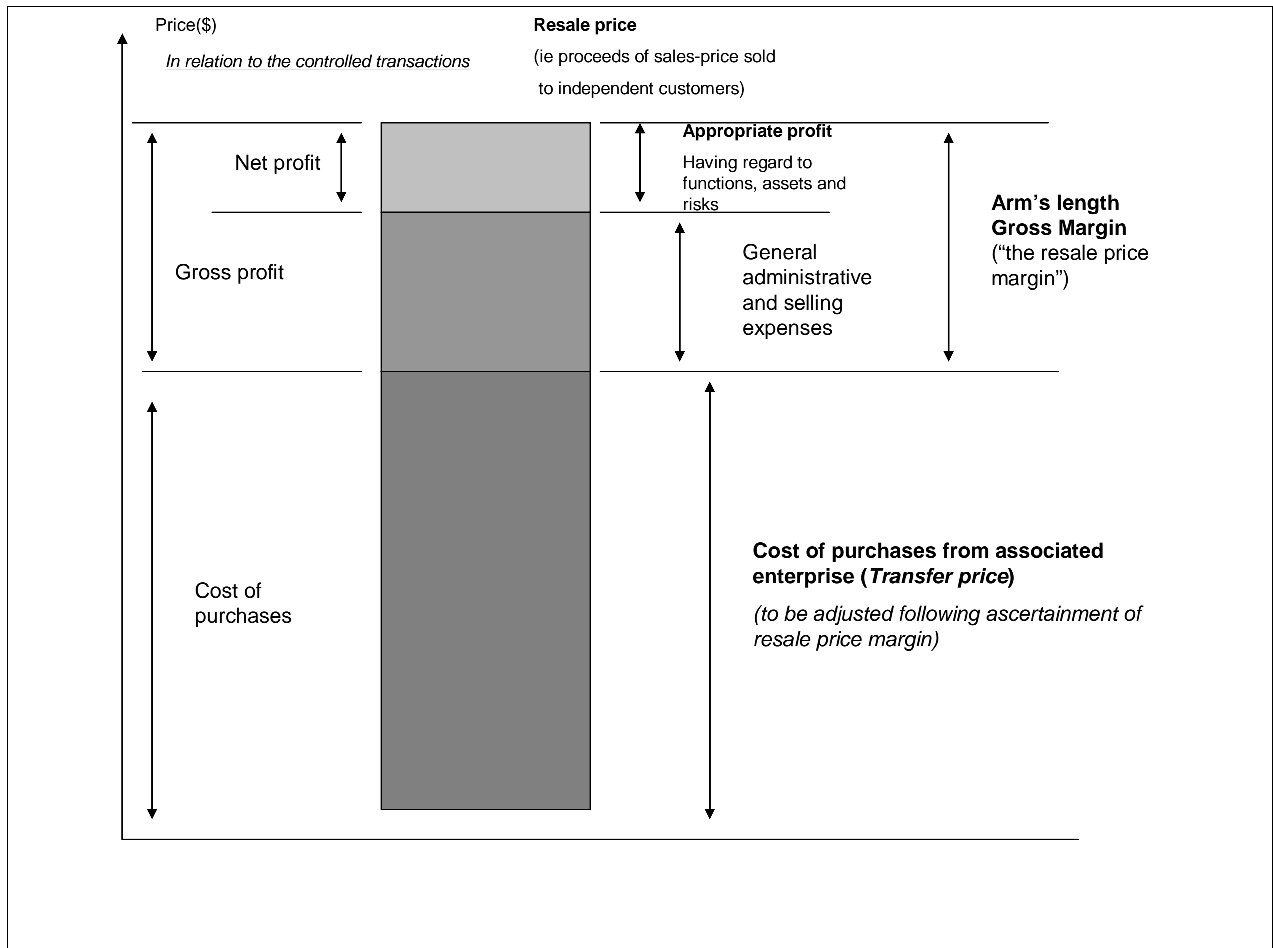
2.4.2 <u>The resale price method</u>

The resale price method entails taking the price at which the goods will eventually be sold to a party external to the group of companies and deducting a discount for the gross margin that would be earned on a comparable transaction. The guidelines do allow for the adjustment of the gross profit margin for factors that may be different when compared to the comparable transaction (Pricewaterhousecoopers, 2009:26).

The biggest practical problem with this method is to determine an arm's length resale gross margin, as information is not always available in respect of uncontrolled entities used for comparison (SARS, 1999:16).

Figure 3 below is an illustration of the resale price method. The diagram illustrates that the starting point to determine the transfer price is to use the resale price that would be applicable to an uncontrolled comparable transaction. The price would then be reduced by an arm's length gross margin, as indicated in the diagram to arrive at an arm's length transfer price.

Figure 3: The resale price method



Source: Lord (2007:20).

