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University of the Witwatersrand, Johannesburg

South African transfer pricing income tax legislation: is there still a gap?

Trisha Garach Bhaga Muljee

A research report to be submitted to the Faculty of Commerce, Law and Management in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation)

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ABSTRACT

Transfer pricing is a continuously evolving phenomenon and is a topical issue world-wide. With increasing inter-company cross-border transactions, multinational enterprises are using loopholes in the interaction of tax legislation of different countries as a tool to shift profits to a more favourable jurisdiction, thereby avoiding tax in the jurisdiction in which they are resident and eroding the resident jurisdiction's tax base. This research report examines and discusses the substituted South African transfer pricing legislation that applies for the years of assessment commencing on or after 1 April 2012 as well as the related SARS guidance. An analysis of transfer pricing legislation and guidelines in three selected countries and the OECD transfer pricing guidelines will also be performed. The comparisons of the legislation and guidelines will highlight whether there are still weaknesses in the South African transfer pricing legislation and will indicate possible solutions to these weaknesses which will assist in reducing the erosion of the South African tax base.

Key words: Tax, Transfer pricing, Tax avoidance, Base erosion and profit shifting, Multinational enterprises ('MNEs'), South African Revenue Service ('SARS'), Organisation for Economic Co-operation and Development ('OECD').

DECLARATION

I declare that this research report is my own unaided work. It is submitted for the degree of Master of Commerce in the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination in any other university.

Trisha Garach Bhaga Muljee

September 2017

DEDICATION

To my loving family, especially my caring husband, Heemal and our sweet little son, Pranav, thank you for all your motivation, support and encouragement during the research report process. A special thanks to Heemal, for looking after our son on weekends while I was busy writing the research proposal and research report.

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A**BBREVIATIONS**

‘HMRC’: Her Majesty’s Revenue and Customs

‘KRA’: Kenyan Revenue Authority

‘OECD’: Organisation for Economic Co-operation and Development

‘*OECD Model Tax Convention*’: *OECD Model Tax Convention on Income and on Capital*

‘*OECD Transfer Pricing Guidelines*’: *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators*

‘SARS’: the South African Revenue Service

‘the Act’: Income Tax Act 58 of 1962

‘the Tax Administration Act’: Tax Administration Act 26 of 2011

CHAPTER 1: Introduction and overview

1.1. Introduction

This chapter introduces the topic, it provides an understanding of what transfer pricing is and how it is used to shift profits and erode tax bases. The significance of the research will be discussed together with the problems and sub-problems identified. The research methodology used and limitations of the research report will also be highlighted.

1.2. What is transfer pricing?

Transfer pricing is a topical issue in the international market as a significant volume of international trade arises from companies entering into cross-border transactions with connected persons (within their group of companies) (United Nations Department of Economic & Social Affairs 2013:1). Transfer pricing can be used as a tax avoidance tool by multinational enterprises to shift profits, by entering into non-arm's length transactions between connected parties, in an attempt to pay less tax by the group of companies as a whole (United Nations Department of Economic & Social Affairs 2013:5). The ultimate result of these profit shifting transactions is base erosion (OECD 2013b:5).

Transactions entered into by connected parties within a group of companies are not exposed to the same market forces as transactions entered into between independent parties (United Nations Department of Economic & Social Affairs 2013:1). The pricing of intra-group cross-border transfer of goods, intangibles or services is essentially known as the 'transfer pricing' and these transactions are referred to as 'controlled' transactions as the transaction price can be controlled by the entities involved because they are not independent parties (United Nations Department of Economic & Social Affairs 2013:2). The arm's length principle is an internationally accepted principle underlying transfer pricing (OCED 2013b:36) which has been endorsed by both the OECD and the United Nations Tax Committee (United Nations Department of Economic & Social Affairs 2013:11). In order for the transfer price to be at arm's length, the price at which the goods or services would have been sold to a non-connected/independent party would have to be determined (OECD 2010:33). When transfer pricing is not executed at arm's length and at market-related conditions, the tax liabilities of those connected parties and the related tax revenues of the tax jurisdiction could be distorted (OECD 2010:32).

If a tax administration identifies that multinationals/entities are transacting with their connected parties at prices which are not arm's length, according to domestic law, in order to obtain an overall benefit (by reducing the total/consolidated tax paid by the group); the issue of potential tax avoidance could arise (United Nations Department of Economic & Social Affairs 2013:2). The only way to restrict this tax avoidance is by putting in place anti-avoidance legislation. However, it should be noted that with the general anti-avoidance provisions, it could become difficult to successfully challenge related party transactions, hence there is a need for specific anti-avoidance transfer pricing provisions (United Nations Department of Economic & Social Affairs 2013:335). In transfer pricing the 'what would independent parties do' approach is used and where it is found that there is 'no commercial rationale' behind the taxpayer's conduct, anti-avoidance provisions are triggered (Venter 2013).

Tax avoidance is the use of perfectly legal means of arranging a taxpayer's affairs, for example, by exploiting loopholes in the tax legislation and making use of these loopholes to the taxpayer's advantage (Haupt 2016:638). The transaction is thus regarded as a *bona fide* transaction which has the effect of avoiding tax or reducing the tax liability in a particular jurisdiction. The only way in which tax avoidance transactions or schemes can be restricted is if the legislature identifies these loopholes and amends the legislation or includes further anti-avoidance provisions in order to curb the tax avoidance in the future (Haupt 2016:638).

It should be noted that the underlying contractual obligations would not be affected by the need to make a tax adjustment to reflect the arm's length principle for tax anti-avoidance purposes (OECD 2010:31).

1.3. **What is base erosion and profit shifting?**

'Base erosion was recognised as a serious threat to tax revenues, tax sovereignty and tax fairness' for all countries (Sweidan 2013). With increasing inter-company cross-border transactions, multinational enterprises are using loopholes in the interaction of the varying tax legislation of different countries as a tool to shift profits so that they appear lower in a country with higher tax rates, yet higher in a country with lower tax rates (OECD 2013b:5-6). The outcome that results from this phenomenon is base erosion and profit shifting by either double non-taxation or a reduction in high tax jurisdictions' tax base (Adams & Adams 2016:3). Multinational enterprises use various techniques to manipulate their taxable income in the jurisdictions in which they operate which results in major losses in domestic tax revenue for those jurisdictions (Adams & Adams 2016:0). Profit shifting is the most significant source of base erosion (OECD 2013b:5).

As multinational enterprises integrate across borders, they create corporate structures which are legal but which take advantage of asymmetries in the tax provisions domestically and internationally (OECD 2013b:49). Governments recognise this phenomenon and acknowledge that a change in this legal framework can only be achieved through a holistic approach which requires international co-operation and collaboration in order to strengthen domestic actions to protect tax bases and to provide a comprehensive world-wide solution to the issue of base erosion and profit shifting (OECD 2013b:51). Although co-ordination will be key in the implementation of any solution to base erosion and profit shifting, all countries may not necessarily use the same tools/provisions to address the issue (OECD 2013b:8).

It may be difficult for a single country, acting alone, to fully address this issue of base erosion, it is therefore recommended by the OECD that a universal approach is required to properly address the issue of base erosion and profit shifting (OECD 2013b:7-8). This can be done by the local Governments by taking actions such as, *inter alia*, striking a balance between source and residence based taxation; imposing tax provisions relating to intra-group financial transactions; and implementing anti-abuse and transfer pricing provisions (OECD 2013b:7).

1.4. **Transfer pricing in the South African context**

As the protection of a jurisdiction's tax base is of vital importance, transfer pricing has become a priority area for African countries, like South Africa (Adams & Adams 2016:4).

For developing countries, such as South Africa, transfer pricing legislation is of utmost importance as it creates certainty for foreign investors and an environment for increased cross-border trade but at the same time ensures that the jurisdiction is not losing out on its rightful share of tax revenue (OECD 2013b:6-7).

As South African subsidiaries of off-shore multinational enterprises increase their market-share and earn more revenue in the South African jurisdiction, their South African taxable income may rise resulting in an increase in tax payable. This increase in tax payable reduces the net profit after tax of the company thereby reducing the returns to the shareholders. It is contended by multinational enterprises that they legally reduce the taxes paid by their entities as a result of their responsibility towards their shareholders to earn profits (Davis Tax Committee BEPS Sub-Committee 2014a:9). In order to reduce an increased tax charge, multinational enterprises may set up schemes in the form of cross-border transactions in order to shift the taxable profits from the subsidiary in the South African jurisdiction (where it is resident) which has a higher tax rate to a jurisdiction which has more favourable lower tax rate, which may include jurisdictions

which are so-called tax havens. The typical transaction would entail the South African entity paying a sum of money in respect of goods or services (such as, *inter alia*, management fees, royalties and interest) to a connected party in a jurisdiction which has more favourable tax rates. The South African entity therefore gets a deduction in terms of s 11(*a*) of the Act (for management fees and royalties) or s 24J of the Act (with respect to interest) in respect of the goods purchased or services received and in so doing, the tax expense in the South African jurisdiction is reduced and the total tax payment by that group of companies is reduced.

1.5. **Statement of the problem**

What recommendations can be identified in respect of improvements to the South African transfer pricing legislation (in s 31 of the Act) and SARS practices, from a comparison between s 31 of the Act and SARS practices and the transfer pricing legislation and practices of three selected countries, namely Kenya, India, the United Kingdom and the published guidelines of the OECD?

1.6. **The sub-problems**

1.6.1. The first sub-problem is to determine what the current transfer pricing legislation and practice is in South Africa. The transfer pricing legislation in South Africa is covered in s 31 of the Act and the practice of SARS is set out in *Practice Note 7 Section 31 of the Income Tax Act, 1962 (the Act): Determination of the taxable income of certain persons from international transactions: Transfer pricing* and the addendum thereto. Section 31 of the Act was substituted (National Treasury 2011:116-117; 154) for years of assessment commencing on or after 1 April 2012.

1.6.2. The second sub-problem is to determine what the current transfer pricing legislation and practice is of each of the three selected countries. The three countries selected for comparison are Kenya, India and the United Kingdom. The reason for the selection of Kenya and India[1] is that they are developing countries like South Africa and they are

[1] According to the World Bank, the term developed countries/economies is used for high-income countries/economies while the term developing is used to denote all low- and middle-income countries/economies. The term 'developing' is used for convenience; it is not intended to imply that all economies in the group are experiencing similar development or that other economies have reached a preferred or final stage of development. As of 1 July 2015, low-income economies are defined as those with a gross national income ('GNI') per capita of $1 025 or less in 2015; middle-income economies are those with a GNI per capita of more than $1 026 but less than $12 475; high-income economies are those with a GNI per capita of $12 746 or more. Lower-middle-income and upper-middle-income economies are separated at a GNI per capita of $4 036. Kenya is a lower-middle income country as its GNI per capita was $1 340 in 2015. India is a lower-middle income country as its GNI per capita was $1 590 in 2015. South Africa is an upper-middle income country as its GNI per

not OECD member countries (OECD 2016b) however they have been quite aggressive in their approach to transfer pricing in recent years (Amable 2012; Spearman 2013). The reason for the selection of the United Kingdom is that it is a developed[2] country and is a member country of the OECD. The second reason for the selection of these three countries is that their transfer pricing legislation has been tested by the courts. The transfer pricing legislation and case law of the three selected countries that will be discussed in the report are as follows:

- Kenya: The transfer pricing provisions are in s 18(3) of the Income Tax Act and Legal Notice no.67 of 2006 (Deloitte 2016:152). A transfer pricing case heard by the Kenyan court was *Unilever Kenya Ltd v CoT* Income Tax Appeal 753 of 2003.

- India: The transfer pricing provisions are in s 92, 92A, 92B, 92C, 92CA, 92CB, 92CC, 92CD, 92D and 92F of Chapter X of the Income-tax Act 1961 and the relevant rules for transfer pricing are rule 10A to 10TG of Income-tax Rules 1962 (OECD 2012; Deloitte 2016:123). A transfer pricing case heard by the Indian court was *CIT v Glaxo SmithKline Asia (P) Ltd* (2010) 236 CTR (SC) 113.

- United Kingdom: The current transfer pricing rules are in Part 4 of the Taxation (International and Other Provisions) Act 2010 (Deloitte 2016:263). A transfer pricing case heard by the United Kingdom court was *DSG Retail Ltd v HMRC* (2009) UK FTT 31 (TC) 1.

1.6.3. The third sub-problem is to determine what the current OECD transfer pricing guidelines are. These guidelines are based on Article 9 of the *OECD Model Tax Convention* (OECD 2010:33). While South Africa is not a member country of the OECD, South Africa tends to follow the OECD transfer pricing guidelines (Grant Thornton 2014). The OECD (OECD 2008:2) indicates that:

> '…The Organisation provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and work to co-ordinate domestic and international policies…'

It is therefore useful to determine whether South Africa is in fact following these guidelines in relation to its transfer pricing legislation as the OECD transfer pricing guidelines can be used as benchmark for international practice.

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capita was $6 050 in 2015. All three countries are therefore considered to be developing countries according to the World Bank statistics. (http://data.worldbank.org/news/2015-country-classifications).

[2] According to the World Bank, the United Kingdom is a high income country as the GNI per capita was $43 340 in 2015.

1.6.4. The fourth sub-problem is to compare s 31 of the Act and SARS practice to the transfer pricing legislation and practice of the three selected countries as well as the OECD transfer pricing guidelines. The initial comparison has led to the identification of potential weaknesses in the South African transfer pricing legislation and practices, for example:

- There are no specific penalty provisions which have been included in s 31 of the Act for instances where non-compliance is identified.
- South Africa does not make use of advance pricing agreements. Advance pricing agreements are used as a tool by revenue authorities to resolve potential transfer pricing disputes in advance based on verified facts and circumstances.

1.6.5. The fifth sub-problem is what recommendations can be identified, with respect to improving s 31 of the Act, from the comparisons made between the three selected countries and the OECD transfer pricing guidelines.

1.7. **Research methodology**

The research methodology used will be qualitative. The main sources of data used are primary and secondary materials. Primary sources included domestic legislation, regulations and guidelines (of the country on which research is conducted) as well as international guidelines. Secondary sources consulted include books, journal articles and articles. The most recent and up-to-date primary sources will be utilised for the research report.

As a detailed analysis of the transfer pricing legislation and practice of the three selected countries is beyond the scope of this report, the main focus areas of the legislation and practice will be discussed.

CHAPTER 2: South Africa's transfer pricing legislation and practice

2.1. History

It was found by the Katz Commission (Katz 1994:231) that the general anti-avoidance provision was an ineffective tool to provide the necessary protection against transfer pricing in South Africa. The South African tax legislation required 'legislative teeth' to protect itself from the abuse afforded by relaxation in exchange control regulations, excessive price manipulation between connected parties and to correct the imbalance of disproportionate funding by foreign investors through debt as opposed to equity (i.e. thin capitalisation[3]) (Katz 1994:231; Katz 1995:1). On the other hand, a balance was required between protecting the tax base and imposing legislation so rigorous that the provisions become a deterrent for foreign investment (Katz 1994:231). The anti-avoidance transfer pricing and thin capitalisation legislation was introduced in 1995 as s 31 of the Act based on the findings from the Katz Commission (Katz 1995:8). On recommendation from the Katz Commission, the transfer pricing legislation was based on a flexible arm's length principle, as per the OECD guidelines, to dictate acceptable pricing practice (Katz 1994:232; Katz 1995:2). The 'relatively simple' United Kingdom rules (which relied strongly on the OECD guidelines) were considered to be a 'valid model' for the South African transfer pricing provisions (Katz 1994:232). In addition, the Katz Commission recommended that a Practice Note relating to thin capitalisation should be issued, by the then Commissioner for Inland Revenue, now called SARS, to provide all stakeholders with a 'high degree of predictability' and guidance in the application of the provisions, but would not be so rigid so as actually to constitute the legislation (Katz 1995:8).

The Katz Commission further suggested that in order to provide a measure of certainty to international investors, advance pricing agreements should be considered for companies to agree to an acceptable pricing range in advance with the South African revenue authorities, thereby avoiding future disputes (Katz 1994:233). It was acknowledged by the Katz Commission that the then Inland Revenue, did not have the capacity or sufficiently trained personnel to provide advance pricing agreements, therefore this aspect should be outsourced (Katz 1994:233). Provisions relating to advance pricing agreements were not put in place in 1995 and these agreements are currently not available to taxpayers (Deloitte 2016:236).

[3] Thin capitalisation refers to the situation in which a company is financed through a relatively high level of debt in comparison to equity. These companies are referred to as highly geared or highly leveraged companies (OECD Secretariat 2012b:3).

The South African transfer pricing legislation had various amendments over a period of 16 years. In 2010, SARS announced their intention to fundamentally realign the transfer pricing provisions with the *OECD Transfer Pricing Guidelines* (Honiball and Delahaye 2013). The substituted s 31 (transfer pricing legislation) was brought into effect for years of assessment commencing on or after 1 April 2012. The new transfer pricing provisions are, according to National Treasury, now aligned to the wording of the OECD and United Nations Model Tax Convention and are consistent with South African tax treaties and other international tax principles (National Treasury 2010:76). Further amendments have been made to the substituted legislation to date. The fundamental arm's length principle, according to Article 9 of the OECD and United Nations Model Tax Convention, has not been revised and has remained the foundation of the South African transfer pricing legislation from inception as it is the internationally accepted transfer pricing principle (United Nations Department of Economic & Social Affairs 2013:409; SARS 1999:8).

2.2. **Analysis of the substituted s 31 transfer pricing legislation**

In summary, s 31 of the Act is applied where any affected transaction, being a cross-border transaction, operation, scheme, agreement or understanding, and any term or condition imposed thereof results in or will result in a South African tax benefit for one of the connected parties to that transaction, then the taxable income of the parties that have benefitted must be calculated as if that transaction had been entered into at arm's length (Davis Tax Committee BEPS Sub-Committee 2014b:16; Adams & Adams 2016:1). In South Africa the OECD methods, which are encapsulated in SARS *Practice Note 7*, are used to determine an arm's length price (Davis Tax Committee BEPS Sub-Committee 2014b:16).

The substituted South African transfer pricing provisions' wording, in s 31 of the Act, is now aligned to the *OECD Model Tax Convention*, which focuses on the economic substance of the related party transactions rather than the pricing of the specific transactions (Brodbeck 2012). South Africa thus, according to OECD's recommendation, utilises the arm's length principle to curtail transfer pricing.

2.2.1. **Section 31(2) wording: Affected transaction being 'any transaction, operation, scheme, agreement or understanding'**

With the use of these words there has been a shift from a single transaction approach to an entity-based approach (Honiball and Delahaye 2013). In doing so, the scope of the transfer pricing provisions is broadened and encompasses the overall profit, the 'economic substance

and the commercial objective of the arrangement' with the related party/parties (National Treasury 2010:75).

By the adoption of a holistic approach in the substituted s 31, SARS is seeking to gain an understanding of the multinational group's entire business process by obtaining a comprehensive understanding of the commercial rationale prevailing over the intra-group transactions, the agreements, the arrangements and so forth in order to determine whether a suitable arm's length profit has been derived (United Nations Department of Economic & Social Affairs 2013:411).

This wording is likewise aligned with the definition of 'arrangement' under the South African general anti-avoidance regulations contained in s 80A to s 80L of the Act which must be read together with s 34 to s 39 (reportable arrangements) of the Tax Administration Act.

2.2.2. **Section 31(2): Determination of the arm's length consideration**

Guidance on how to determine the arm's length consideration is provided in SARS *Practice Note 7*. This guidance is based on the *OECD Transfer Pricing Guidelines*.

The determination of the arm's length consideration is not 'exact science' hence what is generally accepted is a range of arm's length prices, however, this range could be wide and SARS *Practice Note 7* indicates that it is doubtful whether all the points in the calculated range are arm's length prices (Joubert, Woolmer and du Preez 2016:4). Conversely, where the traditional OECD transactional method is used to calculate the arm's length range, any point within this range is acceptable (Joubert *et al* 2016:4).

A great amount of judgement is required in order to determine the most appropriate point in the arm's length range which would be applicable to the taxpayer, this point can also be affected by other factors, such as the taxpayer's risk profile (Joubert *et al* 2016:4).

2.2.3. **Section 31(2): Thin capitalisation provisions**

Previously, the thin capitalisation provisions were dealt with under a separate subsection of s 31 of the Act, however, with the substituted provisions, the thin capitalisation provisions have now been incorporated into the general transfer pricing provision under s 31(2) of the Act (SARS 2013a:4).

The debt:equity safe harbour of 3:1 was replaced with an arm's length test rendering SARS *Practice Note 2*, which contained guidelines relating to the safe harbour, redundant (Brodbeck 2012).

The arm's length approach to thin capitalisation is the determination of the funding that the taxpayer would have been able to secure in the open market (Honiball and Delahaye 2013). Although SARS has introduced this arm's length test, no official guidance has to date been provided for the determination of the arm's length thin capitalisation rules which is an area of great concern (Honiball and Delahaye 2013).

A draft Interpretation Note, which is discussed in further detail in part 2.4.1 of this report, was released in 2013 with no final Interpretation Note published.

2.2.4. **Section 31(3): Secondary adjustment**

Where a transfer pricing adjustment (the difference between the arm's length price and the price actually charged) is made by the taxpayer or SARS, a secondary adjustment is required to be made in terms of s 31(3) of the Act. The secondary adjustment is implemented as follows:

- Prior to 1 January 2015, the difference gave rise to a deemed loan on which arm's length deemed interest would have accrued to the taxpayer, resulting in taxable income for the taxpayer (National Treasury 2014:61).

- With effect from 1 January 2015, the difference is deemed to be a dividend *in specie* declared and paid by the South African company[4] to the connected party (s 31(3)(i)) which is subject to dividend withholding tax in the hands of the South African company at the rate of 15% (s 64E). The reason for this change was the administrative burden for both the taxpayer and SARS as the accounting treatment of the deemed loan was not practical and there were potential exchange control issues (National Treasury 2014:61-62).

- Owing to the change in the secondary adjustment, all existing deemed loans which arose prior to 1 January 2015 were converted to deemed dividends *in specie*, in the case of a company[5], on 1 January 2015 (proviso (*a*) to s 31(3)) and were accordingly

[4] In terms of s 31(3)(ii), where the person is not a company, the difference will be deemed to be a donation.

[5] In terms of proviso (*b*) to s 31(3), where the person is not a company, the existing deemed loans were converted to a deemed donation.

subject to the dividend withholding tax of 15% (s 64E) in the hands of the South African company (Joubert *et al* 2016:4; National Treasury 2014:62).

2.2.5. **Obligation to make the s 31 adjustment**

In terms of s 31(2) of the Act, by the use of the words 'must be calculated', the onus is on the taxpayer to make a transfer pricing adjustment in order to reflect the arm's length consideration of the transaction, operation, scheme, agreement or understanding (Joubert *et al* 2016:2). This onus, however, does not in any way reduce SARS' powers to make a further adjustment where SARS is of the view that the taxpayer has incorrectly determined the transfer pricing adjustment (Joubert *et al* 2016:2).

2.3. **Penalties and interest relating to the transfer pricing provisions**

Understatement penalty

There is no specific penalty in s 31 of the Act which applies to transfer pricing adjustments. An understatement penalty can be imposed where the Commissioner finds that the taxpayer's transfer pricing adjustment was not at arm's length (Deloitte 2016:235).

In terms of s 222 of the Tax Administration Act, in the event of an 'understatement' (which is defined in s 221 of the Tax Administration Act as: a default in rendering a return; an omission in a return; an incorrect statement in a return; or where no return was required, failure to pay the correct amount of tax) by a taxpayer, the taxpayer must pay, in addition to the tax payable for the relevant tax period, the penalty determined by applying the highest applicable understatement penalty to the 'shortfall' unless the 'understatement' results from a '*bona fide* inadvertent error', in which case no penalty will be levied (s 222(1) of the Act). '*Bona fide* inadvertent error' has not been defined in the Tax Administration Act or the Act and is, in the author's view, a very subjective phrase which many taxpayers may try to use so that no understatement penalty can be imposed.

A fixed penalty percentage is determined in terms of a table in s 223 of the Tax Administration Act which is based on the behaviour and the conduct of the taxpayer, which is again, in the author's view, very subjective.

Table: Understatement penalty percentage table

1	2	3	4	5	6
Item	*Behaviour*	*Standard case*	*If obstructive, or if it is a 'repeat case'*	*Voluntary disclosure after notification of audit or investigation*	*Voluntary disclosure before notification of audit or investigation*
(i)	'Substantial understatement'	10%	20%	5%	0%
(ii)	Reasonable care not taken in completing return	25%	50%	15%	0%
(iii)	No reasonable grounds for 'tax position' taken	50%	75%	25%	0%
(iv)	Gross negligence	100%	125%	50%	5%
(v)	Intentional tax evasion	150%	200%	75%	10%

SARS has published a guide in relation to the Tax Administration Act which includes guidance on the above table with respect to the behaviours and the conduct (SARS 2013b:79-81). As each case is different, the understatement penalty imposed will be based on the facts, the circumstances and the behaviour associated with the specific case.

SARS may remit the understatement penalty (s 223(3) of the Tax Administration Act) if it is satisfied that the taxpayer:

- Made full disclosure of the arrangement, in terms of s 34 of the Tax Administration Act (reportable arrangements), at the time of submission of the return; or
- Was in possession of an opinion by an independent registered tax practitioner upon submitting the return and that opinion would be upheld in a court of law.

In terms of s 224 of the Tax Administration Act, the taxpayer may object to the understatement penalty imposed by SARS.

Non-compliance with documentation requirements

In terms of s 210 of the Tax Administration Act, if SARS is satisfied that a taxpayer failed to comply with an obligation that is imposed by or under a tax Act and is listed in a public notice issued by the Commissioner, as is the case for the notice to keep transfer pricing documentation (SARS 2016b), SARS must impose the appropriate penalty in accordance with s 211 of the Tax Administration Act as follows:

Table: Amount of administrative non-compliance penalty

1 Item	2 Assessed loss or taxable income for 'preceding year'	3 'Penalty'
(i)	Assessed loss	R250
(ii)	R0 – R250 000	R250
(iii)	R250 001 – R500 000	R500
(iv)	R500 001 – R1 000 000	R1 000
(v)	R1 000 001 – R5 000 000	R2 000
(vi)	R5 000 001 – R10 000 000	R4 000
(vii)	R10 000 001 – R50 000 000	R8 000
(viii)	Above R50 000 000	R16 000

It is submitted that, in most transfer pricing instances, the highest penalty of R16 000 will be applicable. This penalty is minimal taking into consideration that the transfer pricing documentation requirement will be an important source of information and will speed up the audit process. It is further submitted that SARS should consider imposing specific penalties relating to non-compliance with documentation requirements.

Interest

Interest, at the current rate of 10.25% effective from 1 May 2016 (SARS 2016f), applies to both the tax on the under-reported income and the penalties imposed on the taxpayer in terms of s 89*quat* of the Act (Deloitte 2016:235).

2.4. **Analysis of the guidelines issued by SARS related to s 31 transfer pricing legislation**

2.4.1. **SARS *Practice Note 2***

SARS *Practice Note 2*, which was issued in May 1996 and amended in May 2002, dealt with the debt:equity safe harbour of 3:1 for thin capitalisation purposes. With the substitution of the transfer pricing provisions, the debt:equity safe harbour was replaced with an arm's length test, making SARS *Practice Note 2* redundant (Brodbeck 2012).

A draft Interpretation Note to replace the outdated *Practice Note 2* was released in April 2013 entitled *Determination of the Taxable Income of Certain Persons from International Transactions: Thin Capitalisation* (SARS 2013a).

In terms of the draft Interpretation Note, SARS would focus on funding arrangements coming from offshore connected parties to South African entities to assess whether there is a genuine 'business need or reason or commercial benefit for the additional finance' (SARS 2013a:7).

The taxpayer would be required to prepare a function analysis in relation to the funding arrangement, providing documented details such as, *inter alia*:

- The group structure and an understanding of the business;
- The funding structure, including, *inter alia*, the source, the relevant dates; and terms and conditions of loan funding indicating the interest rates and repayment terms;
- The financial strategy of the entity including the allocation and the utilisation of the funding by providing cash flow information;
- The credit worthiness of the entity (if available); and
- The security available.

(SARS 2013a:7-8)

The South African entity receiving connected party funding would be required to satisfy SARS that an independent lender, taking into account the overall financial position of the entity, would have been willing to provide it with the same funding, therefore SARS would require the taxpayer to look at the funding from both the lender's and the borrower's perspectives (SARS 2013a:7).

In order to determine whether the borrowed amount is at arm's length, the taxpayer would be required to provide comparable data (compiled with the assistance of databases, models and scorecards to provide a range of industry sector norm ratios, based on credit ratings) which SARS can use as a basis to assess the taxpayer's application of the arm's length borrowings (SARS 2013a:8). Just as the amount borrowed is required to be at arm's length, the interest rate of the borrowing is also required to be at arm's length (SARS 2013a:9).

SARS' draft Interpretation Note further indicates that in performing risks analysis, SARS will consider transactions of greater risk if the Debt:EBITDA (earnings before interest, tax, depreciation and amortisation) ratio of the South African taxpayer exceeds 3:1 (SARS 2013a:11). On the other hand, meeting the requirement is not considered to be a safe harbour

and does not guarantee that the loan is considered to be at arm's length by SARS (SARS 2013a:12).

Furthermore, the OECD has noted that if the tax administration can provide safe harbour provisions which are to be applied in the relevant circumstances, this can provide taxpayers with more certainty and assist in reducing a portion of the time consuming and costly compliance and administration burdens (OECD 2013c:9). The author has noted that SARS has not taken these factors into account in drafting the Interpretation Note.

This draft Interpretation Note has to date not been re-drafted or ratified more than three and half years later, hence, it is submitted that certainty and guidance on the determination of arm's length for thin capitalisation purposes has not been provided to taxpayers. It is further submitted that this also provides a possible indication to taxpayers that SARS is not confident in the manner in which to accurately determine the arm's length range for thin capitalisation purposes.

2.4.2. **SARS *Practice Note 7***

SARS *Practice Note 7* was brought into effect in August 1999 and dealt with guidance on transfer pricing.

SARS endorses the *OECD Transfer Pricing Guidelines* and has indicated that these guidelines should be used in interpreting the arm's length principle in South Africa as set out in SARS *Practice Note 7* (SARS 1999:6). *Practice Note 7* is actually required to be read in conjunction with the *OECD Transfer Pricing Guidelines* in order to obtain in-depth guidance on how to apply these rules in practice (Joubert *et al* 2016:2). *Practice Note 7* specifically states that in the absence of specific guidance provided in s 31 of the Act, *Practice Note 7* or the tax treaties entered into by South Africa, the *OECD Transfer Pricing Guidelines* should be followed (SARS 1999:6).

The legislators have not referred to the *OECD Transfer Pricing Guidelines* in s 31 of the Act itself. The *OECD Transfer Pricing Guidelines* are referred to in *Practice Note 7*, which is not a legally binding document (Davis Tax Committee BEPS Sub-Committee 2014b:16).

A legally binding general ruling, in terms of s 89 of the Tax Administration Act, should be recorded on s 31 of the Act without departing from the OECD guidelines but including

principles which reflect the reality of South Africa (Davis Tax Committee BEPS Sub-Committee 2014b:16-17).

SARS *Practice Note 7* is now 17 years old and has not been updated to keep up with OECD developments, even though for several years there have been indications from SARS and National Treasury that an updated transfer pricing Interpretation Note is forthcoming (Davis Tax Committee BEPS Sub-Committee 2014c:15). The Interpretation Note is expected to replace both *Practice Note 2* and *Practice Note 7* (Joubert *et al* 2016:2). As SARS *Practice Note 7* is based on the *OECD Transfer Pricing Guidelines*, it is highly unlikely that the new Interpretation Note would fundamentally deviate from *Practice Note 7* but it will take into consideration the recent OECD changes (Joubert *et al* 2016:2). Conversely, the guidance in relation to thin capitalisation is expected to be dramatically different from the guidance provided in SARS *Practice Note 2* (Joubert *et al* 2016:2).

2.4.3. **Documentation Requirements**

Income tax return

An important way in which SARS can identify that a taxpayer is transacting with its foreign connected party is through check boxes on the income tax return submitted by the South African entity.

Notice for record keeping of transfer pricing documentation

In December 2015, SARS issued a draft notice which provides for additional record-keeping requirements relating to transfer pricing transactions for a company which is a member of a group of companies, which has a consolidated South African turnover of at least R1 billion and which has entered into transactions with its foreign connected parties (SARS 2015). In July 2016, an amended draft notice was issued, changing the threshold from R1 billion to the higher of 5% of gross income or R50 million (SARS 2016a:3). The lower threshold is a great concern, as this impacts a much wider range of taxpayers than previously thought who would be required to incur costs in order to comply with the transfer pricing record keeping notice (Stelloh 2016).

The final and approved notice for transfer pricing record keeping was issued on 28 October 2016 applying to years of assessment commencing on or after 1 October 2016 (SARS 2016b). The approved threshold for record keeping is potentially affected transactions which are reasonably expected to exceed R100 million, which is still fairly low.

Should a South African entity meet the threshold and criteria, it would be required to keep and maintain information and documentation as indicated in the final notice (Joubert *et al* 2016:5). With regard to taxpayers falling below this threshold, the guidance is not very clear, as the final notice merely indicates that such taxpayers should 'keep and retain all information and documentation necessary' in order to satisfy SARS that the potentially affected transactions were conducted at arm's length (Joubert *et al* 2016:5).

Taxpayers who do not comply with the final notice, by not being in possession of all the necessary information and documentation would be in contravention of s 210(2) of the Tax Administration Act and a non-compliance penalty will be imposed in addition to any other penalties relating to additional transfer pricing assessments (Stelloh 2016), as indicated above in part 2.3 of this report.

2.4.4. **Country-by-country reporting**

In December 2016, the Minister of Finance approved South Africa's 'regulations specifying the country-by-country reporting standard for multinational enterprises' (SARS 2016c:29). South Africa, as a member of the OECD Base Erosion and Profit Shifting project, will be adopting the model legislation for country-by-country reporting, as indicated in *Base Erosion and Profit Shifting Action 13* (Joubert *et al* 2016:5).

A country-by-country report would be required to be filed, no later than 12 months after the last day of the reporting fiscal year (SARS 2016c:Article 5), if the multinational enterprise group's total consolidated group revenue exceeds R10 billion (SARS 2016c:Article 1, para 3).

Further, in terms of Article 2 where the 'Ultimate Parent Entity' is not situated in South Africa, a country-by-country report will still be required to be filed by a South African group company which forms part of a multinational enterprise if the total consolidated group revenue exceeds Euro 750 million (SARS 2016c:Article 1, para 3) and one of the following conditions apply:

- Where the ultimate parent entity of the multinational enterprise group is not obligated to file a country-by-country report in its jurisdiction of tax residence; or
- The ultimate parent entity's tax jurisdiction has an international agreement (which includes the Multilateral Convention for Mutual Administrative Assistance in Tax Matters, any bilateral or multilateral Tax Convention, and any Tax Information Exchange Agreement (SARS 2016c:Article 1, para 11)) with South Africa but does

not have a qualifying Competent Authority Agreement in effect to which South Africa is a party at the time of filing the country-by-country report, being 12 months after the reporting fiscal year (SARS 2016c:Article 5); or

- There has been a systemic failure (where automatic exchange of information has been suspended or there is a persistent failure to automatically exchange information (SARS 2016c:Article 1, para 13)) of the ultimate parent entity's jurisdiction of tax residence that has been notified by SARS to the constituent entity resident for tax purposes in South Africa.