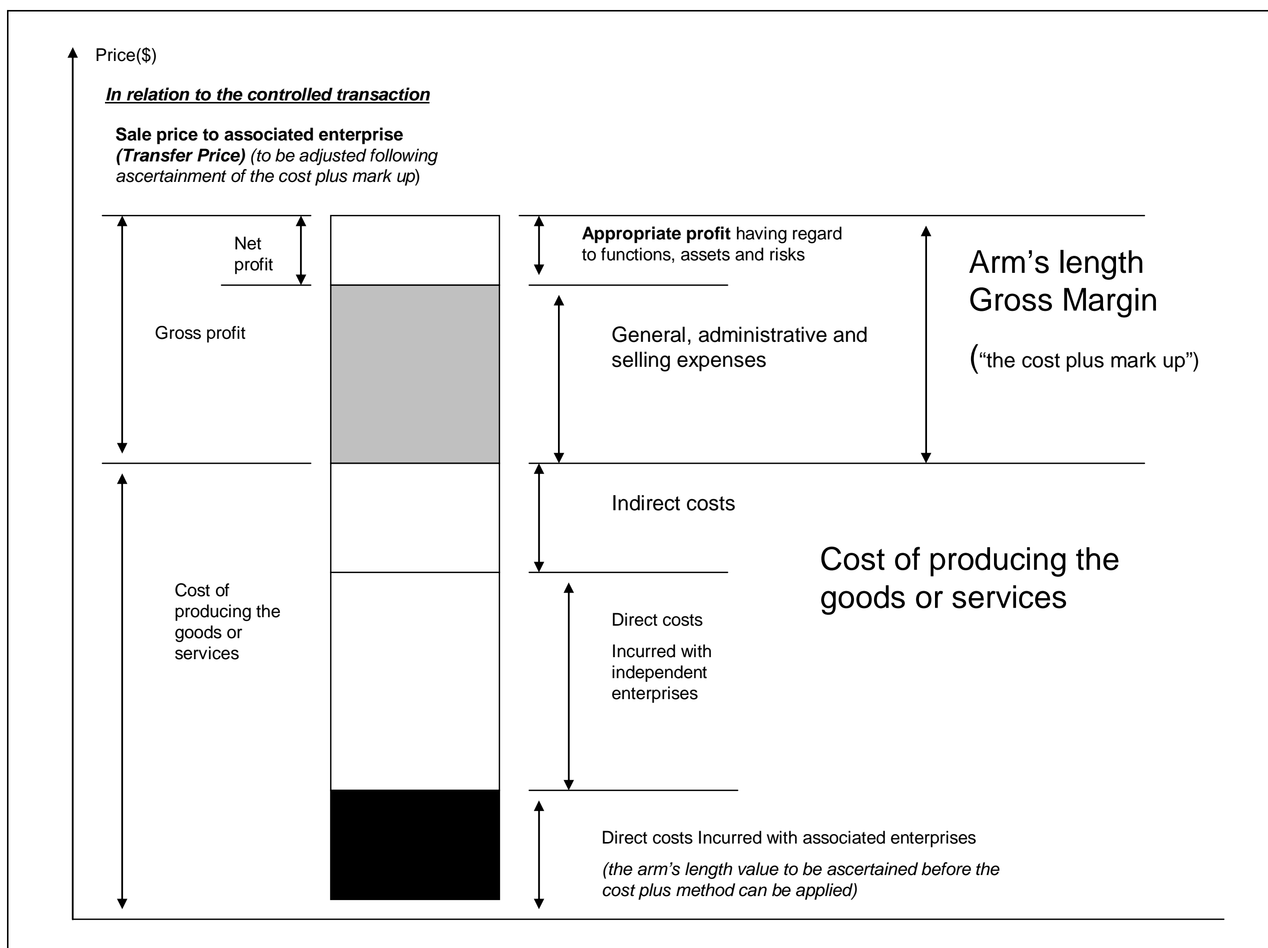
2.4.3 The cost plus method

The cost plus method is the easiest to apply in industries such as the manufacturing industry and industries where services are being supplied. This entails determining the costs incurred to produce the goods and then adding the relevant mark-up that would normally be added by the company for uncontrolled transactions of a similar nature (SARS, 1999:17).

One of two conditions should be met for a controlled transaction to be compared to an uncontrolled transaction. The first condition is that none of the differences between transactions being compared should materially affect the cost plus mark up in the open market. The second condition is that reasonable adjustments should be made to eliminate material effects of such differences (SARS, 1999:17).

Figure 4 below is an illustration of the cost plus method. The diagram illustrates that the starting point to determine the transfer price is to take the costs incurred in producing the goods and services and to add to that an arm's length gross margin that the entity would make on uncontrolled transactions. This will arrive at the transfer price to be charged to the connected party, referred to as associated enterprise in the diagram.

Figure 4: The cost plus method



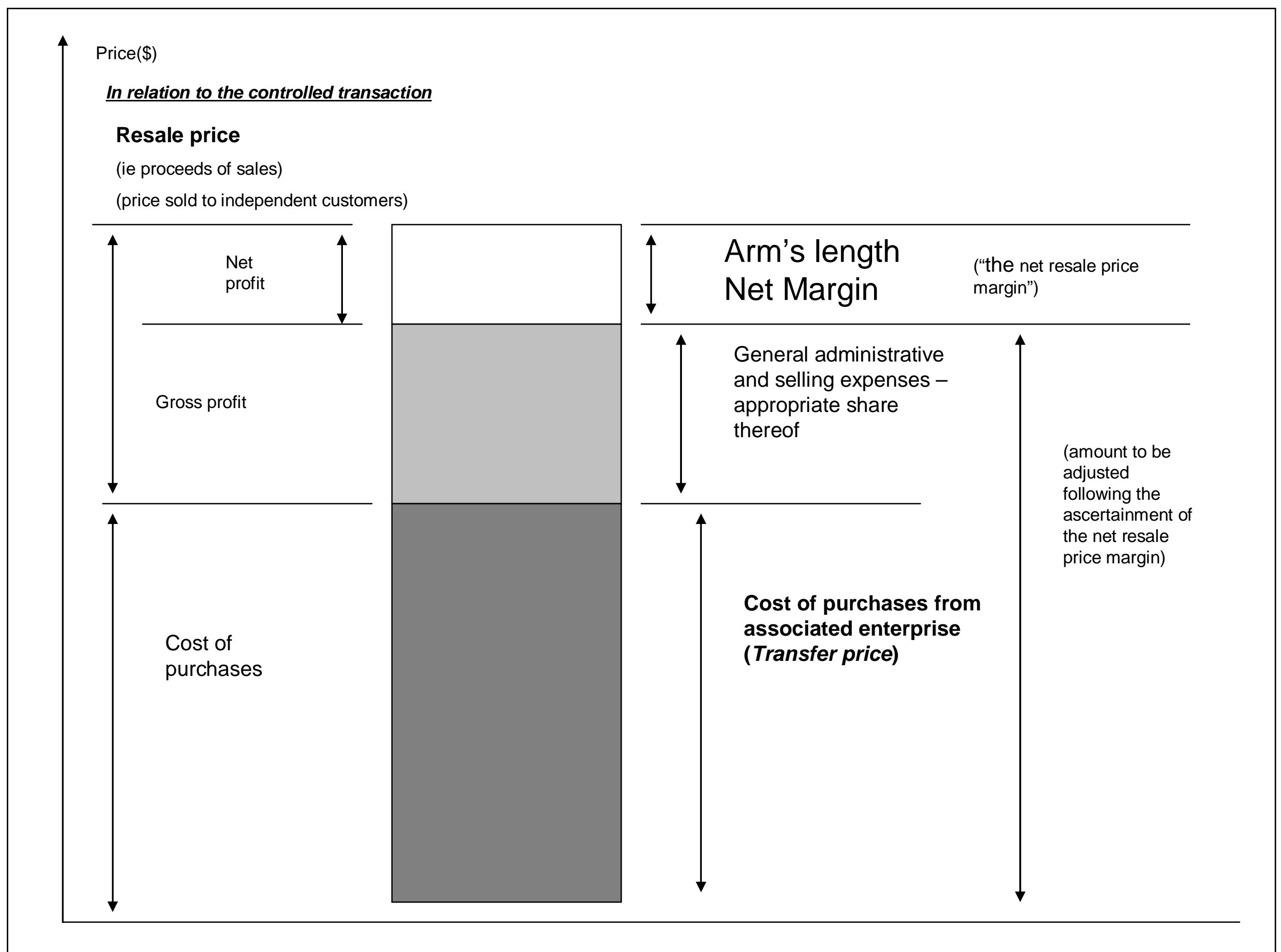
Source: Lord (2007:22).

2.4.4 Transactional net margin method (TNMM)

The transactional net margin method examines the net profit margin that a taxpayer makes on a controlled transaction relative to an appropriate base. Examples of appropriate bases would be: cost, sales or assets. This ratio is known as the profit level indicator. This profit level indicator is compared to the profit level indicators of comparable independent parties (SARS, 1999:18).