(SARS 2016c:Article 2)

Where the criteria are met, a country-by-country report is required to be filed for the multinational enterprise group in South Africa.

The OECD guidelines on the country-by-country reporting are discussed in more detail below in part 4.3 of this report.

2.5. **Other considerations relating to transfer pricing**

2.5.1. **Case law:** In South Africa there has been no reported case involving transfer pricing, this could be owing to litigation being a lengthy and costly process coupled with a lack of resources available to SARS to deal with these litigations, hence negotiating a settlement is a far more attractive option rather than to proceed with litigations (Sweidan 2013; Joubert *et al* 2016:6).

2.5.2. **Personnel:** SARS is required to ensure that the enforcement capacity of its transfer pricing division is adequate (Davis Tax Committee BEPS Sub-Committee 2014b:17). SARS should also ensure that adequate training is provided to transfer pricing staff and that the transfer pricing division increase in size (Davis Tax Committee BEPS Sub-Committee 2014b:17). Adequately skilled staffing is essential as transfer pricing methods are complex and requires the time and attention of these personnel, more especially personnel with accounting or legal education and experience (United Nations Department of Economic & Social Affairs 2013:34).

2.5.3. **Exchange of information:** SARS often face difficulties in obtaining information relating to the non-resident party to the transaction, thereby creating challenges in verifying the calculation of the transfer pricing adjustment (SAIT 2013:3). SARS does

have a wide double tax treaty network which can be used to obtain non-resident information in terms of the exchange of information article, however, this treaty network does not include some low tax jurisdictions, like Isle of Man (SARS 2016d). Furthermore, bilateral tax information exchange agreements were introduced to enable tax administrations of two countries to exchange tax information upon request, however, to date only 13 agreements have been signed and are in force (SARS 2016e).

2.5.4. **Comparable data:** The traditional transfer pricing methods, as indicated in the *OECD Transfer Pricing Guidelines*, rely directly on closely comparable data in order to perform a transfer pricing analysis (United Nations Department of Economic & Social Affairs 2013:33). Comparable data related to South African companies, and African countries, is not generally available because South Africa has limited requirements for filing of statutory accounts and this filing is restricted to publically listed companies (Deloitte 2015:198). These filings are often rare and reliance cannot be placed on these figures as they include extensive intra-group transactions (Deloitte 2015:198). Currently, SARS is making use of international comparables, mainly European data because Europe is considered to be the most comparable, of all the locations where such databases are available, to the South African market (Deloitte 2015:199; Joubert *et al* 2016:3). SARS has indicated that if another database is utilised for comparability purposes, the taxpayer is required to provide appropriate reasons why the other database is considered to be more appropriate for the case at hand (Joubert *et al* 2016:4). It should also be noted that finding comparable data which can be relied on and making adjustments to this comparable data for South African purposes (for example, country risk adjustments) is not a simple task and is very subjective from both the taxpayer's and SARS' perspective (United Nations Department of Economic & Social Affairs 2013:415).

2.5.5. **Advance pricing agreements:** While it was recommended in 1994 by the Katz Commission that South Africa should provide advance pricing agreements, this was never implemented and is still not available to taxpayers in South Africa (SARS 2013a:15; Deloitte 2016:236).

Audit approach: A South African company will be at risk of being identified for a transfer pricing audit by SARS if it transacts with its foreign connected party and indicates (by a declaration on the tax return) that it does not have a transfer pricing policy document in its possession (Joubert *et al* 2016:4). SARS also sends transfer pricing questionnaires to taxpayers for risk identification purposes (Joubert *et al* 2016:4).

2.5.6. **Prescription:** In terms of s 99 of the Tax Administration Act, the period of limitation of issuing a revised assessment is 3 years from the date of the original assessment. SARS does not operate a self-assessment system as yet, but when it does put this system in place, the limitation to issue a revised assessment would increase to 5 years (s 99(1)(*b*)). The limitation to issue a revised assessment does not apply in a case where the full amount of tax chargeable was not assessed due to fraud, misrepresentation or non-disclosure of material facts (s 99(2)(*a*) and s 99(2)(*b*)). SARS and the taxpayer can nevertheless extend prescription provided it is agreed upon within the limitation period (s 99(2)(*c*)). Under s 99(4) of the Tax Administration Act, incorporated by the Tax Administration Laws Amendment Act 2015, the Commissioner may, by prior notice to the taxpayer of at least 60 days prior to expiry, extend the limitation period by a further 3 years (in the case of an assessment by SARS) or 2 years (in the case of a self-assessment) where an audit or investigation relates to, *inter alia*, the application of the doctrine of substance over form or s 31 of the Act. The reason for the 60 day period is to provide the taxpayer with an opportunity to make representations as to why the period should not be extended (National Treasury 2015:52). Section 99(4) is a relatively new sub-section and it is yet to be seen how SARS will implement this subsection of the Act.

2.6. **Conclusion on South Africa's transfer pricing legislation and practice**

The following is submitted with regard to South Africa's transfer pricing legislation and practice:

The substituted South African transfer pricing provisions in s 31 of the Act includes wording which is now aligned to the *OECD Model Tax Convention*, which focuses on the economic substance of the arrangements between connected parties, rather than the pricing of specific transactions (Brodbeck 2012). This shift in focus has provided SARS with a much wider scope of inspecting and auditing transfer pricing transactions.

When the transfer pricing legislation was originally suggested, the Katz Commission recommended the introduction of legislation to provide taxpayers with the option to enter into advance pricing agreements (Katz 1994:233), but this process was never implemented (Deloitte 2016:236). SARS should consider introducing advance pricing agreements into the transfer pricing legislation which will assist in bringing certainty to taxpayers and foreign multinational enterprises.

SARS, with the assistance of the OECD, is trying to curb base erosion and profit shifting by putting in place country-by-country reporting regulations which was finalised and approved in December 2016 (SARS 2016c), but only time will tell whether the country-by-country reporting is an effective tool.

The penalty to be imposed (in terms s 210 and s 211 of the Tax Administration Act) for non-compliance with documentation retention requirements is, in the author's view, too low. A higher amount should be imposed on the taxpayer to enforce compliance with documentation retention.

The much talked about Interpretation Note on s 31 should be drafted and released by SARS as soon as possible. This will give SARS the opportunity to update the outdated *Practice Note 2*, the outdated *Practice Note 7* (SARS 1999), and to finalise the draft Interpretation Note on thin capitalisation (SARS 2013a) as well as provide more appropriate, comprehensive guidance to taxpayers based on the updated 2010 OECD guidelines and in addition, incorporate and address issues of base erosion and profit shifting.

SARS should consider moving to a self-assessment system which will assist them in extending the original prescription period, in terms of s 99 of the Tax Administration Act, from 3 years to 5 years. This will afford SARS additional time to conduct detailed risk assessments and to perform more in-depth audits of multinational taxpayers.

Furthermore, for SARS to ensure that efficient and comprehensive audits are performed within the necessary time-frames, it is crucial for SARS to employ an acceptable number of transfer pricing staff and provide them with sufficient training in order to enhance their transfer pricing knowledge and skill (Davis Tax Committee BEPS Sub-Committee 2014b:17).

South Africa does not have any case law for transfer pricing purposes (Joubert *et al* 2016:6). SARS should litigate a few transfer pricing cases to confirm transfer pricing principles for South African tax purposes. Alternatively, in terms of s 89 of the Tax Administration Act, at least one legally binding general ruling should be issued to confirm the acceptance of the *OECD Transfer Pricing Guidelines* but include South African based principles (Davis Tax Committee BEPS Sub-Committee 2014b:16-17).

In the next chapter, the transfer pricing legislation and guidance of three selected countries, namely Kenya, India and the United Kingdom will be discussed.

CHAPTER 3: Analysis of the transfer pricing legislation and practices of selected countries

This chapter analyses the transfer pricing legislation and practices of three selected countries, namely Kenya, India and the United Kingdom in order to provide a basis for comparison to the South African transfer pricing legislation. This comparison will assist in determining whether South Africa should still make further improvements to its transfer pricing legislation.

KENYA

3.1. Kenya's transfer pricing legislation

3.1.1. History

The Income Tax Act, Chapter 470 ('Kenyan Income Tax Act') had a transfer pricing provision which was included in s 18(3) of the Kenya Income Tax Act and which required that transactions between a foreign connected party and a Kenyan resident taxpayer should be conducted at arm's length, however prior to 2006, there was no guidance which was provided by the KRA to determine how the arm's length principle would be applied in practice (PWC 2012:169).

On 1 July 2006, the Kenyan Ministry of Finance was compelled to introduce transfer pricing guidelines after they lost a court case, *Unilever Kenya Ltd v CoT* Income Tax Appeal 753 of 2003, which involved cross-border transactions with connected persons (Anyanzwa and Olingo 2015). The transfer pricing guidance was brought into effect by Legal Notice no.67 of 2006 to provide support to the transfer pricing legislation (Deloitte 2016:152; PwC 2012:169).

3.1.2. Summary of the Kenyan transfer pricing section

Section 18(3) of the Kenya Income Tax Act, requires that where related parties (one party being a resident and the other being a non-resident) transact with each other, the profits of the resident company shall be deemed to be the amount that would have accrued if the transaction had been conducted by independent persons dealing at arm's length.

This provision of the Kenyan Income Tax Act is an empowering provision as it provides the Commissioner of the KRA with the power to make an adjustment where the transaction is not

considered to be in adherence with the arm's length principle (in other words, to accrue for the profits that would have been expected to be earned if the business was dealing with independent persons at arm's length) (Deloitte 2016:152). There is no provision in the Kenyan Income Tax Act which allows for secondary adjustments to be made.

It is for the taxpayer to prove that they have conducted the transaction in accordance with s 18(3) of the Kenyan Income Tax Act and in terms of the arm's length principle (PWC 2012:171).

3.1.3. **Thin capitalisation provisions**

Thin capitalisation provisions are set out in s 4A(a), s 16(2)(j) and s 16(3) of the Kenyan Income Tax Act (PWC 2012:173). The KRA has imposed a safe harbour of 3:1 debt:equity ratio and where there is excessive loan funding, the deemed interest, calculated at the average 91-day Kenyan Treasury Bill rate, is not deductible for tax purposes (PWC 2012:173).

3.2. **Penalties and interest relating to the transfer pricing provisions**

Additional assessment and interest

There are no specific penalties which apply in respect of tax arising from the additional assessment relating to the transfer pricing adjustment, however, the general penalty provision of 20% of the principal tax would apply to the additional assessment and late payment interest of 2% per month would be imposed thereon from the date the tax should have been paid (being from four months after the year-end in which the transfer pricing adjustment is made) (Deloitte 2016:154). In terms of s 84 of the Tax Procedures Act 29 of 2015 ('Kenyan Tax Procedures Act'), this penalty has remained at 20% (s 84(2)(b)) unless the offence was deliberate in which case a penalty of 75% would be imposed (s 84(2)(a)) (PWC 2016:2). Furthermore, where the taxpayer has a second or third underpayment offence, the penalty imposed shall be increased by an additional 10% and 25%, respectively (s 84(3)) (PWC 2016:2).

Prior to 19 January 2016, there was no provision for a reduction in the 20% penalty imposed (Deloitte 2016:154). This has subsequently been amended by the introduction of the Kenyan Tax Procedures Act, wherein s 89(6) allows the taxpayer to submit an application in writing together with reasons for the remission of the penalty imposed. With the exception of a penalty imposed for tax avoidance, upon consideration and with the approval of the Cabinet Secretary, the Commissioner will remit the penalty in whole or in part (s 89(7)).

Penalties imposed for non-compliance with documentation requirements

After the introduction of the Kenyan Tax Procedures Act on 19 January 2016 (PWC 2016:1), in terms of s 82 read with s 94, a penalty of 10% of the amount of tax payable will be imposed under the tax law to which the document retention failure relates (s 82(1)(a)) alternatively where no tax is payable a penalty of 100 000 Kenyan shillings applies (s 82(2)).

3.3. **Kenya's transfer pricing practice**

3.3.1. **Legal Notice no.67 of 2006 ('the transfer pricing rules')**

Legal Notice no.67 of 2006, which is part of the legislation, provides the transfer pricing guidance for the determination of the arm's length price and is based on the *OECD Transfer Pricing Guidelines* for the use of the most appropriate method (rule 8) of the five available OECD methods (rule 7) for determining the arm's length price (PWC 2012:169;171). Where the taxpayer finds it inappropriate to apply one of these five methods, the Commissioner of the KRA would approve an alternative method (rule 7) which is used by the taxpayer (PWC 2012:170).

The transfer pricing rules also provide the administrative regulations which include the types of records and documentation which is required to be submitted to the Commissioner by a taxpayer who is involved in transfer pricing arrangements (Deloitte 2016:153).

Since the introduction of the transfer pricing rules, there have been no further transfer pricing court cases (PWC 2012:171).

3.3.2. **Documentation requirements**

Documentation requirements are set out in the transfer pricing rules (Deloitte 2016:153).

When a taxpayer claims that they have entered into a transaction with a connected party and the application of arm's length pricing is necessitated, that taxpayer is required to develop and maintain, in terms of rule 9(2), documentation such as a suitable transfer pricing policy and the necessary documentation to evidence the taxpayer's analysis, so that the taxpayer's actual business reality is reflected in the documentation (Deloitte 2016:153). This documentation should be available at the time of submission of the tax return (Deloitte 2016:153). In terms of

rule 9(1), upon request, the KRA will provide the taxpayer 14 days within which they are required to submit the supporting documentation and the transfer pricing policy to support their arm's length calculation (Deloitte 2016:153). The KRA has interpreted the provisions in rule 9 to mean that it is obligatory for a taxpayer to have documentation at hand in readiness if the Commissioner requests such documents (PWC 2012:170). Penalties will be imposed for non-compliance as indicated above in part 3.2 of this report.

Other details which are required, at the very least, to be disclosed are as follows:

- The global organisational structure of the taxpayer;
- The details of the transaction under review;
- The transfer pricing policies applied in selecting the appropriate method, the method selected and the reasons therefore;
- The assumptions and strategies used in the application of the transfer pricing method;
- How the method has been applied;
- The calculations made as well as the price adjustment factors taken into account; and
- Any other background information as may be required to support the arm's length price calculation.

(Deloitte 2016:153)

In 2014, the Kenyan Income Tax Act was amended to require corporate taxpayers to notify the KRA within 30 days of any changes in their business structure, especially with regard to changes in shareholding, nominee shareholders or beneficial ownership, as well as the sale or cessation of the relevant business (Deloitte 2016:153).

3.3.3. **Other considerations relating to transfer pricing**

- **Case law:** Kenya has one transfer pricing case which forced the introduction of guidance on transfer pricing (PWC 2012:172). The *Unilever Kenya Ltd* court case is discussed in further detail below in part 3.4 of this report.

- **Personnel:** Within the domestic tax department, the KRA has created a specialised transfer pricing division. The KRA has further invested in their personnel by training them locally and abroad in order to provide them with adequate knowledge and the necessary skills on advanced transfer pricing issues in order to assist them to conduct efficient and effective transfer pricing audits.

  (PWC 2012:172)

- **Exchange of information:** The Kenyan double taxation treaty network is not extensive. It is therefore submitted that their ability to exchange information with other tax jurisdictions is limited to the countries with which they have 'ratified and in force' double taxation agreements.

  (Kenyan Revenue Authority 2016)

- **Comparable information:** The traditional OECD transfer pricing methods are used by the KRA for transfer pricing analysis purposes. Comparable data related to Kenyan public companies are only available through published interim and year-end reporting while private company information is not available. For this reason, the KRA makes use of international comparables, namely the Orbis database (which contains information on over 200 million private companies worldwide) to which it subscribes. Owing to the lack of local comparables in Kenya, the KRA allows its taxpayers to rely on global databases such as Amadeus (a database which contains comprehensive information on about 21 million companies throughout Europe) and Orbis for their benchmarking studies and the KRA also allows for the application of country risk adjustments to these international benchmarking studies. While the KRA allows country risk adjustments, they have not provided guidance on the country risk adjustments which would be useful for the taxpayers in performing their comparability analyses.

  (PWC 2012:172; Deloitte 2016:152)

- **Advance pricing agreements:** The KRA does not have advance pricing agreements in place as it is hesitant to give binding rulings to a particular taxpayer or particular group of taxpayers for KRA's practices or policies (PWC 2012:172).

- **Audit approach:** The KRA has indicated that it regards transfer pricing as possibly the main revenue earner, therefore it will have a robust approach when it comes to transfer pricing audits, this is further assisted by the wide and vigorous transfer pricing rules which are currently in place (PWC 2012:171; Adams & Adams 2016:4).

- **Prescription:** The KRA has a self-assessment system in place, thereby affording it 7 years in which it can audit a taxpayer and raise an additional assessment. Where the KRA identifies fraud, intentional negligence or gross negligence by the taxpayer concerned, there is no time limitation imposed on the KRA in which it is required to make an additional assessment in respect of a transfer pricing audit.

  (PWC 2012:170)

3.4. **Court case: *Unilever Kenya Ltd v CoT* Income Tax Appeal 753 of 2003**

3.4.1. **Factual background**

Unilever Kenya Limited (UKL), the appellant, is engaged in the manufacture and sale of a variety of household goods. Unilever plc., incorporated in the United Kingdom, held a significant shareholding in UKL. UKL and Unilever Uganda Limited (UUL), are related companies as is required in s 18 of the Kenyan Income Tax Act. (At 2.)

The Commissioner of Income Tax, the respondent, raised assessments against UKL in respect of the 1995 and 1996 tax years, with regard to the sales made by UKL to UUL on the basis that these sales were not at arm's length prices with the Commissioner relying on the literal meaning of the words in s 18(3) of the Kenyan Income Tax Act. The most important issue was that UKL and UUL were connected parties and due to this relationship, the transactions between them resulted in less taxable profits than those which would have been earned if the trading transactions were done with non-related entities at arm's length. (At 2 and 3.)

The appellant argued that its (UKL's) internal transfer pricing policy was not binding; however, under the circumstances and with the absence of guidance by KRA, the internal transfer pricing policy was based on the *OECD Transfer Pricing Guidelines* (at 5; 9 and 10.). The cost plus return method was used as the most appropriate method with a return on capital employed of 10% according to UKL's internal transfer pricing policy and being the return made on sales to unrelated parties in the Unilever Group (at 9 and 10.). In accordance with clause 3 of their contract, UKL and UUL applied the cost plus method by providing that the price was to be the aggregate of fixed and variable costs incurred by UKL plus a return of 7% (net of tax) on capital (at 11.). The appellant was, therefore, of the view that the calculation was in accordance with its transfer pricing policy and must therefore be regarded as an arm's length price (at 11.).

The Respondent argued, *inter alia*, that the *OECD Transfer Pricing Guidelines* were not applicable to the case as they were not part of the Kenyan law and they are only used for guidance on double taxation agreements. The Respondent further argued that UKL and UUL arranged between themselves to fix or set prices of goods between themselves without taking into consideration the market forces and this resulted in less taxable profits than those which would have been earned if the trading transactions were performed between non-connected parties, at arm's length. (At 12 and 13.)

3.4.2. **Judgment**

The Judge indicated that the wisdom of taxpayers and tax collectors in other jurisdictions cannot be overlooked as '[w]e live in… a global village'. With the absence of any guidelines in Kenya, best practice would prevail as it is the best way to develop Kenya's laws and jurisprudence will be enhanced. The ways of conducting a business have substantially changed over the last 20 years and it would be incompetent for any court to disregard internationally accepted principles of business as long as these do not conflict with Kenyan laws. The *OECD Transfer Pricing Guidelines* 'are not just there for relaxed reading'. (At 15 and 16.)

While the wording of s 18(3) of the Kenyan Income Tax Act is clear and must be read literally as it is, there are certain words or sentences which are amenable to more than one interpretation. The Indian Income-tax (21st amendment) Rules provide lengthy guidelines in relation to the methods which can be used to determine the arm's length price while s 18(3) of the Kenyan Income Tax Act is silent on the methods which can be used or how to prove that the transaction is at arm's length. This should therefore be a lesson for the KRA to establish rules with regard to the determination of arm's length prices. (At 16 and 17.)

The high court was unable to see the 'arrangement', as argued by the Respondent, between UKL and UUL during the course of business which enabled UKL to make no profit or a reduced amount of profit (at 17.). In the circumstances at hand, UKL did fittingly apply the cost plus method to determine the arm's length price (at 17.). The court did not uphold the Respondents' argument and consequently allowed the appeal with costs (at 18.) thereby forcing the KRA to reverse the assessments raised in terms of s 18(3) of the Kenyan Income Tax Act in relation to the 1995 and 1996 years of assessment.

3.4.3. **Comment on the judgment**

It is submitted that the high court thus endorsed the use of the *OECD Transfer Pricing Guidelines*, being international best practice.

It is further submitted that while South Africa does place reliance on the *OECD Transfer Pricing Guidelines*, through *Practice Note 7* which is not legally binding, it should consider including the *OECD Transfer Pricing Guidelines* in the Act, thereby placing total reliance on these guidelines as this judgment provides confirmation that the *OECD Transfer Pricing Guidelines* are international best practice.

3.5. **Conclusion on Kenya's transfer pricing legislation and practice**

The following is submitted with regard to Kenya's transfer pricing legislation and practice:

Whilst the Kenyan Income Tax Act did include transfer pricing provisions which incorporated the arm's length test, it was essential for the KRA to provide guidance for the determination of the arm's length price. If the KRA did have the necessary guidance in place, there may not have been a dispute with Unilever Kenya Ltd. The transfer pricing rules were drafted to include the OECD transfer pricing methodology (further explained below in part 4.2.2 of this report) for the purposes of determining the arm's length price (PWC 2012:169;171). It is submitted that the legislation together with the transfer pricing rules have made the Kenyan transfer pricing provisions robust enough to combat the mispricing of foreign connected party transactions.

The KRA is afforded 7 years to evaluate and identify any risks related to cross-border connected party transactions and to conduct an audit on a taxpayer before the assessment prescribes (PWC 2012:170). This coupled with the extensive investment in upskilling the transfer pricing personnel (PWC 2012:171) empowers the KRA to perform thorough and extensive transfer pricing audits.

The KRA should on the other hand provide detailed guidance on country risk adjustments which are required to be made to comparable data in order to assist taxpayers with a more accurate determination of an arm's length price in accordance with the KRA's expectations (PWC 2012:172; Deloitte 2016:152).

The KRA should moreover contemplate the introduction of advance pricing agreements (PWC 2012:172), which could possibly enhance direct foreign investment into Kenya, as they bring certainty to foreign entities with regard to transfer pricing concerns.

INDIA

3.6. India's transfer pricing legislation

3.6.1. History

Indian transfer pricing provisions were first introduced by the Finance Act, 2001 as a separate means of reporting and assessing cross-border transactions between connected parties with the effective date of 1 April 2001. The provisions were included in Chapter X 'Special provisions relating to avoidance of tax' under s 92 to s 92F and s 94A of the Income-tax Act 1961 ('Indian Income-tax Act') and rules 10A to 10THD of the Indian Income-tax Rules ('the rules'). In addition, with effect 1 April 2013, the transfer pricing provisions were extended by the inclusion of s 92BA to cover specified domestic transactions in a year of assessment between two resident taxpayers (Butani 2016:3).

According to the OECD, India is one of three countries which has emerged as an economic giant (OECD 2016a), with one of the fastest growing economies in the world, consequently it is vital that India's transfer pricing regime is investor friendly but on the other hand, the transfer pricing regime should be robust enough to combat mischiefs related to transfer pricing (RSM India 2016:19).

According to the African Tax Administration Forum, India has emerged as a benchmark for many countries' transfer pricing provisions as it has one of the most aggressive transfer pricing regulations in the world coupled with court case precedent (Spearman 2013; RSM India 2016:19).

3.6.2. Summary of the Indian transfer pricing provisions

India's transfer pricing legislation is essentially aligned to the *OECD Transfer Pricing Guidelines* where the underlying principle is the arm's length principle with some principles

adopted from the *United Nations Practical Manual on Transfer Pricing for Developing Countries* (Butani 2016:3).

In terms of s 92 of the Indian Income-tax Act, upon entering into an international transaction or specified domestic transaction with an associated enterprise, the income arising from the transaction must computed by taking into consideration the arm's length price.

That being said, the transfer pricing provisions do not apply in an instance where the arm's length price reduces the taxable income or increases a declared loss of the taxpayer (s 92(3)). If this instance does occur, no adjustment can be made (s 92(3)).

Currently, there is no provision in the Indian Income-tax Act which allows for secondary adjustments to be made. However, with effect from 1 April 2018 a new provision, s 92CE, will be included in the Indian Income-tax Act which provides for a secondary adjustment, based on certain conditions, when a primary adjustment is made to a transfer price (Government of India, Income Tax Department 2017:24).

Definitions

The term 'associated enterprise' is so widely defined in s 92A (for example, to include an enterprise which participates, directly or indirectly or through one or more intermediaries, in the management, control or capital of the other enterprise (RSM India 2016:26)), that even unrelated parties could be deemed to be associated enterprises (an example being where one enterprise provides guarantees not less than 10% of total borrowing of the other enterprise (RSM India 2016:27)) and the transfer pricing provisions would be applicable to their transaction (Butani 2016:3). This deeming provision may well, if it has not already, lead to numerous disputes for the Indian revenue authority.

The term 'international transaction' is exhaustively defined, in s 92B, and is all-encompassing as it includes any 'arrangement, understanding or action in concert' pertaining to, *inter alia*, tangible or intangible property, borrowings, services provided and any other transaction which affects the profit, loss, or assets of a resident company (RSM India 2016:29). The term is further broadened by the inclusion of a deemed 'international transaction' provision (s 92B(2)).

The term 'specified domestic transactions' is defined in s 92BA of the Indian Income-tax Act and includes, *inter alia,* the following transactions:

- Expenses incurred by related parties (s 40A(2)(b));
- Income and expenditure incurred between different business units of the same taxpayer (s 80A, 80IA(8)); and
- Profits in relation to close corporations (s 80IA(10)).

and where the aggregate of such specified domestic transactions entered into by the assessee in the previous year exceeds a sum of INR 20 crore (200 million Indian Rupees).

(RSM India 2016:34-35)

Determination of the arm's length price

Where transfer pricing provisions are applicable to transactions, the transactions are required to be calculated taking into consideration the arm's length price; the functions, assets and risks of the company; and other economic and commercial factors (RSM India 2016:44).

In calculating the arm's length price, there are six methods available to the taxpayer, being the five traditional OECD methods and an alternate method/the sixth method[6] approved by the Central Board of Direct Taxes (Butani 2016:10).

A proviso to s 92C(2) provides taxpayers with a margin of inaccuracy, not exceeding 3%, in the calculation of the arm's length price. The margin of inaccuracy is 1% for wholesalers and 3% for other taxpayers (RSM India 2016:83).

In addition, in terms of s 92CB, there are safe harbour rules which can, at the option of the taxpayer, be applied by certain eligible taxpayers for 'eligible international transactions' which can be used to determine the arm's length price. Further details on the guidance issued for the purpose of s 92CB are provided below in part 3.8.1 of this report.

The burden of proof, for the determination of the arm's length price with respect to international transactions/specified domestic transactions, lies with the taxpayer (RSM India 2016:110).

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[6] The sixth method provides for the mandatory use of publicly quoted commodity prices for certain commodity transactions (OECD 2014:7). This method is not an OECD approved method as in some instances it may not be consistent with the arm's length principle (OECD 2014:7).

3.6.3. **Thin capitalisation provisions**

Currently, the Indian transfer pricing legislation does not include thin capitalisation provisions. While the Indian exchange control guidelines provide specific guidance on external commercial borrowings by resident connected parties which automatically approves borrowings if the debt:equity ratio is within 4:1, there is no specified thin capitalisation limit for tax purposes. With the introduction of general anti-avoidance rules, with effect from April 2017, the foreign loan may perhaps be treated as an impermissible arrangement and the revenue authority could re-characterise the debt into equity.

(Butani 2016:2-3)

With effect from 1 April 2018, it has however been proposed that a new provision, s 94 B, will be included in the Indian Income-tax Act which will limit excessive interest paid to non-resident associated enterprises, based on certain conditions (Government of India, Income Tax Department 2017:24).

3.7. **Penalties and interest relating to the transfer pricing provisions**

The penalties imposed are very stringent and there are penalties for various transfer pricing offences. These penalties are summarised as follows:

Penalty section of the Indian Income-tax Act	**Description of the penalty**	**Penalty applicable**
Section 270A Will come into effect for the years of assessment commencing 1 April 2017 (Singhal 2016)	- Under-reporting - Misreporting of income	50% of the amount of tax sought to be under-reported. 200% of the amount of tax sought to be misreported. This penalty is a fixed percentage.
Section 271(1)(c) read with explanation 7 to s 271 Will be replaced by s 270A with effect from 1 April 2017	Concealment of particulars or furnishing inaccuracies related to income.	A minimum of 100% of the amount of tax sought to be evaded. A maximum of 300% of the amount of tax sought to be evaded. This penalty was imposed at

(Singhal 2016)		the discretion of the Indian tax authority (Singhal 2016).
Section 271AA(1)	If the taxpayer - Fails to keep and maintain documents and information required in terms of s 92D(1) and s 92D(2); or - Fails to report such transactions; or - Provides incorrect documents or information.	2% of the value of the international transaction/ specified domestic transaction for each such failure.
Section 271BA	Failure to provide the accountant's report with Form 3CEB as is required by s 92E.	INR 100 000
Section 271G	Failure to furnish information or documents required under s 92D(3)	2% of the value of the international transaction/ specified domestic transaction for each such failure.
Section 271GB(1), 271GB(2) and 271GB(3) With effect 1 April 2017 (Bilaney 2016)	Failure to furnish country-by-country report	1 month = INR 5 000 per day More than 1 month = INR 15 000 per day Continuing default beyond serving a penalty order for non-compliance = INR 50 000 per day
Section 271GB(4) With effect 1 April 2017 (Bilaney 2016)	For country-by-country reporting, if the taxpayer: - Has knowledge of the inaccuracies; - Discovers inaccuracies subsequently; and fails to inform the Indian revenue authority; or - Knowingly furnishes inaccurate information in response to the Indian revenue authority request to check for accuracy of the report provided.	INR 500 000

(RSM India 2016:111-112)

In terms of s 246A(q), a taxpayer has the right to appeal against any penalty imposed under any provision which falls under chapter XXI of the Indian Income-tax Act (Singhal 2016).

Furthermore, in terms of s 274, no penalty may be imposed on a taxpayer without providing the taxpayer with an opportunity to put forward their case (Singhal 2016).

Interest

Interest is levied on the tax under-paid. While a request can be made to extend the time to make payment of the tax under-paid, the interest is required to be paid within 30 days of the date of service of notice of demand. Furthermore, interest will only be levied on penalties if the penalties levied have not been paid within the time-frame specified in the service of notice of demand.

(Deloitte 2016:125)

3.8. **India's transfer pricing practice**

India's transfer pricing practices are included in rules 10A to 10THD of the rules.

3.8.1. **Aspects of the transfer pricing legislation covered by the rules (other than documentation requirements)**

Determination of arm's length price

The methods which can be used to determine the arm's length price is provided in rule 10B, being the five OECD methods or the other method (per s 92C(1)(f) and defined in rule 10AB). There is no preferred method which should be used to determine the arm's length price, but the method which is selected should be best suited to the facts and circumstances at hand and should provide the most reliable arm's length price (rule 10C).

Comparability

In order to perform a comparability analysis, there are various factors which must be taken into account (rule 10B(2)) such as, *inter alia*, the type of service or goods; the industry; the geographical location and market size; the functions performed; the risks assumed; the assets employed; and the contractual terms. The entities will be comparable if there are no differences which could materially affect the price in an open market and where there are material differences, 'reasonable adjustments' should be made to eliminate such differences (rule

10B(3)). The rules do not provide any guidance on such 'reasonable adjustments', therefore the adjustments are very subjective.

Computation of the arm's length price

Guidance on the computation of the arm's length price, based on the method selected and the comparability analysis performed, is provided in rule 10CA.

Advance pricing agreements

Guidance on advance pricing agreements is provided in rules 10F to 10T and rule 44GA. Advance pricing agreements are discussed in further detail below in part 3.8.4 of this report.

Safe harbour rules

Safe harbours rules were introduced in s 92CB of the Indian Income-tax Act, having a release date of 18 September 2013, with the aim of reducing the increasing number of transfer pricing audits and the lengthy disputes (RSM India 2016:131). Guidance on the safe harbour rules is provided in rules 10TA to 10TG. These safe harbours rules are only available to certain 'eligible international transactions' as defined in rule 10TC. A table for each eligible international transaction and the related safe harbour is provided in rule 10TD. If a taxpayer exercises the option to use the rule 10TD safe harbour (for a maximum period of five years), the transfer price stated will be accepted as an arm's length price by the Indian revenue authority.

3.8.2. **Documentation requirements covered by the rules**

Section 92D of the Indian Income-tax Act indicates that every person who has entered into an international transaction/specified domestic transaction shall keep and maintain the necessary information and documents pertaining to such transaction. Further guidance on the documentation requirements is provided in rule 10D.

There is a minimum threshold which is required to be met for mandatory record-keeping and maintenance of the prescribed information and documents (rule 10D(2)). In terms of rule 10D(2), documentation will not be required (but the taxpayer will be required to substantiate, with supporting documentation, that the determination of the income arising from international

transactions/specified domestic transactions was performed having regard to the arm's length price) if:

- International transactions: The aggregate value of the transactions does not exceed INR 1 crore (10 million Indian Rupees); or
- Specified domestic transactions: The aggregate value of the transactions does not exceed INR 20 crore (200 million Indian Rupees).

The mandatory documentation requirements, which should be available at the time of submission of the income tax return, are as follows:

- A description of the organisational structure and profile of the multinational group, including the name, address, legal status and jurisdiction of tax residence of each entity, shareholding details within the group, and other ownership interest held by other entities;
- A general description of the taxpayer's and associated enterprise's business, as well as an industry analysis;
- A comprehensive description of the nature and the terms of the international transactions/specified domestic transactions entered into;
- A detailed analysis of the functions performed, the assets utilised and the risks borne by each party involved in the transactions;
- Any economic analysis, market analysis, forecasts, budgets or any other financial estimates prepared by the taxpayer;
- A list of uncontrolled transactions taken into account for analysing their comparability with the international transactions/specified domestic transactions;
- Analyses performed to evaluate comparability of uncontrolled transaction with the relevant international transactions/specified domestic transactions;
- A description of the methods which were considered, the method selected, reasons for the selection and how the method was applied for the determination of the arm's length price in relation to the relevant international transactions/specified domestic transactions;

- Details of the workings performed, comparable data and other financial data used, adjustments made with reasons, the assumptions, the policies, the negotiations and any other factors which were considered in the determination of the arm's length price; and

- Any other information, data or document, relating to the taxpayer or associated enterprise which may be pertinent for the determination of the arm's length price.