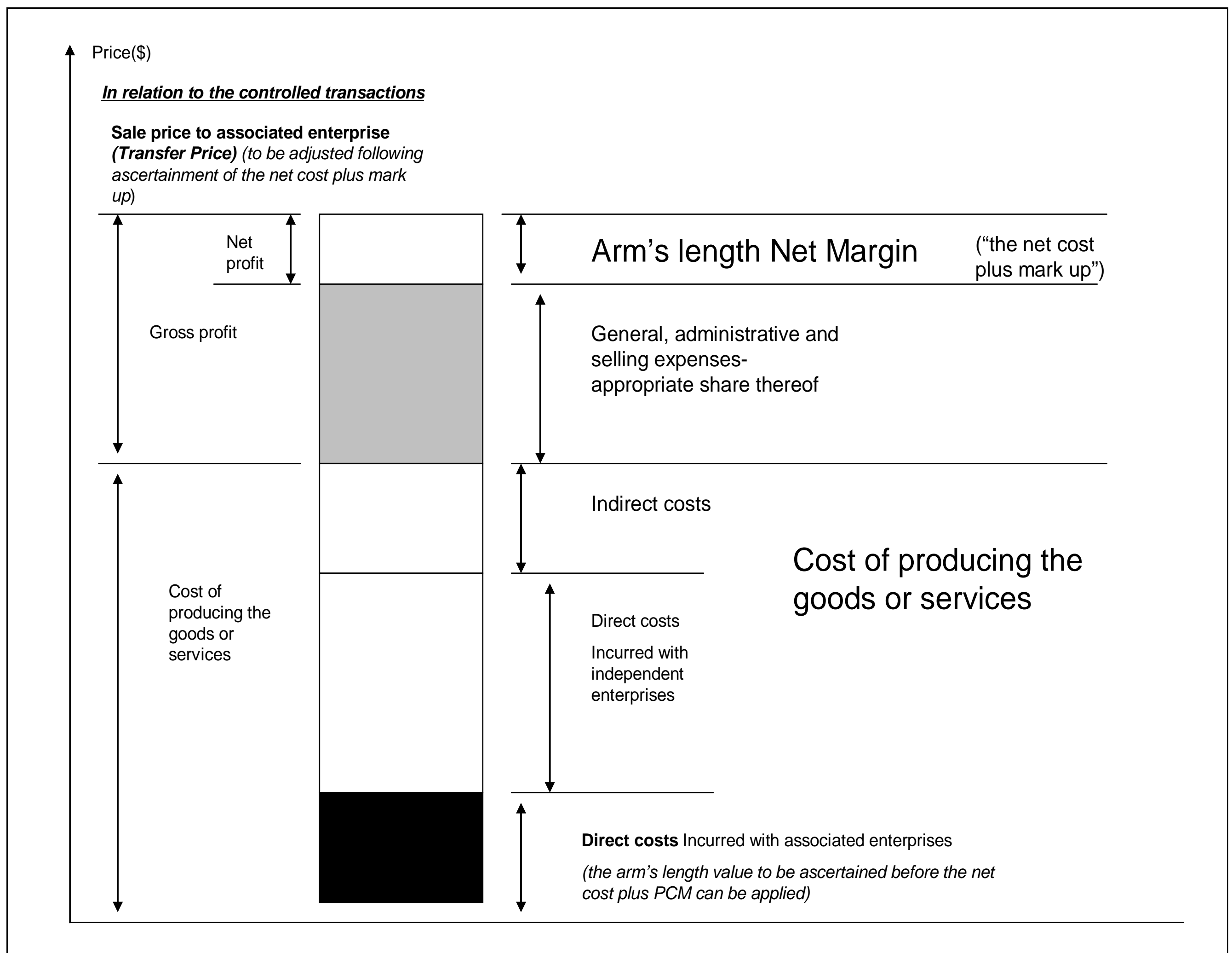
Figures 5 and 6 below illustrate the TNMM applied on the "net resale price basis" and "net cost plus basis" respectively. Figure 5 illustrates that the transfer price is determined by taking the resale price that would be applicable in an uncontrolled transaction with independent parties, less the arm's length net resale price margin that is normal to similar uncontrolled transactions in order to determine the transfer price to be charged to a connected party. Figure 6 illustrates the transfer price as determined by taking the cost of producing the goods and services in an uncontrolled transaction and the arm's length net cost plus margin is added thereon to determine the transfer price.

Figure 5: The transactional net margin method applied on a net resale price basis



Source: Lord (2007:24).

Figure 6: The transactional net margin method applied on a net cost plus basis



Source: Lord (2007:25).

According to SARS Practice Note 7 this method is less reliable than the first 3 methods discussed above.0020The reason for the lower reliability is that the net margins used in this method are sensitive to the relative cost structures of the companies being compared. This sensitivity is a result of operating expenses being included in the calculation of net profit, and operating expenses tend to vary between companies (SARS, 1999:18).

2.4.5 The profit split method

The profit split method entails two steps. The first step is the identification of the combined profit to be split between the connected persons in a controlled transaction. The next step is to split the "... profit according to an economically valid basis" (SARS, 1999:19). There are two ways of splitting the profit, the residual profit split approach and the contribution analysis approach.

- "Under the residual profit split approach, each of the parties to a transaction is assigned a portion of the profit according to the basic function it performs. The residual profit or loss is then allocated between the parties on the basis of their relative economic contribution in respect of the amount to be allocated." (SARS, 1999:20).
- "Under the contribution analysis approach, it is generally combined operating profit (profit before interest and tax) that is divided between the parties on the basis of the relative contribution of each party to that combined gross profit." (SARS, 1999:20).

According to SARS Practice Note 7 issued by SARS (1999:12), the choice of method adopted by companies should be based on evidence having regard to the following:

- The nature of the transactions that are being considered;
- The availability, quality and reliability of the data;
- The nature and extent of any assumptions that are used in determining the arm's length price; and
- The comparability between the controlled and uncontrolled transactions (SARS, 1999:12).

The most reliable method adopted by companies when pricing the transfer of goods and services, is considered to be the method that requires the least number of adjustments to be made. Despite the guidelines provided by the OECD, applying the methods based on the arm's length principle is not always easy. It is not always possible to find comparable market transactions on which to base an acceptable transfer price. (Neighbour, 2002.)

The tax collection agencies of the various countries that have adopted the arm's length principle usually require companies to have detailed documentation on how arm's length prices were determined. This is required for transactions between companies in the same group of companies. When companies have considered various methods, it is preferable that they document reasons for the decision to adopt one method over the others that were considered (SARS, 1999:12).

2.5 CONCLUSION

The concepts of transfer pricing and thin capitalisation have been discussed in detail and the manner in which companies could use these concepts in order to shift profits in an attempt to avoid taxation has been explored. In an effort to ensure that transactions between connected companies occur at prices that would be applicable in an uncontrolled transaction between independent parties, the arm's length principle was introduced. There are various methods to determine arm's length transfer prices, and these have been discussed in this chapter. The method adopted by the company would be dependent on the type of business operations conducted by the company and by the availability of comparable transactions with which transfer prices may be compared.

The arm's length principle related to transfer pricing was introduced by the OECD to provide guidance on cross border transfer-pricing transactions. The following chapter considers the manner in which transfer pricing is regulated at an international level and the actions taken by various countries around the world to ensure that transfer pricing transactions occur at arm's length prices. The following chapter also includes a discussion on the role played by the OECD in ensuring that transfer-pricing transactions occur at arm's length prices.