(Rule 10D(5))

This information and documentation is required in terms of rule 10D(5) to be kept and maintained by the taxpayer for a period of 8 years from the end of the year of assessment.

3.8.3. **Country-by-country reporting**

India being a member of the OECD Base Erosion and Profit Shifting project, has adopted the model legislation, three tiered approach, related to country-by-country reporting. This was done by the insertion of s 286 in the Indian Income-tax Act by the Finance Bill 2016 with an effective date of 1 April 2017. The country-by-country reporting is required for every parent entity or alternate reporting entity, which is an Indian resident, with consolidated revenue for the previous year exceeding the equivalent of Euro 750 million in Indian Rupees as indicated in the *Memorandum to the Finance Bill 2016.*

(Government of India, Income Tax Department 2016a:24-26).

No guidance relating to the country-by-country reporting has been issued by the Indian revenue authority to date (Bilaney 2016).

3.8.4. **Other considerations relating to transfer pricing**

- **Case law:** There have been many Indian court judgments which have been the cause of changes in the Indian transfer pricing legislation. An example being, *CIT v Glaxo SmithKline Asia (P) Ltd* (2010) 236 CTR (SC) 113 (discussed in part 3.9 of this report) after which the transfer pricing legislation was changed to include 'specified domestic transactions' (RSM India 2016:34). The transfer pricing division in the Indian revenue authority has a large volume of litigation cases compared to other areas of audit, with many still awaiting a hearing in the courts (Bhatnagar 2016).

- **Personnel:** The building of transfer pricing capacity in India is mainly by providing on the job training, engaging with the training academy to assist with specialised training, providing seminars and conferences to assist with the sharing of knowledge and experiences by transfer pricing officers engaged in transfer pricing audits. The transfer pricing division had to grow in size due to the increasing number of cases referred to audit.

  (United Nations Department of Economic & Social Affairs 2013:111-112)

- **Exchange of information:** India does have a wide double tax treaty network which can be used to obtain non-resident information in terms of the exchange of information article, however, this treaty network does not include some low tax jurisdictions, like Switzerland (Government of India, Income Tax Department 2016b). Furthermore, India does have bilateral tax information exchange agreements which were introduced to enable tax administrations of two countries to exchange tax information upon request (Government of India, Income Tax Department 2016b).

  Where India does not have an effective exchange of information with certain countries, that country is declared as a 'notified jurisdictional area'. Section 94A of the Indian Income-tax Act states that where an Indian taxpayer transacts with a person located in a 'notified jurisdictional area' (as specified by the Central Government by way of *Official Gazette)*, that person will be deemed to be an 'associated enterprise' and any transaction between these parties will deemed to be an 'international transaction' (RSM India 2016:33). As such, the deemed international transaction will be subject to the Indian transfer pricing provisions as well as all compliance requirements, including the maintenance of documents as required under transfer pricing provisions but the person will not be entitled to the benefit of the second proviso to s 92C(2) being the application of the allowed percentage variation for the determination of the arm's length price (RSM India 2016:33). To date, only Cyprus is a 'notified jurisdictional area' (RSM India 2016:33). It is submitted that the concept of 'notified jurisdictional area' is a concept unique to India.

  Comparable information: Indian databases, which the Indian tax authority relies on for comparability purposes, contain vital data of more than 30 000 companies. These databases are Prowess (which contains financial information of Indian companies from the Centre for Monitoring Indian Economy), Capitaline Plus (which contains fundamental market data on Indian listed, unlisted and subsidiary companies) and ACE TP (which is an Indian business database application for the

comparison of company financial information for transfer pricing purposes). The foreign databases are not utilised by the Indian taxpayers as they will not be comparable to Indian companies or they do not have Indian company financial information. In relation to adjustments which are made to the comparability analysis, rule 10B(3) does not provide ample guidance, nevertheless, the Indian courts have consistently been of the view that adjustments must be passed for differences in, *inter alia*, working capital, risk identification, growth and personnel dimensions of the company concerned so as to enhance the reliability of the results.

(RSM India 2016:91-92; 95-96)

- **Advance pricing agreements:** Advance pricing agreements provisions (s 92CC and s 92CD) were introduced, in July 2012 and became effective on 30 August 2012, in order to reduce the number of disputes and to provide taxpayers with tax certainty on the determination of the arm's length price. When a taxpayer enters into an advance pricing agreement with the Commissioner (and the Income-tax authority subordinated to him), they mutually agree on the determination of the arm's length price by prescribing the transfer pricing methodology and any critical assumptions (in other words, the most critical factors and assumptions used in the agreement) relating to that specific international transaction, for a specific period.

  (RSM India 2016:137)

  The maximum validity period of each advance pricing agreement is five consecutive years with the option to 'roll back' the agreement to four previous years of assessment (s 92CC(9A) introduced in 2014). In addition, the advance pricing agreement will not be binding if there is a change in the critical assumptions or a there is a failure to meet the conditions on which the agreement was based (rule 10M). Advance pricing agreements are not applicable to specified domestic transactions (RSM India 2016:43).

  The process to be followed for an advance pricing agreement is provided in rule 10H, rule 10-I and rules 10-O to 10S of the rules.

- **Audit approach:** Transfer pricing audits are usually risk based audits which are triggered, in most circumstances, by the deduction of expenses relating to royalty or technical fees; advertising, marketing or promotional overheads paid to a foreign entity; management services fees; and loans (Bhatnagar 2016).

- **Prescription:** As of 1 June 2016, in terms of s 153 of the Indian Income-tax Act, the time to complete a transfer pricing audit is 33 months (2 years and 9 months)

from the date of submission of a return by the taxpayer which is generally submitted a year after the end of the financial year (31 March for all companies in India) (RSM India 2016:115).

3.9. **Court case: *CIT v Glaxo SmithKline Asia (P) Ltd* (2010) 236 CTR (SC) 113**

3.9.1. **Factual background**

Glaxo SmithKline Asia (P) Ltd ('GSKA') had only one employee being the company secretary, and was engaged in the manufacture and sale of fast-moving consumer products. Glaxo Smith Kline Consumer Healthcare Ltd ('GSKCH') provided administrative services to GSKA, which included, *inter alia*, marketing, finance, human resource and secretarial services. Both GSKA and GSKCH were Indian residents. According to the agreement between GSKA and GSKCH, GSKA would reimburse GSKCH for providing various services at cost plus 5%, the 'cross charges'. Since the said agreement did not prescribe the basis for allocation of costs incurred for the various services provided to GSKA, the assessing officer believed that the payment of cross charge to GSKCH could not be justified and was not fully and exclusively for GSKA's business purposes. The assessing officer was of the view that the payment of cross charges to the extent of 7% of net sales was reasonable and disallowed the balance. The Commissioner of Income Tax upheld the assessment of the assessing officer on appeal. The same approach was adopted by the assessing officer for the subsequent assessment years.

(Bilaney 2011)

The matter proceeded to the Income Tax Appellate Tribunal where it was held that the matter did not fall within the scope of s 40A(2) (which deals with the disallowance of excessive and unreasonable expenditure) as the entities (GSKA and GSKCH) were not considered to be related parties in terms of the said section and therefore it was held that the assessment raised was invalid. The Indian tax authority thereafter filed an appeal to the High Court which also dismissed the case on the same basis as the Income Tax Appellate Tribunal.

(Bilaney 2011)

3.9.2. **Judgment**

While in the case of domestic transactions, the under declaration of sales and over declaration of expenses will lead to a neutral ground for income tax purposes, there are two circumstances where tax arbitrage could occur between related parties, which are as follows:

- Where one entity is loss making and the other is profit making and revenue is shifted into the loss making entity; and
- The entities are taxed at different rates of tax due to, *inter alia,* different tax statuses, area specific incentives and the nature of the business;

then the revenue will be diverted to the entity with the lower tax rate thereby causing a loss in revenue to the Indian fiscus. (At 2.)

For this reason, the court recommended to the Central Board of Direct Taxes that an investigation into the matter should be performed to determine whether the transfer pricing provisions should be applied to domestic transactions between related parties for the purposes of s 40A(2) of the Indian Income-tax Act (at 2.). The Judge indicated that the Supreme Court does not normally provide recommendations, however, with the aim of reducing complex future litigations, the court advised that s 40A(2) and s 80IA(10) (disallowance of 'super normal' profits) should be amended to allow the Indian tax authority to make adjustments, utilising the transfer pricing provision principles, to resident related party transactions which are not considered to be at fair market value (at 3.). In addition, the compulsory documentation requirements and an accountant's report, as set out in rule 10D and rule 10E, should be extended to include domestic related party transactions (at 3.).

Based on the facts at hand, the special leave petition filed by the Indian tax authority was dismissed by the Supreme Court as GSKA and GSKCH were not considered to be related parties in terms of s 40A(2) and further the transaction entered into was a 'revenue neutral exercise' (at 2.).

3.9.3. **Comments on the judgment**

The transfer pricing provisions were amended with effect from 1 April 2012 to include 'specified domestic transactions' (as indicated above in point 3.5.3 of this report) under the transfer pricing provisions. It is submitted that the Indian tax authority therefore responded swiftly to this loophole identified in the legislation and the recommendations made by the

Supreme Court. It is further submitted that while the introduction of 'specified domestic transaction' provisions may have caused costly tax compliance burdens for the local taxpayers, it assists in curbing the tax arbitrage for the Indian tax authority.

It is submitted that, for South African purposes, there may be provisions in the Act which could possibly be used to curb this tax arbitrage, such as the 'in the production of income test' in s 11(*a*) that can be applied to certain expenditure that is excessive as a result of it not being market related (Haupt 2016:139); s 20A providing that the assessed loss of certain trades should be ring-fenced; s 103(2) which disallows the utilisation of assessed losses when there is a change in shareholding of the entity or an agreement which results in income in the said entity; or s 80A being the general anti-avoidance provision. Further research should be performed on this aspect within South Africa to determine whether this arbitrage is occurring and whether there is a need to introduce such domestic transfer pricing legislation.

3.10. **Conclusion on India's transfer pricing legislation and practice**

The following is submitted with regard to India's transfer pricing legislation and practice:

The Indian transfer pricing legislation, which is to a large extent based on the *OECD Transfer Pricing Guidelines*, is robust and complex (Butani 2016:3; RSM India 2016:19). Taxpayers need to ensure that they have calculated the arm's length price accurately by using the most appropriate method and disclosed all relevant information on the required forms otherwise substantial penalties apply (RSM India 2016:111-112).

On a yearly basis there are amendments made to the transfer pricing provisions or rules, therefore taxpayers need to keep abreast of the latest developments to the transfer pricing provisions in the Indian Income-tax Act (RSM India 2016:2-8). Furthermore, as there are many Indian litigations, due to the aggressive nature of the transfer pricing provisions (RSM India 2016:19), once these court cases are finalised, more amendments may occur to curb mischiefs surrounding related party transactions, as can be seen from the court case discussed above in part 3.9 of this report. That being said, court cases create precedent which enforces and confirms transfer pricing principles for the Indian tax authority which is invaluable for future audits.

Advance pricing agreements, safe harbour rules and the allowable margin of inaccuracy are ideal tools to reduce the number of transfer pricing litigations for the Indian revenue authority and provide certainty to both local and foreign taxpayers (RSM India 2016:81;131;137). With respect to the advance pricing agreements the only downside for the taxpayer is that there is a

fee which is required to be paid whereas in many other jurisdictions no fee is required (RSM India 2016:144-146). The roll back of the advance pricing agreements will also benefit taxpayers who have incorrectly calculated their arm's length prices in prior years (RSM India 2016:142).

India currently does not have thin capitalisation provisions which can assist in protecting its tax base from excessive interest deductions. However, a proposal has been made to include such provisions with effect from 1 April 2018 (Government of India, Income Tax Department 2017:24).

THE UNITED KINGDOM

3.11. The United Kingdom's transfer pricing legislation

3.11.1. History

The United Kingdom, being an OECD member country, follows the OECD's Transfer Pricing Guidelines (HM Revenue & Customs 2013). The current United Kingdom transfer pricing rules are included in Part 4, being transfer pricing, and Part 5, being advance pricing agreements, of the Taxation (International and Other Provisions) Act 2010 ('TIOPA') (Slaughter and May 2015:1). TIOPA contains a redraft of the previous transfer pricing rules which were contained in Schedule 28AA (as amended) of the Income and Corporation Taxes Act 1988 and which was in effect for accounting periods ending on or after 1 July 1999 (PWC 2014:792).

3.11.2. Summary of the United Kingdom's transfer pricing provisions

The United Kingdom transfer pricing provisions are based on the arm's length principle (as provided in chapter 1 of Part 4 of the TIOPA) and requires that where there is a 'provision', which is created by a 'transaction' or a 'series of transactions', between two 'affected persons' (who share a direct or indirect control relationship, as defined), 'the arm's length provision' must be substituted for 'the actual provision' in the case where there is a difference between the actual provision and the arm's length provision; and that difference gives rise to a tax benefit for either of the persons (Casley 2016:3). This substitution of the arm's length provision for the actual provision gives rise to a transfer pricing adjustment, which can only be an upward

adjustment, in other words, only an increase in taxable income or a decrease in a tax loss (Casley 2016:4). These transfer pricing provisions are very wide and apply to both cross-border transactions and to domestic transactions (PWC 2014:793). Where a transfer pricing adjustment arises, HMRC does not make any secondary adjustments (such as deemed dividends or deemed loans) as there is no provision in the United Kingdom law for such adjustments (PWC 2014:795).

The OECD transfer pricing guidelines and any subsequent amendments are specifically included in the United Kingdom's legislation by s 164 of the TIOPA. It further indicates that the United Kingdom transfer pricing legislation must be interpreted in such a way that it does not deviate from these guidelines.

The United Kingdom has mechanisms in place to provide relief in the form of compensating adjustments to taxpayers who are affected by transfer pricing adjustments (Casley 2016:5).

There is also an exemption, in terms of s 166 of the TIOPA, from the application of the transfer pricing provisions which applies to most small (no more than 50 staff and either an annual turnover or balance sheet total of less than Euro10 million) and medium sized enterprises (no more than 250 staff and either an annual turnover of less than Euro 50 million or a balance sheet total of less than Euro 43 million) (HMRC 2016c:INTM412070).

The burden of proof relating to the compliance with the transfer pricing provisions rests with the taxpayer upon submitting the tax return (Casley 2016:50).

3.11.3. **Thin capitalisation provisions**

Prior to 1 April 2004, thin capitalisation was a separate component from the transfer pricing legislation. The thin capitalisation provisions are now included in the transfer pricing provisions and are based on the arm's length principle which enables HMRC to disallow excessive interest paid as a tax deduction by a United Kingdom company on a loan from a related party.

(PWC 2014:812)

There is no formal safe harbour, however, for risk identification purposes, HMRC's historical data has provided that a debt:equity ratio of 1:1 and an interest cover of 3:1 may be considered to be 'safe'. It should be noted that these safe harbours could vary between industries.

(PWC 2014:812)

To provide certitude to a financing transaction, a taxpayer can apply for an advance thin capitalisation agreement under Part 5 of the TIOPA. The same provisions which apply to normal advance pricing agreements, apply to thin capitalisation agreements.

(PWC 2014:810-811)

3.12. **Penalties and interest relating to the transfer pricing provisions**

Guidance on penalties is included in the *Compliance Handbook*, CH81000 (penalties for inaccuracies) and CH400000 (charging penalties) (HMRC 2016a) and the *Enquiry Manual*, EM4500 (HMRC 2016b).

There is no specific transfer pricing penalty provision which can be applied to transfer pricing adjustments made by HMRC, therefore the general penalty provisions, as indicated below, would apply (PWC 2014:803).

Failure to keep or preserve adequate records

A penalty of up to GBP 3 000 may be charged for each failure to keep or preserve adequate records and there can only be one failure for each return or claim (HMRC 2016b:EM4650). No penalty shall be imposed merely due to the fact that the information was not available in the appropriate format (Casley 2016:49).

Careless or deliberate error

Where there is an adjustment required due to a potential loss in revenue, a penalty of between 0% and 100% of the potential lost revenue will be levied. These tax geared penalties will be levied in the following instances:

- An understatement in the tax liability by the inclusion of inaccurate information through an overstatement of a loss or an overstated claim to repayment of tax; and

- The inaccuracy is as a result of carelessness or failure to take reasonable care (HMRC 2016a:CH81140). Where the taxpayer can show that they made a reasonable attempt to comply, this cannot be considered to be carelessness. It is possible that where a transfer pricing audit adjustment is made, an inaccuracy penalty could apply. The maximum penalty for this type of inaccuracy is 30% of potential loss in revenue; or

- The inaccuracy is deliberate. In this instance, the taxpayer must have had knowledge of the inaccuracy in the return. The maximum penalty for this type of deliberate inaccuracy is 70% of potential loss in revenue where it was not concealed or 100% of potential loss in revenue where it was concealed (for example, *inter alia*, destroying supporting documents, falsifying documents and back-dating documents).

(Casley 2016:48-49)

Further guidance is provided in CH72540 (HMRC 2016a).

Failure to comply with an information notice

Where an enquiry is made with a taxpayer, the said taxpayer could appeal against the information notice or elements of the notice by approaching the tax tribunal. However, where no appeal is made by the taxpayer and the taxpayer fails to submit the requested information, penalties of up to GBP 60 per day may be charged for each day of such failure.

(Casley 2016:55)

Fraudulently or negligently providing information

A penalty of up to GBP 10 000 is imposed on a taxpayer for fraudulently or negligently providing false or misleading information in connection with an advance pricing agreement or an advance thin capitalisation agreement (s 227 of the TIOPA*;* Casley 2016:62).

Reduction in penalties

Where the taxpayer identifies the error and informs HMRC prior to HMRC identifying the error, alternatively, where the taxpayer is highly co-operative with HMRC during the audit process, the penalty imposed could possibly be reduced (Casley 2016:48).

Interest

HMRC generally charges interest on taxes which have been underpaid, as would be in the case of a transfer pricing audit adjustment, and it is calculated from the original due date of the said tax (PWC 2014:803).

3.13. **The United Kingdom's transfer pricing practice**

3.13.1. **The Manuals**

HMRC prepares and maintains a series of manuals (which are updated periodically) to provide guidance to its tax inspectors (collectively known as the *HMRC Manual*) but these manuals are published in redacted form for taxpayers and their advisors to consult (Casley 2016:4). The reason for the redactions is that the *HMRC Manual* is not law, it is not binding and cannot be used in court (Casley 2016:4). On the other hand, where a taxpayer deviates from the manuals, disclosure is essential (Casley 2016:4). Overall, these manuals provide HMRC's interpretation of the existing legislation, the rationale behind the legislation and explanations of transfer pricing developments (PWC 2014:796).

The transfer pricing guidance is mainly included in the comprehensive *International Manual* (HMRC 2016c) (Casley 2016:4). The *International Manual* contains guidance on, *inter alia*, transfer pricing legislation and principles, transfer pricing methodology, types of transactions, business structures, operational guidance, intra-group funding and thin capitalisation. The key transfer pricing aspects of the *International Manual* are as follows:

- The terms 'provision' and 'transactions' are defined (HMRC 2016c:INTM412050). The term 'provision' refers to all the terms and conditions attached to the transaction or series of transactions and the term 'transaction' refers to arrangements, understandings and mutual practices (whether legally enforceable or not) (HMRC 2016c:INTM412050). It is therefore submitted that the meaning of the word

provision and transaction is very wide and all-encompassing. These terms are also dealt with in the United Kingdom court case discussed below in part 3.14 of this report. The term 'series of transactions' is also defined (HMRC 2016c:INTM440190).

- The five traditional methods as per the OECD guidelines are available to be used by taxpayers in the United Kingdom (HMRC 2016c:INTM421010). With the introduction of the 2010 *OECD Transfer Pricing Guidelines*, there is no preferred method for comparability purposes, that being said, where there are two equally reliable methods, one of which is the comparable uncontrolled price method, then the comparable uncontrolled price method will be used as it is the simplest and best method to use (Casley 2016:14). Additionally, HMRC usually considers that within the business itself, a comparable transaction may exist with an independent party which would be the best source of information for comparability purposes (HMRC 2016c:INTM421030; Casley 2016:11).

- Guidance is provided on various types of transactions. Examples of these types of transactions are, the sale of physical goods (HMRC 2016c:INTM440020) and services provided (HMRC 2016c:INTM440060 to INTM440080). The guidance also gives consideration to the circumstances in which a provision may be set aside and replaced with something different, in other words, what would have happened between independent parties (HMRC 2016c:INTM440010/INTM440200).

- With multinational enterprises increasing their operations on a global basis, inter-company cross-border transactions rise with improved communications and distribution channels which could cause potential incidences of inappropriate pricing (HMRC 2016c:INTM441010). Guidance is provided to audit teams on commonly known business and legal structures which multinational enterprises use to drive down their effective tax rate by making use of cross-border transactions (such as, *inter alia*, royalties, commission, service fees), where tax may be a motivating factor for such a structure (HMRC 2016c:INTM441010).

- Operational guidance is provided on governance of transfer pricing (HMRC 2016c:INTM481000); which includes the risk assessment process and key focus areas for risk identification purposes (HMRC 2016c:INTM482000); guidance on practical and compliance issues involved in a transfer pricing case (HMRC 2016c:INTM483000); assistance in evaluating transfer pricing reports (HMRC 2016c:INTM484000); and practical guidance on how to establish the transfer price, including how to find and use comparables (HMRC 2016c:INTM485000):

- Guidance is provided to audit teams on intra-group funding, from the provisions of the legislation and case law to potential taxpayer arguments upon adjusting the interest to an arm's length amount (HMRC 2016c:INTM500000).

- The United Kingdom approach to thin capitalisation (included in Part 4 of the TIOPA) is to apply the arm's length principle to lending and borrowing transactions, treating the parties to the transaction as if they were independent, as per the *OECD Transfer Pricing Guidelines* (HMRC 2016c:INTM511010). Since March 2007, the only way a corporate taxpayer can obtain certainty for the application of the thin capitalisation legislation is by an advance thin capitalisation agreement made under the advance pricing agreement legislation, as contained in part 5 of the TIOPA (HMRC 2016c:INTM512010). The guidance relating to thin capitalisation is intended for technically trained HMRC personnel, while providing tax advisors with insight into the advance thin capitalisation agreement processes and offers transparency on HMRC's approach to financial transfer pricing issues and the related audit (HMRC 2016c:INTM511010).

3.13.2. **Documentation requirements**

There is no specific rule in Chapter 4 of the TIOPA which requires the preparation of transfer pricing documentation. Taxpayers are therefore required to interpret the general record keeping requirements in relation to transfer pricing for which HMRC looks to the *OECD Transfer Pricing Guidelines* for guidance. As the United Kingdom has a self-assessment system in place, where the taxpayer submits a return, the taxpayer asserts that the return is considered to be correct and complete even with regard to the transfer pricing provisions and the arm's length position taken.

(Casley 2016:45)

HMRC is of the view that the following records are not required to be submitted but should be maintained, in any format, for a period of 4 years:

- The accounting records, providing income and expenditure book entry details of the relevant transfer pricing transaction together with supporting documentation. This documentation should be in existence at the time of submission of the income tax return. This requirement is imposed in order to determine the actual 'provision';

- Records detailing the related party transaction or series of transactions to which the transfer pricing rules apply, including their nature, the terms and conditions, and the prices relating to the transaction. This documentation should be in existence at the time of submission of the income tax return. This requirement is imposed in order to illustrate the actual 'provision' and the direct or indirect control relationship of the 'affected persons';

- Supporting evidence (the extent of which will depend on the nature and complexity of the transaction) that the arm's length provision has been met. The supporting evidence would include, *inter alia*, the transfer pricing method elected and reasons therefore, the comparable data used and any adjustments made. This requirement is imposed in order to illustrate the 'arm's length provision'; and

- Records of the calculations or evaluations performed in arriving at any tax adjustment which was included in the tax return for the purposes of the transfer pricing provisions. This documentation should be in existence at the time of submission of the income tax return.

(Casley 2016:45-47)

3.13.3. **Country-by-country reporting**

As the United Kingdom is a member of the OECD and the OECD Base Erosion and Profit Shifting project, any recommendations put forward by the OECD will be considered by the HMRC. The United Kingdom has therefore adopted the model legislation, three tiered approach, related to country-by-country reporting with effect from 1 January 2016 with the first country-by-country report due in 2017 (12 months after year-end) (Casley 2016:47).

The first step taken in implementing country-by-country reporting was that 31 countries, including the United Kingdom, signed an agreement to exchange reports from 2017 (Casley 2016:47). With this agreement in place, tax jurisdictions will automatically exchange the country-by-country reports with each other in the countries in which the relevant enterprise operates, provided that the country-by-country reporting has also been introduced in that tax jurisdiction (Casley 2016:47).

Where a taxpayer fails to submit the country-by-country report, penalties may apply (Casley 2016:47).

3.13.4. **Other considerations relating to transfer pricing**

- **Case law:** As there are inherent uncertainties in establishing an arm's length price, transfer pricing enquiries are in most instances settled by negotiation (Casley 2016:55). However, HMRC is now more willing to address transfer pricing risks by following the litigation process in order to obtain case authority and provide clarity on transfer pricing provisions (Casley 2016:55). In 2009, the first United Kingdom case (*DSG Retail Ltd v HMRC*) was heard where issues of the applicability of the most appropriate transfer pricing methodology and the application of the *OECD Transfer Pricing Guidelines* was dealt with fully (PWC 2014:798). This case is discussed below in part 3.14 of this report.

- **Personnel:** In 2008, the HMRC established a dedicated transfer pricing unit to provide expert resources to identify and address transfer pricing risks (HM Revenue & Customs 2013). The unit has grown to 60 personnel who are positioned all over the United Kingdom (Casley 2016:51).

- **Exchange of information**: HMRC does not have the power to obtain information directly from taxpayers who are not United Kingdom residents. The United Kingdom, however, does have an extensive double tax treaty network which can assist in the request for such non-resident information under the exchange of information article.

  (PWC 2014:802)

- **Comparable information:** HMRC has preference for its own United Kingdom sourced comparable data for activities based in the United Kingdom, however, generally HMRC does allow the use of European data for comparability purposes (Casley 2016:11). Similarly if comparable data is required for an enterprise outside of the United Kingdom, the data relating to that geographical area would be more appropriate to use (Casley 2016:11). HMRC makes use of commercial databases, *inter alia*, Orbis and Amadeus databases published by Bureau van Dijk (Casley 2016:12). Comparability adjustments, the most common adjustment being working capital adjustments, should be made if the quality of the results will be improved and the adjustment will change the range of the results (Casley 2016:12-13). If the results fall within the arm's length range of prices, then no adjustment is required, conversely, if the results fall outside the acceptable range then HMRC must revise the taxpayer's tax computation so as to replace the actual price with the arm's length price (INTM485120).

- **Advance pricing agreements:** Legislation relating to advance pricing agreements (unilateral, bilateral or multilateral) is provided in Part 5 (s 218 to s 230) of the TIOPA and guidance provided in a *Statement of Practice SP2/10* (HMRC 2016d). As the resources available to perform work on advance pricing agreements are limited, HMRC generally only accepts applications for more complex transfer pricing issues (being, *inter alia*, a specific issue, a specific transaction or all of the taxpayer's entire transfer pricing arrangements) or in cases where double taxation is likely to occur if no advance pricing agreement is in place (Casley 2016:60). The typical period of an advance pricing agreement is three to five years (HMRC 2016d:para 25) and a condition is included in the agreement whereby an 'annual report' is required to be submitted by the taxpayer with the tax return to demonstrate that they have complied with the advance pricing agreement (HMRC 2016d:para 36). HMRC does not impose a fee for an advance pricing agreement application (Casley 2016:61). The advance pricing agreement may be withdrawn at any time prior to the conclusion of the formal agreement, thereafter it cannot be withdrawn unless it is nullified (as a result of the information provided by the taxpayer being false or misleading), revoked (non-compliance by the taxpayer or the conclusion of the 'conditions having effect') or revised (where there is a change in circumstances) (Casley 2016:61-62).

- **Audit approach:** For risk assessment purposes, HMRC will review documents on hand or have an informal meeting with the taxpayer to justify the opening of a transfer pricing enquiry and to determine whether the case should be pursued taking into consideration the resources required to be deployed and the perceived results relating to the transfer pricing risks. A framework has been designed by HMRC to facilitate an effective transfer pricing enquiry process. The target is to resolve all enquiries (except for complex enquiries) within 18 months and to increase the value of transfer pricing adjustments. With more complex enquiries HMRC intends resolving the enquiry or taking the case to litigation within 36 months.

  (Casley 2016:52)

- **Prescription:** In most cases, HMRC has 12 months after the taxpayer has submitted a return to open an enquiry (start an audit), once the enquiry is sent, there is no time restriction on when the enquiry should be closed except if the taxpayer is of the view that HMRC is excessively prolonging the closure of the enquiry then they will request the tax tribunal to direct HMRC to issue a closure notice (finalisation of audit) (Slaughter and May 2015:6). Effective 1 April 2010, without opening an enquiry, a discovery assessment can be made up to 4 years after submission of the return, where HMRC discovers something that it 'could not have been reasonably

expected ... to be aware of' on the basis of the information made available at the time of submission of the tax return (Casley 2016:51). This 4 year period can be extended up to 6 years and 20 years if it was found that the taxpayer made a careless or deliberate error, respectively, in the transfer pricing calculation (Slaughter and May 2015:6).

3.14. **Court case: *DSG Retail Ltd v HMRC* (2009) UK FTT 31 (TC) 1**

3.14.1. **Factual background**

The case involved DSG Retail Limited ('DSG') which is the retail entity of DSG International plc, the largest retailer of electrical goods in the United Kingdom. Other companies within the group were Coverplan Insurance Services Ltd (CIS), Mastercare Coverplan Service Agreements Ltd ('MCSAL'), Mastercare Service and Distribution Ltd ('MSDL') and Dixons Insurance Services Limited ('DISL'). With the exclusion of DISL, the companies are collectively called 'the Group'. For goods sold, DSG offered its customers extended warranties, which continued after the one year manufacturing guarantee for an additional period of one to four years, at a premium. (At 2.)

DISL was established in the Isle of Man on 27 March 1986. DISL was exempt from tax and was not authorised to write insurance in the United Kingdom (at 6.).

There are two periods which are required to be considered:

- The first period being 'the Cornhill period': Between May 1986 and April 1997 Cornhill Insurance plc ('Cornhill'), a third party to the DSG group, was the insurer of the extended warranties. DISL reinsured 95% of the risk, leaving the balance of 5% of the risk with Cornhill. Accordingly, 95% of Cornhill's net premium (after commissions paid to CIS for acting as Cornhill's agent and administration fees paid to MSDL for repairs done) was ceded to DISL and in return Cornhill received a ceding commission of 1.5% (this was negotiated by the Group instead of DISL) of the amount ceded to DISL. Various agreements were entered into between Cornhill and DISL and Cornhill and other group companies, all of which were entered into on the same day and which were considered to operate as one agreement. DSG and DISL did not have a direct contractual arrangement. (At 5 to 10.)

- The second period being 'the ASL period': From April 1997 onwards, as a consequence of an increase in insurance premium tax which would have reduced DISL's profits, the insured extended warranties were offered as service contracts which were issued to customers by a non-group company, Appliance Serviceplan Limited ('ASL'), whose liability was 100% insured by DISL (Field Fisher Waterhouse 2010:5). A similar arrangement was made as per the Cornhill period except MCSAL acted as agent for ASL instead of MSDL (Field Fisher Waterhouse 2010:5).

The legislation changed during the periods under review as follows:

- For periods ending before 30 June 1999: Section 770 of the Income and Corporation Taxes Act 1988 was applicable. There was no reference to the OECD guidelines. (At 28 to 29.)

- For periods ended after 30 June 1999: Schedule 28AA of the Income and Corporation Taxes Act 1988 specifically indicated that guidance from the OECD guidelines should be considered (at 29 to 31.).

HMRC argued the following:

- DSG contracted with the third party (Cornhill/ASL) based on the consensus that the third party would in turn be insured by DISL;

- The Group had given DISL a 'business facility' with the contractual changes in 1993 whereby Cornhill's position was disadvantaged whereas DISL's profit remained unchanged, therefore s 770 was potentially applicable;

- Upon analysing the transactions, it could be shown that the contracts were entered into on the basis that they were seen to be 'a series of interlocking agreements'. For the purposes of Schedule 28AA , the way in which the arrangement was carried out, was as if a provision had been made between DSG and DISL;

- DISL obtained an advantage from the 'point of sale' in all DSG stores for which a person dealing at arm's length would have had to pay DSG something for the benefit DISL received;

- While DSG had a number of potential comparable uncontrolled prices, these comparables were all rejected due to differences in, *inter alia*, the market conditions,

product differences and the bargaining power for which reliable adjustment could not be performed;

- The profit split method was considered to be the most appropriate method in determining the arm's length return on capital for DISL and allocating the remaining profit to DSG since DISL's profits were dependent on DSG's 'point of sales'.

(Field Fisher Waterhouse 2010:6)

3.14.2. **Judgment**

The Tax Tribunal agreed with the contentions made by HMRC. The case was adjourned for the parties involved to formulate an appropriate profit split for the parties concerned (at 58.). This issue was subsequently resolved between HMRC and the taxpayer (Field Fisher Waterhouse 2010:6).

3.14.3. **Comment on the judgment**

This case provided persuasive authority and confidence for HMRC especially with regard to the terms 'provision' and 'series of transactions' (HMRC 2016c:INTM INTM412050).

The various entities knew that the different agreements would take effect altogether, so much so that they were planned and were seen to be interlocking and interdependent. The 'fronter' would not have been contracted with unless it would reinsure with DISL. The structuring of these agreements gave rise to a 'series of transactions' as set out at s 150 of the TIOPA, therefore, the 'provision' was considered to be 'something different to the transactions'.

(HMRC 2016c:INTM412050)

As the principle coming out of this court case (which is where independent third parties are interposed, transfer pricing provisions can be applied to those indirect transactions) was of such importance, SARS considered it necessary to include the word 'indirectly' in drafting the 2012 transfer pricing legislation so as to include transactions which interpose third parties (Honiball and Montsho 2010). Therefore, South Africa has already taken this judgment into consideration in drafting the 2012 transfer pricing legislation (s 31(1)).

3.15. **Conclusion on the United Kingdom's transfer pricing legislation and practice**

The following is submitted with regard to the United Kingdom's transfer pricing legislation and practice:

The United Kingdom's transfer pricing legislation places total reliance on the *OECD Transfer Pricing Guidelines*, so much so that HMRC has incorporated the *OECD Transfer Pricing Guidelines* into the legislation (s 164 of the TIOPA) thereby implying that there can be no deviation from the *OECD Transfer Pricing Guidelines*. Furthermore, all HMRC guidance relating to the transfer pricing provisions refers to specific paragraphs of the OECD transfer pricing guidance (HMRC 2016c). This gives the taxpayers in-depth guidance on the treatment of controlled transactions and how the arm's length principle should apply to different types of transactions and related scenarios (HMRC 2016c).