CHAPTER 3: THE INTERNATIONAL REGULATION OF TRANSFER PRICING

3.1 INTRODUCTION

Ellingsworth (2009:273) stated "A vivid lesson of the 21st century for tax and commerce is that the world is truly interconnected. For many businesses, cross border activity is now fundamental and is often seen as the key to their growth." The increase in cross-border transactions has compelled countries to develop and enforce international tax regulations (Borkowski, 1997:321). International transfer pricing has been a topical issue in recent years, with various countries, including South Africa, adapting their legislation (Pricewaterhousecoopers, 2009:194). This has been done to minimise the exploitation by foreign companies of deficiencies in tax legislation when they transfer goods and services to and from South African resident companies.

Having explained the fundamental concepts to this research, the previous chapter provided an understanding of the manner in which transfer pricing functions. Furthermore an understanding was obtained of the arm's length principle that is used to ensure that transactions between connected persons occur at fair transfer prices.

This chapter discusses the trends in the international market regarding the manner in which countries throughout the globe have begun to implement regulations that will minimise the amount of tax revenue that is being lost in the past due to transactions between connected persons taking place at non-arm's length prices.

3.2 INTERNATIONAL TRENDS OF TRANSFER PRICING REGULATION

Multinational entities have played an increased role in world economic trade in the last two decades. The fact that different countries have separate rules for the taxation of multinational entities, has given rise to complex taxation issues with regard to how to tax these multinational entities. As a result it is difficult to view the

rules of the different countries in isolation, as there are links between the countries because of the multinational entities. The most suitable approach to follow on the taxation rules is to view the taxation of multinational entities in an international context. (OECD, 2009:11.)

The Ernst & Young (2009:2) global survey on transfer pricing highlights that there has been growth in the number of countries that are focusing their attention on transfer pricing activities and that there has been an increasing trend in jurisdictions that are "... introducing documentation requirements and penalty rules". Some of the key trends in international transfer pricing that were highlighted by the survey were the following:

- Tax authorities throughout the world are increasing the resources dedicated to transfer pricing and they are improving their specialist capabilities;
- Countries are gearing up for more tax audits, penalties and more tax disputes;
- Transactions with tax haven countries are being increasingly scrutinised and it has become common for tax authorities to create 'watch lists'; and
- There have been substantial differences in the practical application and the governance of the arm's length principle.

Transfer pricing has become a challenging issue for developing countries as they face the risk of forfeiting tax income that could be collected on cross-border transactions that are conducted by multi-national companies if they do not amend their respective taxation laws to tighten control on transfer pricing between their resident companies and the connected multinational companies that transact with them (Silberztein, 2009:276). South Africa is considered to be the most active country in Southern Africa with regard to legislating transfer pricing activities (Pricewaterhousecoopers, 2009:194). Kruger (2006:21) points out that there is a rise in regulations when it comes to transfer pricing as the RSA government attempts to stem the outflow of tax revenue. Another developing African country that is paying closer attention to transfer pricing policy is Liberia, which according to Hodges (2011:21) is "vulnerable to having its natural resources transported to other countries due to unfavourable transfer pricing transactions." As a result of this, Liberia recently

issued its Consolidated Tax Amendment Act of 2011 that contains provisions that are aimed at minimising its risk in relation to transfer pricing transactions (Hodges 2011:21). Transfer pricing has thus become an increasingly topical issue for developing countries in recent years.

As countries begin to develop their own legislation for the taxation of transfer pricing for international transactions, taxpayers have the challenge of keeping up to date and adhering to the different rules in the various countries where their business is conducted. The legislation in various tax jurisdictions is often inconsistent, which leaves the taxpayer with the burden of ensuring compliance with the relevant countries' legislation and the documentation requirements that accompany the legislation (Pricewaterhousecoopers, 2011:18). Two motivations can be identified for compliance by companies. Firstly, to reduce the risk of a tax audit and a dispute that may arise with the tax authority as a result of the audit and secondly, to enhance consumer confidence by maintaining a transparency with stakeholders and tax authorities (Dean *et al*, 2008:12).

Tax collection agencies around the globe have intensified their efforts and resources into conducting transfer-pricing audits to retrieve additional taxes that were avoided by companies. SARS has indicated its intention to scrutinise multi-national companies that have connected party companies that are situated in jurisdictions that levy lower rates of tax. (Pricewaterhousecoopers, 2009:198.)

Beeton and Kersch state that (2007:42), "Tax authorities can make lengthy inquiries if they believe that a transfer pricing policy may have resulted in the under reporting of taxable profit in their jurisdiction." It has become apparent to the tax collection agencies of countries around the globe that substantial revenue is being lost as a result of transfer pricing occurring at non-arm's length prices. As a result, authorities have tightened their controls regarding international transfer prices and are regularly implementing new strategies of recovering this lost revenue. One of the methods used is conducting more stringent tax audits to verify that companies are conducting inter-group transactions at prices that would be considered arm's length. According to Erasmus (2011:18) who discusses a recent worldwide survey conducted by Ernst

& Young, multinational companies can expect a 40% chance of being subjected to a transfer-pricing audit. This further highlights the importance of multinationals to keep up to date with the relevant legislative requirements in countries in which they conduct business and to have the documentary evidence to prove compliance in the likely event that they are subjected to a transfer-pricing audit.

Based on the different taxation rules in different countries, it became necessary to provide guidance on how to effectively tax inter-group transactions and to set a manner of determining that prices were at arm's length. These guidelines have been set by an international body, whose purpose is to ensure that countries are treated equitably in the taxation of transfer-pricing transactions.

3.3 THE ROLE OF THE OECD IN THE REGULATION OF TRANSFER PRICING

The Organisation of Economic Co-operation and Development's (OECD) is an organisation of thirty member countries that have collaborated efforts in order to address the challenges that are being faced as a result of globalisation. The latter poses the following challenges relevant to the OECD countries, namely social, economic and environmental challenges (OECD, 2009:2). The role of the OECD is to assist governments in the fostering of prosperity and in the battle against poverty through "economic growth and financial stability" (OECD, 2010). The OECD is responsible for providing guidance on a number of international tax issues that have arisen due to the economic challenges posed by globalisation. This organisation has, amongst other things, developed the framework that is used by many countries in the drawing up of international Double Tax Agreements. The aim of the framework is to ensure that countries have agreements in place that eliminate double taxation and ensure that it is clear in relevant international transactions, which country has the right to tax profits, whether in full or in part (OECD, 2010).

South Africa is not a member of the OECD but it does, however, have an observer status, which entitles it to engage in decision processes despite South Africa not being a member of the organisation (Pricewaterhousecoopers, 2009:201). As a result of this engagement, many of the principles adopted in South African Income

Tax legislation originate from OECD principles. The OECD standard (OECD, 2009:25) specifies that a transfer price should be the price at which two independent companies, which are not in the same group of companies, would trade. Should a company be found to have applied an inappropriate transfer price, the regulating tax authority can assign a transfer price that it deems to be sufficient and thus calculate a revised tax liability (Dean *et al*, 2008:12).

The OECD issued a report in 1995 entitled "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" after recognising that it would be beneficial to provide guidelines to its member countries on international transfer pricing. The guidelines have been amended various times since initial adoption to make provision for changing trends and new developments in international transfer pricing (OECD, 2009). The fundamental principle of transfer pricing as per the OECD is that all inter-company transactions should be conducted at arm's length prices (Pricewaterhousecoopers, 2009:22). The OECD provides a description of the arm's length principle and the methods that are considered acceptable in determining arm's length prices. The arm's length principle has been discussed in detail in Chapter Two of this research.

The transfer pricing provisions as per the OECD are contained in article 9 of the OECD Model tax treaty (OECD, 2009:27). The article requires the determination of the true arm's length profits that arise from a transaction so that the correct country has the right of taxing the profits (OECD, 2009:27). Therefore, it is considered compulsory for member countries to adjust transfer prices to reflect arm's length prices.

The OECD guidelines provide guidance on steps to follow when there is a dispute between tax administrations and the taxpayers regarding the transfer prices that are applicable to a transaction (OECD, 2009:90).

The documentation of transfer pricing methods used by taxpayers to ensure compliance with the arm's length principle is of great importance to tax administrations as they have the duty of determining whether arm's length prices

were used by taxpayers. The OECD guidelines provide direction to tax administrations on what type of transfer pricing documentation and policies should be required to facilitate the process of determining whether arm's length prices were used by the taxpayer (OECD, 2009:141). As tax administrations around the globe apply stricter rules regarding the documentation of transfer pricing policies by companies, it is important for multinationals to obtain an understanding of the documentation requirements of different tax authorities in countries wherein they transact business (Pricewaterhousecoopers, 2011:2). Tax authorities have implemented both formal and informal requirements for companies to keep documentation that demonstrates that the transfer prices have been determined at arm's length prices (Pricewaterhousecoopers, 2009:60).

3.4 CONCLUSION

As countries have become aware of the tax revenue collections that are being lost due to income shifting by controlling companies, stricter controls have been put in place within the legislation of the various countries to ensure that transactions between multinationals and their group of companies are at arm's length prices. Eden and Smith (2001:1) state that, "because transfer prices can be manipulated to avoid taxes; governments insist that these prices must be set as if the firms were at arm's length." This has given rise to challenges for companies, as they need to comply with the legislative requirements of different countries where they conduct business.

The following chapter contains an analysis of the UK income tax legislation regarding transfer pricing. The UK income tax legislation is used as a basis of comparison to SA income tax legislation on transfer pricing in determining whether there are any deficiencies in RSA legislation for which the UK legislation has been able to effectively regulate.

CHAPTER 4: UNITED KINGDOM TRANSFER PRICING LEGISLATION

4.1 INTRODUCTION

"The new transfer pricing rules in the United Kingdom... mark a significant shift by the UK government to a tougher approach to the taxation of international transactions," according to Davies (2000:58). Since the introduction of transfer pricing rules in the UK nearly 50 years ago (Davies, 2000:58), the UK government has attempted to regularly update its transfer pricing rules to keep up with the trends followed by companies in their attempt to avoid taxation. Her Majesty's Revenue & Customs (HMRC) is the revenue collection agency in the UK and together with the UK government, is implementing a tougher approach to the taxation of international transactions.

The UK tax legislation dealing with transfer pricing was until recently contained in schedule 28AA of the Income and Corporation Taxes Act 1988. HMRC has highlighted that UK transfer pricing rules have some important features, as listed below:

- "They are based on the internationally recognised 'arm's length' principle promulgated by the OECD;
- They help protect the UK tax base by preventing artificial diversion of profits;
- They have the potential to impose a significant compliance burden on companies to demonstrate... that arm's length results have been used in the calculation of taxable profit; and
- Where the nature of the issue merits it, Advance Pricing Agreements can be reached to achieve earlier and greater certainty." (HMRC, 2007:6)

In the light of the importance that is placed on the features of UK transfer pricing rules by HMRC, it will be valuable to analyse these transfer pricing rules as part of the research in determining whether the provisions of UK income tax legislation are

adequate in ensuring arm's length international and domestic transfer pricing transactions. The UK is a member of the OECD, and as a result has adopted the arm's length principle when regulating international and transfer pricing transactions between companies that are in the same group (OECD, 2010).

This chapter will thus analyse the UK transfer pricing legislation for international as well as domestic transactions. This analysis will form the basis on which to compare UK transfer pricing legislation with RSA transfer pricing legislation in the final chapter.

4.2 INTERNATIONAL TRANSFER PRICING

The basic rule for transfer pricing was previously contained in schedule 28AA paragraph 1 of the Income and Corporation Taxes Act 1988. The legislation applies to transactions in which control is exercised by one party over the other party in a transaction or series of transactions. For an understanding of the legislation, the terms "provision" and "transaction" as used in the Income and Corporation Taxes Act 1988, are explained by HMRC to mean the following: 'provision' refers to the terms and conditions that are imposed on a transaction. 'Transaction' includes arrangements, understandings and mutual practices, whether or not they are, or are intended to be, legally enforceable (HMRC, 2011).

The legislation stipulates that if an actual provision (terms and conditions) has been made in a transaction between two affected (connected) parties, and one of the affected parties exercises control over the other party, then that provision that has been made should be compared to an arm's length provision (terms and conditions) that would have been made between two independent parties. Upon comparison of the actual and arm's length provision, if a UK tax advantage has been given to one of the affected parties to the transaction, then the provision is required to be adjusted to increase the profits to what they would have been if the provision had been at arm's length. An important feature of the UK legislation is that this adjustment can only be made to increase taxable profits or reduce a tax loss; therefore it cannot be used to reduce the taxable profits of the affected parties. (HMRC, 2011.)

Paragraph 2 of schedule 28AA of the Income and Corporation Taxes Act 1988 required that the interpretation of the legislation is consistent with the arm's length principle contained in article 9 of the OECD model as well as the transfer pricing guidelines issued by the OECD (HMRC, 2011).

The legislation in the Income and Corporation Taxes Act includes a provision that incorporates financial transactions and relates to thin capitalisation. Thus, UK legislation enables the HMRC to challenge the deductibility of interest paid by a UK company on a loan from a connected party if the loan amount or interest rate used is excessive (Pricewaterhousecoopers, 2009:734).

The UK income tax legislation on transfer pricing is based on a self-assessment principle that requires all companies to automatically self-assess whether an international transaction is at an arm's length basis. The impact of this self-assessment principle is that companies are required to maintain detailed documentation to prove that the transactions they conducted with connected persons are at arm's length prices. (Davies, 2000:59.)

In February 2010, the Taxation (International and other Provisions) Act 2010 was enacted by the UK government in an effort to update personal and corporate tax legislation. According to HMRC (2011), the aim of the new legislation is to make the UK tax legislation "clearer and easier to use, without changing the law." Part 4 of the Taxation (International and other Provisions) Act 2010 contains a restatement of the transfer pricing rules that were previously contained in schedule 28AA of the Income and Corporation Taxes Act 1988. The basic transfer pricing rules applicable to international transactions that were contained in 28AA of the Income and Corporation Taxes Act 1988 are still applicable in the Taxation (International and other Provisions) Act 2010. Therefore the UK income tax rules relating to transfer pricing as discussed above still remain applicable (Pricewaterhousecoopers, 2011:752).