The DSG court case has been a cornerstone for the understanding that the term 'provision' is aligned to Article 9 of the *OECD Model Tax Convention* (PWC 2014:794) and the application of the *OECD Transfer Pricing Guidelines* (PWC 2014:798) and in addition provided principles and international case authority for other tax administrations around the world, such as South Africa, who adopt the *OECD Transfer Pricing Guidelines* (Honiball and Montsho 2010).

THE COMPARISON

3.16. **The comparison of all four countries**

The following comparison can be made from the analysis of all four countries' transfer pricing legislation and practice (the cross references given below indicate the parts of the research report where the various issues are discussed for each country):

- All four countries (South Africa in part 2.1, Kenya in part 3.1.1, India in part 3.6.2 and the United Kingdom in part 3.11.2) follow the arm's length principle which, according to the OECD, is the underpinning principle for transfer pricing legislation.
- The *OECD Transfer Pricing Guidelines* have specifically been included in s 164 of the TIOPA in the United Kingdom (part 3.11.2) and they are also referred to in the HRMC manuals (part 3.12). Kenya (part 3.3.1) and India (part 3.8) do not place

total reliance on the *OECD Transfer Pricing Guidelines* but have included the sections where they do place reliance in their rules, which are legally binding on the relevant tax authorities. While South Africa has included the *OECD Transfer Pricing Guidelines* in its SARS Practice Notes and draft Interpretation Note, these documents are not legally binding documents (part 2.4).

- While transfer pricing does not usually relate to domestic transactions, India (part 3.6.2) and the United Kingdom (part 3.11.2) have included domestic transfer pricing rules to curb tax arbitrage. South Africa should consider whether it would be feasible to include such provisions in its transfer pricing provisions.

- South Africa (part 2.2.3) and the United Kingdom (part 3.11.3) have incorporated thin capitalisation provisions which are based on the arm's length principle; however, South Africa does not provide adequate guidance on the arm's length principle (part 2.4.1). Kenya also has thin capitalisation provisions with a debt:equity safe harbour of 3:1 (part 3.1.3). India currently does not have any thin capitalisation provisions in its legislation, but has proposed to introduce such legislation with effect from 1 April 2018 (part 3.6.4).

- The burden of proof is on the taxpayer for all four countries (South Africa in part 2.2.5, Kenya in part 3.1.2, India in part 3.6.2 and the United Kingdom in part 3.11.2)

- South Africa (part 2.2.4), currently, is the only country amongst the four countries that applies a secondary adjustment to the primary transfer pricing adjustment (Kenya in part 3.1.2, India in part 3.6.2 and the United Kingdom in part 3.11.2). That being said, India will be introducing a secondary adjustment with effect from 1 April 2018 (part 3.6.2).

- None of the countries analysed impose specific penalties relating to the transfer pricing adjustment. All four countries refer to the general penalty provisions, which range from 5% to 200%, and the general interest provisions apply. South Africa's penalties are applied in terms of s 222 of the Tax Administration Act and ranges from 5% to 200% of the tax on the amount understated (part 2.3). Kenya's penalties are applied in terms of s 84 of the Kenyan Tax Procedures Act and ranges from 20% to 100% of the principal tax amount (part 3.2). India's penalties are applied in terms of s 270A of the Indian Income-tax Act and ranges from 50% to 200% of the amount of tax under-reported/misrepresented (part 3.7). The United Kingdom's penalties range from 30% to 100% of the potential lost revenue (part 3.12).

- Documentation requirements are compulsory in all four countries analysed (Kenya in part 3.3.2, India in part 3.8.2 and the United Kingdom in part 3.13.2). South

Africa only recently, with effect from 1 October 2016, introduced compulsory record keeping and maintenance of transfer pricing documentation (part 2.4.3).

- Where documentation requirements are not complied with, all four countries impose penalties which vary between the countries. South Africa imposes the general non-compliance provision, in terms of s 211 of the Tax Administration Act, which is a maximum of R16 000 (part 2.3). Kenya imposes the general non-compliance provision, in terms of s 82 of the Kenyan Tax Procedures Act, which is 10% of the amount of tax payable to which the documentation retention failure relates (part 3.3.2). India imposes a specific penalty provision, in terms of s 271AA(1) of the Indian Income-tax Act, which is 2% of the value of the international transaction/specified domestic transaction for each failure (part 3.7). The United Kingdom imposes the general non-compliance provision, in terms of EM4650, which is GBP 3 000 (part 3.12). It is submitted that in comparison to other countries, the South African non-compliance penalty is too low.

- Country-by-country reporting has been adopted by South Africa, India and the United Kingdom and is based on the OECD guidelines provided for country-by-country reporting. India (part 3.8.3) and the United Kingdom (part 3.13.3) have already included the country-by-country reporting provisions in their legislation and these are effective from 1 April 2017 and 1 January 2016, respectively. South Africa only recently, in December 2016, approved the country-by-country reporting regulations (part 2.4.4). The author has not been able to establish Kenya's status on the adoption of the country-by-country reporting.

- Case law is available on transfer pricing in Kenya (parts 3.3.3 and 3.4), India (parts 3.8.4 and 3.9) and the United Kingdom (parts 3.13.4 and 3.14). South Africa does not have case authority related to transfer pricing provisions (part 2.5.1). It is suggested that, while litigation is a costly affair, it would be beneficial for SARS to obtain case authority on the South African transfer pricing provisions.

- As transfer pricing is complex and each transaction/case is different, adequate staff with the necessary skill and knowledge is required to audit such cases. Kenya has invested in their staff by training them locally and abroad to assist them in conducting efficient and effective transfer pricing audits (part 3.3.3). In India the transfer pricing unit has increased in size and adequate training is provided to ensure the necessary knowledge is transferred to staff (part 3.8.4). In the United Kingdom there are sufficient staff and experts to assist in transfer pricing audits (part 3.13.4). South Africa should ensure that the transfer pricing division is adequately staffed and the necessary knowledge is provided to them to perform efficient and effective

transfer pricing audits. It should be noted that the author has been unable to establish what training has been provided to the South African transfer pricing staff.

- Double taxation agreements are available in all four countries which can be used to exchange information between tax jurisdictions. While some countries may have an extensive double taxation treaty network (such as the United Kingdom in part 3.13.4), others do not. Kenya's treaty network is very limited, therefore exchange of information with countries where there are no double taxation agreements would be very difficult (part 3.3.3). South Africa (part 2.5.4) and India (3.8.4) have extensive treaty networks but there are no double taxation agreements available with certain low tax jurisdiction countries, in these instances obtaining information for taxpayers in those jurisdictions would be difficult. It is also the author's view that the exchange of information is not a quick process and it could take months before the information which is requested from another jurisdiction is received.

- Reliable local comparable data is readily available in India (part 3.8.4) and the United Kingdom (part 3.13.4). For the African countries, South Africa (part 2.5.5) and Kenya (3.3.3), while local data is available, it may not be reliable; therefore European databases are used for comparability purposes. The use of European comparables is problematic as adjustments are required to make the comparability analysis more reliable. Therefore South Africa and Kenya should determine a way in which more reliable local data can be obtained.

- Advance pricing agreements are available in India (part 3.8.4) and the United Kingdom (3.13.4). South Africa (part 2.5.5) and Kenya (part 3.3.3) have not implemented legislation relating to advance pricing agreements. South Africa should consider implementing advance pricing agreements.

- The audit approach in all countries evaluated is very similar (South Africa in part 2.5.6, Kenya in part 3.3.3, India in part 3.8.4 and the United Kingdom in part 3.13.4). The audit approach starts with the identification of transfer pricing risks, based on certain criteria which each tax authority uses. Thereafter the case will be prioritised based on the available resources and the potential revenue to be earned.

- The prescription period varies amongst all four countries. In South Africa, the prescription period is, in terms of s 99 of the Tax Administration Act, 3 years extended to 5 years for transfer pricing cases if notice is served to the taxpayer and an unlimited period applies where there has been fraud, misrepresentation or non-disclosure on the part of the taxpayer (part 2.5.7). In Kenya, the prescription period is 7 years, but where there has been fraud, intentional or gross negligence then the

limit does not apply (part 3.3.3). In India, the prescription period is 33 months, in terms of s 153 of the Indian Income-tax Act (part 3.8.4). In the United Kingdom, the prescription period is an unlimited period where there is an enquiry or 4 years extended to 6 years for carelessness and 20 years for deliberate errors (part 3.13.4). Where there are limited resources to perform transfer pricing audits, the prescription period may become an issue as there is insufficient time to perform comprehensive audits.

The next chapter will provide an overview of the OECD guidelines.

CHAPTER 4: The OECD's transfer pricing guidelines

This chapter will provide an overview of the OECD guidelines and analyse whether the substituted transfer pricing legislation (s 31 of the Act) has been aligned to them. Where it has not been aligned, this will be highlighted and recommendations will be made to improve s 31 of the Act.

4.1. History of the OECD

The OECD is an international organisation which was established in 1961 to assist its member countries in growth, change in the market economy and economic development by issuing publications and statistics on several topical areas, such as competition, corporate governance, electronic commerce, trade and taxation (Davis Tax Committee BEPS Sub-Committee 2014a:18). Further goals of the OECD include the expansion of trade globally and the development of the global economy which affects both member and non-member countries, such as South Africa (Davis Tax Committee BEPS Sub-Committee 2014a:18). The OECD, therefore, requests that non-member countries utilise its recommendations as guidelines (Davis Tax Committee BEPS Sub-Committee 2014a:18). There are currently 35 OECD member countries (OECD 2016a). Brazil, India, the People's Republic of China, Indonesia and South Africa are Key Partners of the OECD which provide contributions to the OECD work (OECD 2016a). The countries which sit at the OECD table and assist in combating global challenges, account for 80% of world trade and investment (OECD 2016a).

4.2. OECD transfer pricing guidelines

4.2.1. History

OECD reports on transfer pricing were first published in 1979 and 1984, thereafter the *OECD Transfer Pricing Guidelines* were adopted in 1995, which were subsequently amended and updated, the latest publication being in July 2010 (United Nations Department of Economic & Social Affairs 2013:7).

4.2.2. OECD Transfer Pricing Guidelines (OECD 2010)

The *OECD Transfer Pricing Guidelines* assist Governments in the drafting of legislation which is used to combat abusive transfer pricing (O'Halloran 2013). The *OECD Transfer Pricing*

Guidelines include guidelines, as discussed below, on the arm's length principle, transfer pricing methods, comparability analysis, dispute resolution, documentation, intangible assets, intra-group services, cost contribution agreements and business restructurings.

Chapter 1: The arm's length principle

Paragraph 1 of Article 9 of the *OECD Model Tax Convention* provides the authoritative statement of the arm's length principle, which is as follows (OECD 2010:33):

> '[Where] conditions are made or imposed between the two [associated] 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.'

This Article seeks to adjust profits by treating associated enterprises as if they were operating as independent separate parties in order to focus on the transaction itself and whether the conditions relating to the transaction would have been different in a comparable uncontrolled transaction (OECD 2010:33). Therefore the analysis of comparable data is of key importance to determine what the outcome would have been if the enterprises were independent of each other (OECD 2010:33).

The main reason both OECD member and non-member countries have adopted the arm's length principle is that it puts both associated enterprises and independent enterprises alike on 'equal footing' for tax purposes, which further avoids competitive tax advantages or disadvantages (OECD 2010:34). In separating these tax considerations and economic decisions, the intention of the arm's length principle is to promote the growth of international trade and investment, fairly (OECD 2010:34).

Chapter 2: Transfer pricing methods

The OECD provides guidance on methods which can be used to determine whether the arm's length principle has been consistently applied taking into account the commercial and financial relationship between the associated enterprises (OECD 2010:59). The methods can be split as follows:

- The traditional transaction methods are the comparable uncontrolled price method ('CUP method'), the resale price method, and the cost plus method. These methods are preferred over the transactional profit methods and the CUP method is considered to be the most favoured method; and

- Transactional profit methods are the transactional net margin method and the transactional profit split method.

(OECD 2010:59-60)

The most appropriate method, based on, *inter alia*, the nature of the transaction, the functional analysis and the availability of reliable comparable information, should be used to determine the arm's length price (OECD 2010:59). There are pros and cons to each of the available methods and the one best suited to the circumstances at hand should be elected (OECD 2010:61). Where there are two methods which yield an appropriate arm's length price, the traditional transaction method and more especially the CUP method, should be selected over the other method (OECD 2010:60).

Many countries have adopted these methodologies in drafting their transfer pricing legislation (Adams & Adams 2016:1). South Africa has included these methodologies in *Practice Note 7* which is not a binding document (*Practice Note 7* is discussed in detail above in part 2.4.2 of this report).

Chapter 3: Comparability analysis

In the process of identifying the most appropriate transfer pricing method, the purpose of a comparability analysis is to find the most reliable comparables, which is a very subjective process, to support the transfer pricing adjustments from both a taxpayer's and tax administrator's perspective (OECD 2010:107-108).

Guidance is provided on the steps which can be followed in determining the most reliable comparables by accepting or rejecting potential comparables and making necessary comparability adjustments to obtain more reliable results (OECD 2010:Ch. 3).

Upon completing the comparability analysis, an arm's length range will be derived (OECD 2010:124). Where the price is within the arm's length range, no adjustment will be made, however, where it is outside the range, an adjustment would be required to be made, generally to the midpoint of the range (OECD 2010:125).

Further guidance has been issued by the OECD on comparability data and developing countries (OECD 2014). Both OECD member and non-member countries regularly express concerns, especially with regard to developing countries, regarding the availability and quality of independent companies' financial data which can be used for comparability purposes (OECD 2014:1). Due to these difficulties, taxpayers in developing countries may incorrectly apply transfer pricing methods to unknowingly unreliable data thereby facing uncertainties in complying with transfer pricing regulations (OECD 2014:3). Furthermore, this could result in disputes which may prove difficult to resolve (OECD 2014:3). Possible approaches to resolving this issue are as follows:

- Expanding access to data sources for comparables: With the absence of local comparables, commercial databases should be used; however, this does come at a cost (OECD 2014:4). The African Tax Administration Forum, supported by the OECD, is also carrying out feasibility studies with regard to database options available to its members (OECD 2014:4).

- More effective use of data sources for comparables: Once a tax administration gains access to a commercial database, to effectively make use of it, there needs to be a degree of skill and experience to appropriately perform a search in order to identify the most appropriate comparables (OECD 2014:5). The utilisation of foreign comparables may also pose a problem as comparability adjustments are required to be made which is very subjective and minimal guidance has been provided on such adjustments (OECD 2014:5-6).

- Approaches to reducing reliance on direct comparables: This can be done, for example, by the introduction of additional safe harbours for specific industry averages, or by using the 'sixth method' (which provides for the utilisation of publicly quoted commodity prices for certain commodity transactions) (OECD 2014:7).

- Advance pricing agreements and mutual agreement proceedings: If this process is followed, it is likely that tax administrations and taxpayers will work together by conducting constructive negotiations in an attempt to reconcile differences in their judgements (OECD 2014:8).

This chapter provides a discussion on various procedures which can be applied by tax administrators to assist them in resolving disputes caused by transfer pricing adjustments and double taxation (OECD 2010:131).

The main aspects discussed, *inter alia*, are the following:

- Penalties: The objective of penalties is to make the underpayment of tax or non-compliance of provisions more costly than if the taxpayer complied (OECD 2010:136).

- Corresponding adjustments: This practice can alleviate double taxation where transfer pricing adjustments are made in one jurisdiction and which affects an associated enterprise in another jurisdiction (OECD 2010:140-141);

- Secondary adjustments: Article 9 of the *OECD Model Tax Convention* does not refer to secondary adjustments, therefore it is neither forbidden nor a requirement (OECD 2010:152);

- Safe harbours: The simple definition of a safe harbour is the setting of rules which are automatically accepted as arm's length by the tax administrator (OECD 2010:159-160). The major benefits of the use of safe harbours are the certainty it creates, the reduction in compliance requirements for the taxpayer and the ease in assessing risk by the tax administrators (OECD 2010:161). There are also problems which are associated with the utilisation of the safe harbour by tax administrators such as, *inter alia*, the result being inconsistent with the arm's length principle and the most appropriate method not being applied in line with OECD principles (OECD 2010:162). There is also a separate guideline on safe harbours which was issued by the OECD (OECD 2013c); and

- Advance pricing arrangements: An advance pricing arrangement is an arrangement which determines, through a negotiation process, in advance the arm's length transfer price of a controlled transaction, by setting the criteria (such as the critical assumptions, the most appropriate method, and comparability adjustments) for a fixed period (OECD 2010:168). Tax administrators should take care when agreeing to critical assumptions which cannot be reliably predicted for a long period of time as this may not result in an arm's length price (OECD 2010:168). In order to assess whether the taxpayer has complied with the advance pricing agreement, the tax

administrator may either perform a cycle audit or request that the taxpayer submit an annual report demonstrating their compliance (OECD 2010:171). The advance pricing agreement should be cancelled if it is found that the taxpayer provided fraudulent information, misrepresented facts or did not comply with the agreement (OECD 2010:171-172). The main advantages of entering into an advance pricing arrangement are, *inter alia*, the provision of certainty, the predictability of the tax treatment of a controlled transaction and the elimination of costly litigation expenses (OECD 2010:173). There is also a separate guideline on advance pricing agreements which was issued by the OECD (OECD 1999) as well as assistance in drafting advance pricing arrangement legislation (OECD Secretariat 2012b).