Having analysed the UK income tax legislation with regard to international transfer pricing transactions, it is worth mentioning a court case where the transfer pricing rules were applicable.

Malik (2006:12) describes a well-known UK court case (*Glaxo Group Ltd and Others v. Inland Revenue Commissioners*) involving the manipulation of transfer pricing. The case is described by Malik (2006:12) as being one that involved the selling of Librium and Valium medicines by a holding company, Hoffman-LaRoche to its subsidiary, Roche Products at prices that were higher than what would be expected in the international market. The UK authorities established that the holding company had manipulated transfer prices and as a result ordered the subsidiary company to reduce the price of the products purchased.

The outcome of the case is an example of instances where the UK tax authority has exercised its legal right to ensure that transactions between multinationals and their connected persons are conducted at arm's length transfer prices.

Having analysed UK income tax legislation and case law relating to the transfer pricing of international transactions, the following section considers whether the UK legislation makes provision for domestic transfer pricing transactions between two UK companies that are connected persons.

4.3 DOMESTIC TRANSFER PRICING LEGISLATION

Transfer pricing rules were implemented in the UK with the initial intention of regulating cross border transactions. From 1 April 2004, the UK tax legislation regarding transfer pricing was changed when transfer-pricing legislation became applicable to domestic transactions. Where previously transfer-pricing legislation was applicable to transactions between multinationals and companies resident in the UK, these changes in legislation resulted in the arm's length principle applying to transactions between UK connected companies. (UHY Hacker Young Chartered Accountants, 2006.)

The Income Corporation and Taxes Act 1988 originally exempted UK-to-UK transactions from the provisions of schedule 28AA. However, this exemption in transfer pricing legislation was removed by government in 2004, with amendments to the Finance Act 2004. The reasons for the changes were twofold:

- The UK government was concerned that the legislation in its present form could be in breach of the European Union Treaty that required that the UK tax system does not discriminate against non-UK companies; and
- The changes would counteract a range of UK tax planning structures regarding domestic transfer pricing. (Pricewaterhousecoopers, 2009:712).

Thus UK Income tax legislation now requires that domestic transactions between affected parties be conducted at arm's length prices (Pricewaterhousecoopers, 2009:712).

The amended legislation requires companies to provide proof of the arm's length nature of all transactions that are conducted between UK connected persons. The introduction of the amended legislation has placed a huge compliance burden on UK companies, rather than increasing their taxation liability to the tax authorities, as they have had to keep a record of their application of the arm's length principle (Anon., 2003:1-5).

4.4 CONCLUSION

The UK has been successful in implementing transfer pricing legislation that ensures that transactions between affected parties are at arms' length as the wording and interpretation of UK legislation is in line with OECD principles. The UK has also identified deficiencies in tax legislation that were previously exploited by companies with regard to the transfer pricing of domestic transactions. In an attempt to address these deficiencies, the transfer pricing provisions apply to domestic transfer pricing as well as international transfer pricing. The biggest criticism regarding applying the arm's length principle to domestic transactions is that it places a huge compliance

burden on UK companies that often outweighs the additional tax liability to the revenue authorities.

The following chapter analyses RSA income tax legislation on transfer pricing and the developments in the said legislation since its initial implementation. The chapter also considers whether RSA legislation has similar provisions to ensure that domestic transfer pricing transactions are conducted at arm's length prices.

CHAPTER 5: SOUTH AFRICAN TRANSFER PRICING LEGISLATION

5.1 INTRODUCTION

The RSA Finance Minister, Pravin Gordhan is quoted by Wright (2010:1095) to have said the following in his February 2010 budget speech, "Steps will be taken against several sophisticated tax avoidance arrangements, and such as the use of transfer pricing and cross border mismatches." This statement by the minister is evidence that RSA has, like the rest of the world, become very aware of the misuse of transfer pricing by companies in the avoidance of income tax and is taking further steps to ensure that transactions between connected persons take place at arm's length prices. These further steps were evident on 24 August 2010, when the Taxation Laws Amendment Act No. 7 of 2010 was enacted by parliament. The Taxation Laws Amendment Act No. 7 of 2010 contains the most significant changes to RSA transfer pricing legislation since transfer pricing was first introduced to RSA income tax legislation in 1995 (Wiesener, 2011:17).

The new section 31 on transfer pricing is applies in respect of years of assessment commencing on or after 1 October 2011 and provides *inter alia* that:

- The arm's length test is applicable for thin capitalisation; and
- The onus of proving that transactions are at arm's length now lies with the taxpayer, where previously, SARS had the burden of assessing a transaction to determine whether an adjustment to an arm's length price should be made.

In light of the amendments to legislation regarding transfer pricing, it will be valuable to analyse these amendments as part of the research in determining whether the provisions of RSA income tax legislation are adequate in ensuring arm's length international and domestic transfer pricing transactions. Considering how recent the changes to legislation are, the gap in research knowledge would also be in whether

this new section closes the transfer pricing loopholes that are being exploited by national enterprises in the avoidance of tax.

5.2 INTERNATIONAL TRANSFER PRICING

Prior to 1995 South African income tax legislation did not contain a specific section dealing with transfer pricing. A taxpayer could utilise the section 11(a) general deduction formula to obtain a deduction for expenses incurred in the course of carrying on a trade. In *Income Tax Case 569* 1944, (13 SATC 447), the courts held that grossly excessive expenditure was not allowed as a deduction. The term "grossly excessive" was subjective and the only court case at the time which provided guidance on what was considered to be grossly excessive was *Tobacco Father v Cot*, 1951(1) SA 150 (17 SATC 395) in which the court held that the open market price could not be used as a reference point when determining whether expenditure was grossly excessive (Honiball, 2010). The Commissioner could only rely on section 11(a) and the above-mentioned case law in the adjustment of expenditure allowed as a deduction with regard to transfer pricing transactions.

Section 31 of the act contains the provisions governing the taxation of transfer pricing transactions. The section, which was introduced in 1995, aims to regulate the price at which goods/ services are transferred between connected persons when one party is a resident of the Republic and the other party is a non-resident of the Republic. The South African legislation followed the approach that is used in the UK tax legislation to regulate transfer pricing between connected persons. It is important to note that the section applies to international transactions between connected persons, as the parties to the transaction are described as being a non-resident and a resident. The section referred to the Commissioner's **discretion** at adjusting the consideration at which an international transaction was concluded, to reflect an arm's length transfer price, if the Commissioner considered that the price was less than or greater than the arm's length price (Ernst & Young, 2010). Thus the section was an anti-avoidance provision that could be used by the Commissioner to adjust the price at its discretion in order to receive more taxable income from the seller of the goods/ services and to allow a lesser deduction by the purchaser of the goods and services.

As per the 2010 Taxation Laws Second Amendment Bill, section 31 of the legislation was revised to align South African Income Tax legislation with the OECD model tax conventions and specifically to include the arm's length principle as described in the OECD model (Standing Committee on finance, 2010). The OECD model provides for the adjustment of transfer prices to reflect arm's length prices (OECD, 2009:27). Prior to the amendments to section 31 in the act, South Africa reserved its right to place the words "shall" in their tax treaty, with the effect that the tax treaty lined up with the previous income tax legislation, which afforded the Commissioner the discretion of adjusting the transfer price (Olivier & Honiball, 2008:508-509).The amendment to section 31 now aligns South African domestic legislation with the OECD model in this regard. The Commissioner no longer has the discretion of whether to make an adjustment to transfer prices to reflect arm's length.

The Explanatory memorandum to the 2010 Taxation Laws Amendment Bill emphasises the shift in focus away from transactions merely involving the sale of goods and the provision of services as per the previous section 31 (National Treasury & SARS, 2010:76). The previous section 31 distinguishes between transfer pricing and thin capitalisation, whereas with the revised section, the focus has shifted towards "cross border transactions, operations, schemes, agreements or understandings that result in a South African tax benefit for the parties to the transaction." Thus the revised section includes a wider net of transactions and is worded in a manner that is similar to an anti-avoidance section, in an attempt to close off loopholes that have been used by taxpayers in the past.

The legislation, as revised, now makes it compulsory for all international transactions between connected persons to be concluded at arm's length prices. Therefore the discretion to adjust to arm's length prices no longer lies with the Commissioner, as was the case previously.

The wording of section 31 of the act reads as follows:

> *"... the taxable income of each person that is a party to that transaction, operation, scheme, agreement or understanding that derives the tax benefit* ***must*** *be calculated as if that transaction, operation, scheme, agreement or understanding had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm's length."(Own emphasis)*

The amendment to the legislation is an attempt to close the loophole that existed previously in which the adjustment of prices to reflect arm's length amounts was at the discretion of the Commissioner. Therefore, a taxpayer is now compelled to conduct transactions at arm's length prices and SARS is now compelled to issue their tax assessment using the arm's length principles (Honiball, 2010). Therefore the legislation has moved to a self-assessment requirement for the parties to the transaction, which is similar to the situation in the UK

The revised section 31 no longer distinguishes between transfer pricing provisions and thin capitalisation provisions as before, and it is important to note that the 3:1 thin capitalisation ratio as per Practice Note 2 will need to be amended because the revised section 31 requires all transactions to be determined at arm's length prices. As per the explanatory commentary to the 2010 Taxation Laws Amendment Bill, it was noted that one of the reasons in delaying the date from which the revised section 31 would be effective, was to give SARS the opportunity to amend its practice notes to correlate with the revised section 31 (National Treasury & SARS, 2010:76).

An example of the differences between the previous and the revised section 31 of the act would be as follows:

A subsidiary is located in Mauritius where the rate of taxation is 15% and the parent company is situated in South Africa where the rate of tax is 28%. The parent manufactures a motor vehicle at a cost of R100 000 and exports the car to the subsidiary at a transfer selling price of R110 000. The subsidiary sells the motor vehicle to an external third party for R300 000. Therefore both the subsidiary and

parent company each earn a profit before tax of R10 000 and R190 000 respectively on the motor vehicle.

Based on previous legislation, SARS would have had the discretion of analysing the transaction and based on its analysis would decide on whether a transfer price of R110 000 was considered to be arm's length. If SARS considered that selling a motor vehicle for R110 000 after manufacturing it for R100 000 is not the price that would have applied in a transaction with an independent third party, SARS had the option of adjusting the transfer price to reflect an arm's length transfer price.

Based on the revised legislation, the parent company would need to consider at what price it would sell the motor vehicle to an independent party, and that would be the price at which it must transfer the motor vehicle to its subsidiary. It is unlikely that R110 000 would be an arm's length price and therefore, the parent company would need to increase its transfer price accordingly.

As is demonstrated from the example above, the setting of an arm's length price is now compulsory for the parties to the transaction and no longer merely at the discretion of SARS.

Having analysed RSA income tax legislation regarding the regulation of international transfer pricing transactions, it is beneficial to consider whether the amended section 31 of the act provides for the regulation of domestic transfer pricing

5.3 DOMESTIC TRANSFER PRICING

With the revision of section 31, section 80A was also incorporated into the act and the section relates to impermissible tax avoidance arrangements. The section states that *"[a]n avoidance arrangement is an impermissible avoidance arrangement if its sole or main purpose was to obtain a tax benefit and... in any context it has created rights or obligations that would not normally be created between persons dealing at arm's length."* The concepts of tax evasion and tax avoidance have been discussed in chapter 2.2.

Although South African income tax legislation does not specifically address transfer-pricing transactions in a domestic context, the section 80A anti-avoidance provision in the act specifically refers to transactions being at arm's length. The issue identified as per the research question, in a domestic context was that of a company that exercises control over another company with an assessed loss. The controlling company could transact with the connected company at non-arm's length prices (sell items to the connected company at below arm's length prices). The effect of this would be that when the connected company sold the goods/services to a third party, it would realise the major portion of the profits. Due to the assessed loss that is available to this company, it will utilise the assessed loss to avoid paying tax on the profits from the class of transactions.

Therefore, if a company were to transact with a related party at transfer prices that were not an arm's length, SARS can place reliance on section 80A by proving that a tax benefit will be obtained by the company that wishes to utilise the assessed loss of the other connected company. The benefit would be that the group of companies would pay less tax on the class of transactions. Furthermore the transaction, that would require the selling company to provide goods/services at a lower price to the connected company, would indeed create a right to receive goods and services and an obligation to provide goods and services at prices that are not arm's length. Therefore based on this anti-avoidance provision, it would seem that the income tax legislation does ensure that transactions that occur in domestic context are conducted at arm's length prices.

A recent court case was heard in the Johannesburg tax court, before Judge Willis, wherein the RSA taxpayer succeeded in charging its RSA subsidiary service fees that were considered by SARS to be excessive (Kotze, 2011:16). The judge in this case is quoted to have said that, "taking advantage of an accumulated assessed tax loss is not an inherent wrong. On the contrary, the advantages presented by such losses can influence strategic decisions which can save companies and turn them around to obvious benefit of employees and the revenue services, among others." (Kotze, 2011:16). This further indicates that the applicability of the arm's length principle to domestic transfer pricing transactions is a subjective area that is open to

interpretation by the courts. As such, although the act has an anti-avoidance provision, because it does not specifically refer to an arm's length price for domestic transfer pricing transactions between connected persons, it is open to interpretation that could be detrimental to SARS, companies and the economy.

5.4 CONCLUSION

South African Income tax legislation regarding transfer pricing has evolved over the years as RSA attempts to keep up with international trends in transfer pricing regulations and with the changing landscape in global taxation. The introduction of the arm's length principle into RSA Income tax legislation indicates an alignment with the OECD guidelines and now compels companies to transact at arm's length prices when entering into international transactions with connected persons. The principles adopted in RSA Income Tax Legislation indicate that the taxation authorities have attempted to close loopholes that have been exploited by companies in the past, all in an effort to maximise the taxation revenue that they consider as being is due to the RSA fiscus. The anti-avoidance provisions of the act and the interpretation thereof can be viewed as an attempt to ensure that even domestic transfer pricing transactions are conducted at arm's length prices. However, the anti-avoidance provisions are open to subjective interpretation by the courts and this could result in companies still being able to exploit the loopholes that are apparent in the legislation with regard to domestic transfer pricing transactions. This research concludes with a comparison of the legislation of these two countries, namely the UK and RSA, and suggestions for possible improvement to legislation where necessary.

CHAPTER 6: CONCLUSION

6.1 INTRODUCTION

"Transfer pricing has in recent years gone from being a relatively unimportant aspect of tax compliance and planning to now becoming an issue that demands the attention of many corporations," according to Stirling (2002). Having evaluated the research on transfer pricing, it is evident that transfer pricing is a topical issue in the global economy. Transfer pricing is one of the biggest tax avoidance tools being used by multinationals to shift profits in an attempt to pay less income tax (Sikka, 2009). This is done in transactions with connected persons at transfer prices that are not equivalent to prices that would be used in transactions with independent parties with whom the multinational companies are not connected.

Tax authorities around the globe have gone to great lengths to ensure that they implement legislation that minimise their losses in tax revenue due to transfer pricing (Ernst & Young, 2009:2). The OECD has considered transfer pricing an issue worthy of its involvement, and is continuously issuing guidance to countries to ensure that there is international co-operation regarding international transfer pricing matters. The UK and RSA governments have both implemented transfer pricing legislation in an attempt to ensure that transfer-pricing transactions occur at arm's length prices.

This chapter concludes the research by comparing UK and RSA transfer pricing rules and their similarity to the OECD model on the taxation of transfer prices. The chapter compares the transfer pricing rules in UK and RSA applicable to both international and domestic transactions. This is concluded by an answer to the research question of whether the act ensures that domestic transfer pricing transactions occur at arm's length prices.

6.2 A COMPARISON OF TRANSFER PRICING RULES AS APPLIED BY THE OECD, UK AND RSA

6.2.1. International transfer pricing

The OECD has introduced the arm's length principle that states that transactions between connected persons should be at prices that are considered to be arm's length (OECD, 2009:27). An arm's length transfer price is a price that would be used in a transaction between independent parties who are not connected (OECD, 2009:27). The OECD has provided recommendations on principles and methods to be used in the calculation of transfer prices that are considered arm's length and these principles have been adopted by many countries in their respective income tax legislations.

The UK tax legislation, which was used for comparison purposes, in this study, contains provisions regarding transfer pricing that are in line with the OECD principles. The UK has also included the arm's length principle in its transfer pricing tax legislation and has intended for its legislation to be interpreted as being consistent with OECD principles. The UK legislation is based on a self-assessment principle that requires companies to assess for themselves whether a transfer price is at arm's length and thus they are required to adjust their price to an arm's length price accordingly. Therefore the adjustment of transfer prices is not solely at the discretion of HMRC but rather it is required to be applied by the parties to a transaction (HMRC,2011).

RSA has included international transfer pricing legislation in section 31 of the act and has issued a practice note that gives guidance on the implementation of the legislation. The amendments to the legislation now compel companies to conduct transactions with connected persons at arm's length prices. This was contrasted to the situation in the past where the Commissioner of SARS had the discretion of adjusting transfer prices to reflect arm's length prices.

Therefore the similarities can be seen in the transfer pricing legislation between UK and RSA. Both UK and RSA legislation require arm's length prices in transactions with connected persons, rather than leaving the adjustment of the price to an arm's length price at the discretion of the respective tax collection agencies.

The RSA 2010 Taxation Laws Amendment Act and the changes therein provide further evidence that the RSA National Treasury is working towards ensuring that international transactions occur at arm's length prices, per the OECD guidelines (OECD, 2009:27). It was noted in the research that the amendments in the RSA income tax legislation regarding transfer pricing now made RSA legislation similar to that of the UK with regard to international cross border transactions. The reason for this is that both RSA and UK transfer pricing legislation with regard to international cross border transactions are now in line with OECD arm's length principles.

6.2.2. Domestic transfer pricing

The OECD transfer pricing rules are only applicable to international transfer pricing transactions, which is to be expected since the role of the OECD is to provide guidance on matters related to international tax. It would then be expected that when discussing domestic transfer pricing transactions and the legislation thereof in this section, reference would only be made to UK and RSA legislation rather than comparison with OECD transfer pricing rules.

The UK income tax legislation was amended in 2004 to specifically refer to domestic transfer pricing transactions, requiring these transactions between connected persons to be at arm's length prices. This was done to close the loopholes that were exploited by companies in domestic transactions between connected persons. This is contrasted with the case in RSA where the amendments to section 31 of the act are absent of any reference to transactions between two RSA companies and do not contain a provision dealing specifically with the arm's length transfer prices thereof.

A finding of this research was that RSA income tax legislation does not specifically include a provision regarding domestic transfer pricing transactions, which is in contrast with the UK legislation that has a specific provision in this regard. It was, however, noted in the research that the RSA legislation has a general anti-avoidance provision that compensates for the lack of a specific section dealing with domestic transfer pricing in the income tax legislation. Furthermore it was noted that an anti-avoidance provision is absent in the UK legislation, which indicates the reason for a need arising to include a specific provision dealing with domestic transfer pricing. As explained in the research, the RSA anti-avoidance provision has the potential to be applied in instances in which domestic transfer pricing transactions would take place at prices that are not arm's length. Therefore RSA income tax legislation uses the anti-avoidance provisions therein to ensure that domestic transfer pricing transactions between connected persons occur at prices that are at arm's length.

However, since RSA legislation is not specific with regard to domestic transfer-pricing transactions, it is still an area, which can be exploited by South African companies. This is due to the fact that the absence of specific reference to domestic transfer pricing transactions leaves legislation open to interpretation by the courts that can prove to be subjective on a case by case basis.

6.2.3 Conclusion

The act does not include a specific provision relating to domestic transfer pricing transactions, although it does make room for domestic transfer pricing transactions to be conducted at arm's length prices through the use of an anti-avoidance provision. The reliance by SARS on the anti-avoidance provision to ensure that domestic transfer pricing transactions occur at arm's length leaves a loophole that is subject to exploitation by RSA companies. Based on the similarities between UK and RSA transfer pricing legislation in relation to international transactions, it is recommended that RSA should follow suit with regard to domestic transfer pricing transactions and include a specific provision in

its legislation. In this way, the RSA government would ensure that the arm's length application to domestic transfer pricing transactions is one that is compelled by law rather than being one that is open to subjective interpretation by the courts. In including a specific provision, the compliance burden to companies should be considered to determine whether the benefits of an amended legislation would outweigh the costs thereof.

6.3. FURTHER RESEARCH

An area for further research would be an empirical study on the compliance burden faced by companies in adhering to transfer pricing legislation. The research could consider whether companies in RSA are adequately equipped to prepare the required transfer pricing documentation to ensure that they can weather the storm that is a transfer-pricing audit. The research could further focus on the penalties that are due to companies that do not comply with the stringent transfer-pricing regulations in the various countries wherein they conduct business.

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