Chapter 5: Documentation

Both the taxpayer and the tax administrator should endeavour to demonstrate, in good faith, that they have determined the transfer pricing adjustment in terms of the arm's length principle, regardless of who carries the burden of proof requirement (OECD 2010:181). The information which is considered to be useful by the OECD is as follows:

- The overview of the business with business strategies;
- The group structure with ownership linkages;
- The sales and operating results for a few years prior to entering into the controlled transaction;
- Details of the controlled transaction with the foreign associated enterprise together with the related financial details; and
- An indication of how the arm's length price was determined, the method elected with reasons, the application thereof, the adjustments and the assumptions made in the calculation.

(OECD 2010:186-187)

The tax administration should have a right to obtain documentation to verify that the taxpayer has complied with the arm's length principle (OECD 2010:188-189). That being said, the tax administrator should take cognisance of the fact that there should be a balance between the cost burden to the taxpayer to prepare such documents and the administrative burden (OECD 2010:189).

Chapter 6: Special considerations for intangible property

Intangible property is often very difficult to value, therefore specific guidance is provided by the OECD (OECD 2010:191). Guidance is provided on the most appropriate method to use for determining the arm's length price in relation to commercial activities and marketing activities (the use of trademarks or tradenames in conducting marketing activities but not being the legal owner thereof), as the intangible property may have a 'special character' which makes it difficult to perform comparable searches or to find suitable comparables (OECD 2010:191;195-196).

Chapter 7: Special considerations for intra-group services

Intra-group services provided by multinational enterprises to their associated enterprises may vary, but the most common intra-group services are administration, financial, technical and commercial services, which are generally available from independent enterprises (OECD 2010:205). The main problems with the provision of intra-group services is whether the services were actually performed and if they were performed, was the service provided at an arm's length price, therefore guidance is provided on these services (OECD 2010:206). As a general rule, duplicate services should not be provided to a single entity by two or more connected-parties within a group of companies (OECD 2010:208).

Chapter 8: Cost contribution arrangements

Guidance is provided on a general basis for the determination of whether cost contribution agreements which are entered into between two or more associated enterprises (and possibly including independent enterprises) is in accordance with the arm's length principle (OECD 2010:219). A cost contribution agreement is an agreement entered into between associated enterprises to share costs, the related risks and to determine the extent of each party's interest associated with developing, producing and obtaining assets, rights or services (OECD 2010:220). Mutual benefit is a key concept with cost contribution agreements (OECD 2010:223). For a cost contribution agreement to be in accordance with the arm's length principle, each participant's contribution would have to be consistent with what an independent party would have agreed to contribute, based on the resultant benefits, under comparable circumstances (OECD 2010:222). Guidance is provided on, *inter alia*, how a cost contribution agreement should be drawn up and the documentation requirements which should be maintained in relation to these agreements, in case of an audit (OECD 2010:Ch. 8).

Chapter 9: Transfer pricing aspects of business restructurings

Guidance is provided in cases where the business is restructured by the cross-border relocation of a multinational enterprise's functions, assets and/or risks (OECD 2010:235). Generally, with business restructurings, profits will be reallocated amongst the members of the multinational group (OECD 2010:236). The main purpose of this guidance is to discuss whether the profit reallocated is consistent with the arm's length principle and how the arm's length principle is applied to such business restructurings (OECD 2010:236). Guidance is provided on, *inter alia*, how to audit the business restructuring and what information should be reviewed pre-restructuring and post-restructuring to determine whether the arm's length principle has been met (OECD 2010:Ch. 9).

Criticism of the OECD Transfer Pricing Guidelines

Whilst the *OECD Transfer Pricing Guidelines* provides a theoretical understanding of the arm's length principle, there are occurrences, as indicated below, where the OECD guidelines fall short in addressing how to apply the principle in practice (United Nations Department of Economic & Social Affairs 2013:410).

Some people are of the view that the arm's length principle is inherently flawed as 'economies of scale' and 'interrelation of diverse activities' which is created by an integrated business is not taken into account by the separate entity approach (OECD 2010:34).

Comparability data may also be difficult to find as the transactions which associated enterprises enter into are generally not transactions which independent parties would enter into (OECD 2010:35). Availability of local comparability data is also a major problem (OECD 2010:35).

4.3. **Country-by-country reporting**

The OECD has developed a three tiered approach to transfer pricing documentation to enhance transparency by putting in place provisions whereby multinational enterprises would be required to provide the relevant tax administrations with information, on a common template, relating to the multinational enterprises' global allocation of income, economic activity and taxes paid in various jurisdictions, but also taking into consideration the compliance costs for business (OECD 2015:9).

The three tiers would be as follows:

- First tier being the provision of tax administrations with an overview of the multinational enterprise's global business operations and transfer pricing policies in a 'master file' which would be available to all relevant tax administrations.

- Second tier being a 'local file' which provides country specific detailed transactional transfer pricing documentation, identifying substantial related party transactions, the related values, and the entity's analysis of the transfer pricing arm's length considerations concerning those transactions.

- Third tier relates to large multinational enterprises which are required to file a country-by-country report that will be filed on an annual basis for each jurisdiction in which they perform their business. The report would also include the identification of the entity; the tax jurisdiction of incorporation; its residence if different from jurisdiction of incorporation; the nature of its business; the amount of revenue, the profit before income tax and the income tax paid and accrued; the number of employees in its employ; the stated capital; the retained earnings and the tangible assets in each tax jurisdiction.

(OECD 2015:9)

These three documents (master file, local file and country-by-country report) altogether will require multinational enterprises to express consistent transfer pricing positions for the entire group of companies and will provide tax administrations with useful information to assist in assessing transfer pricing risks, provide a basis for audit enquiries and determine the most effective use of audit resources (OECD 2015:9). This information will provide tax administrations with a base for identifying whether companies have used transfer pricing and other practices to shift income to tax-advantaged jurisdictions (OECD 2015:9). The countries which are participating in the Base Erosion and Profit Shifting project, such as South Africa, have agreed that these reporting provisions will encourage and contribute to the primary objective of controlling base erosion and profit shifting (OECD 2015:9).

4.4. **Conclusion on the OECD guidelines**

It is submitted that the OECD's practice and the arm's length principle is international best practice which is the reason why even OECD non-member countries follow the OECD approach and guidelines. Even the courts of law have used the OECD principles and guidelines

to assess the circumstances and determine a judgment as was the case in *Unilever Kenya Ltd* (discussed above in part 3.4 of this report).

While there may be criticism of certain aspects of the OECD guidelines (for example, comparable data), they provide a starting point for most tax administrations with regard to both legislation and different aspects and possible scenarios which multinational enterprises could possibly enter into to shift profits to low tax jurisdictions, thereby not complying with the arm's length principle.

4.5. **OECD and South Africa**

Before the introduction of the South African transfer pricing legislation, the Katz Commission stated that the OECD guidelines should be applied, reason being that the OECD's influence in international trade and investment has grown to such an extent that the OECD guidelines constituted a 'common language' amongst trading and investment countries (Katz 1995:3).

As majority of developed countries have transfer pricing provisions in their tax legislation, it means that foreign investors are accustomed to the application of such transfer pricing regulations and they ought to have strict policies, within their group of companies, to ensure that their cross-border inter-company transactions are performed at arm's length (Katz 1995:5).

South Africa has adopted the arm's length approach as recommended by the Katz Commission and therefore looks to the OECD for guidance as the OECD supports fair tax practices around the world (O'Halloran 2013). Additionally, South African courts have endorsed the commentary on the *OECD Model Tax Convention* (Davis Tax Committee BEPS Sub-Committee 2014a:18), demonstrating, it is submitted, that the *OECD Transfer Pricing Guidelines* are international best practice.

In 2004, South Africa was awarded OECD observer status (Davis Tax Committee BEPS Sub-Committee 2014a:18), it has enhanced engagement with the OECD, is an observer to the OECD's Committee on Fiscal Affairs (Strydom and Kitcat 2013) and is a member of the OECD BEPS Committee (Davis Tax Committee BEPS Sub-Committee 2014a:18).

South Africa has adopted the *OECD Transfer Pricing Guidelines* in many aspects, such as:

- The Commissioner has endorsed the five OECD transfer pricing methods (as indicated in chapter 2 of the *OECD Transfer Pricing Guidelines*), using the most appropriate method to perform the calculation of the arm's length price (SARS 1999:13).

- Detailed guidance on comparability analysis is provided in *Practice Note 7* which also refers to certain paragraphs of the *OECD Transfer Pricing Guidelines* (OECD 1999:9-12).

- The notice to keep transfer pricing documentation (SARS 2016b), effective from 1 October 2016, incorporates the documentation indicated in chapter 5 of the *OECD Transfer Pricing Guidelines*.

- Reference has been made to chapters 6, 7 and 8 of the *OECD Transfer Pricing Guidelines* for guidance on intangible assets, intra-group services and cost contribution agreements, respectively, in SARS *Practice Note 7* (SARS 1999:34).

While South Africa has adopted the *OECD Transfer Pricing Guidelines* as indicated above, it has not adopted these guidelines in totality, by not implementing certain aspects which are recommended by the OCED, such as:

- Advance pricing agreements which were recommended by the Katz Commission to be incorporated into the South African transfer pricing legislation but were never implemented (Deloitte 2016:236). Advance pricing agreements are beneficial tools to possibly further enhance foreign direct investment by providing certainty. Furthermore, the introduction of advance pricing agreements could assist in avoiding lengthy audits and disputes thereby effectively utilising resources and saving time (OECD 2010:173);

- Corresponding adjustments are not provided for in s 31 of the Act. If South Africa does introduce corresponding adjustments, this may be a further incentive for foreign investors; and

- SARS *Practice Note 7* does not refer to chapter 9, which deals with transfer pricing aspects of business restructurings, as it was only incorporated into the *OECD Transfer Pricing Guidelines* in 2010 and the Practice Note has not been updated since 1999 (SARS 1999).

Additionally, South Africa encounters difficulties with obtaining reliable local comparable data, as is the case with most developing countries (OECD 2014:1), hence they make use of European databases for comparability purposes (Deloitte 2015:199).

It is submitted that South Africa should consider, at the very least, introducing advance pricing agreements.

The next chapter will summarise the findings of the research.

CHAPTER 5: Conclusions and recommendations

This chapter will summarise the findings of the research as well as propose recommendations related to all weaknesses/loopholes identified in s 31 of the Act and will provide an indication of areas requiring improvement with respect to the South African transfer pricing legislation (s 31 of the Act) and guidelines. This chapter will also indicate areas which will require further research.

5.1. **Comment on the South African transfer pricing legislation as a whole**

The substituted South African transfer pricing provisions in s 31 of the Act include wording which is aligned with the *OECD Model Tax Convention*, which focuses on the economic substance of the related party transaction, rather than the pricing of the specific transaction (Brodbeck 2012).

It is submitted that the substituted South African transfer pricing legislation has provided SARS with a much wider scope of inspecting and auditing transfer pricing transactions as a result of the inclusion of the definition of 'affected transaction' which has assisted in shifting the focus from a single transaction approach to an entity-based approach which is a more holistic approach (discussed above in part 2.2 of this report). It is further submitted that this definition, in s 31 of the Act, is also aligned to the definition of 'arrangement' under the general anti-avoidance provisions (s 80A to s 80L of the Act), thereby providing SARS with an alternative basis for assessment if the transfer pricing (s 31) basis of assessment fails.

5.2. **How should the South African transfer pricing legislation be improved?**

The following is submitted on how the South African transfer pricing legislation can be improved:

SARS should consider incorporating the *OECD Transfer Pricing Guidelines* in the primary legislation, being s 31 of the Act, instead of merely referring to them in the outdated SARS *Practice Note 7* and the draft Interpretation Note for thin capitalisation which are not legally binding documents (above in part 2.4.2 of this report). If the *OECD Transfer Pricing Guidelines* are included in the legislation, they will be legally binding, and guidance can be obtained directly from the *OECD Transfer Pricing Guidelines*, which are considered to be

international best practice, as can be seen from the *Unilever Kenya Ltd* case (above in part 3.4 of this report).

India (above in part 3.6.2 of this report) and the United Kingdom (above in part 3.11.2 of this report) have limited the transfer pricing adjustment to upward/positive transfer pricing adjustments. South Africa should consider where it should introduce a limitation to the transfer pricing adjustment; however this may have an adverse effect on direct foreign investment.

India and the United Kingdom have introduced domestic transfer pricing rules (above in part 3.16 of this report). An example of this tax arbitrage would be where a local taxpayer who is in a tax loss position earns excessive non-arm's length revenue from the provision of services or sale of goods to a domestic/local connected party who obtains excessive deductions. While there may be provisions in the Act which could possibly be used to curb this tax arbitrage, such as the 'in the production of income test' in s 11(*a*) that can be applied to certain expenditure that is excessive as a result of it not being market related (Haupt 2016:139); s 20A providing that the assessed loss of certain trades should be ring-fenced; s 103(2) which disallows the utilisation of assessed losses when there is a change in shareholding of the entity or an agreement which results in income in the said entity; or s 80A being the general anti-avoidance provision. Further research should be performed on this aspect within South Africa to determine whether there is a need to introduce domestic transfer pricing legislation.

Advance pricing agreements were suggested by the Katz Commission, nevertheless, 21 years later this process has still not been implemented (above in part 2.1 of this report). SARS should consider introducing advance pricing agreements into the transfer pricing legislation which will provide certainty to taxpayers and foreign multinational enterprises. It may possibly also attract more foreign direct investment. Advance pricing agreements could also eliminate lengthy audit periods as the assumptions, the most appropriate method and the adjustments are agreed upon upfront, and SARS will only be required to perform an annual audit (should it choose this method as recommended by the OECD, discussed above in part 4.2.2 of this report) to ensure that the taxpayer is complying with the advance pricing agreement. This is an area where further research can be performed to determine whether it is feasible to introduce advance pricing agreements, taking into consideration the available staff with sufficient transfer pricing knowledge.

The South African country-by-country reporting regulations were finalised and approved in December 2016 (above in part 2.4.4 of this report). Only time will tell whether the country-by-

country reporting is an effective tool or not, not only for South Africa but for all jurisdictions which are implementing these regulations globally.

5.3. **Penalties relating to transfer pricing adjustments**

There are no specific penalties which are imposed for the South African transfer pricing regulations.

All three countries evaluated (Kenya, India and the United Kingdom), as is the case in South Africa, refer to the general penalty provisions for under-reported income (above in part 3.16 of this report). It is submitted that the major problem identified with the South African understatement penalty (in terms of s 223 of the Tax Administration Act) is the subjectivity of the 'behaviours' which are selected in order to impose the penalty. The author is of the view that if a specific penalty is imposed on a transfer pricing adjustment made by SARS, it may deter taxpayers from incorrectly calculating the arm's length consideration, therefore a specific transfer pricing penalty should be introduced. This penalty could be based on a percentage of the transfer pricing adjustment or a tiered penalty based on the value of the 'affected transaction' should be implemented.

Furthermore, the penalty to be imposed (in terms s 210 and s 211 of the Tax Administration Act) for non-compliance with documentation retention requirements is too low. It is submitted that a fixed penalty of a higher amount or a percentage based penalty (as is the case in India indicated above in part 3.7 of this report) should be imposed on the taxpayer to enforce compliance with documentation retention.

5.4. **How should SARS' guidance be improved?**

The following is submitted on how SARS' guidance can be improved:

SARS should provide appropriate current guidance on thin capitalisation, with only a draft Interpretation Note (SARS 2013c) having being released in 2013 and no subsequent re-draft for comment. This is most disturbing as it leaves taxpayers in limbo as to how to determine what 'arm's length' is in relation to thin capitalisation. Furthermore, in the draft Interpretation Note there are no safe harbours provided which can be beneficial to include for both the taxpayers and SARS as if there are safe harbours in place, it is less time consuming to audit and is administratively less burdensome for the taxpayer.

The much talked about Interpretation Note on s 31 (Joubert *et al*2016:2) should be drafted and released by SARS as soon as possible. This will provide SARS with the opportunity to update outdated *Practice Note 2* and *Practice Note 7* and to provide more appropriate guidance to taxpayers based on the updated 2010 OECD guidelines as well as incorporate and address issues of base erosion and profit shifting.

If SARS does not incorporate the *OECD Transfer Pricing Guidelines* into the Act, at least one legally binding general ruling, in term of s 89 of the Tax Administration Act should be executed on s 31 of the Act (Davis Tax Committee BEPS Sub-Committee 2014b:16-17), for the sake of providing legal status to the principles included in Practice Notes or Interpretation Notes dealing with the provisions of s 31 of the Act.

India and the United Kingdom have very comprehensive guidance on each section of the relevant transfer pricing provisions as well as providing examples relating to definitions used. South Africa should use this approach in the drafting of the impending Interpretation Note dealing with the provisions of s 31 of the Act.

5.5. **Other considerations**

It is submitted that SARS should consider moving to a self-assessment system as soon as possible which will assist them in extending the original prescription period, in terms of s 99 of the Tax Administration Act, from 3 years to 5 years. This will afford SARS additional time to conduct detailed risk assessments and to perform more in-depth audits of multinational taxpayers.

It is further submitted that for SARS to ensure that efficient and comprehensive audits are performed within the necessary time-frames, which are currently very short, it is crucial for SARS to employ sufficient transfer pricing staff and provide them with sufficient training in order to enhance their transfer pricing knowledge and skill.

While South Africa can make use of case law in other jurisdictions, it is the author's view that SARS should take cases to court in order to provide case law and to confirm the arm's length principle as well as other principles for South African transfer pricing purposes.

Comparable data is a major problem for most developing countries (OECD2014:3), like South Africa. While South Africa makes use of European comparables (Joubert *et al* 2016:3), geographical adjustments and other adjustments are required to be made to make the data more

reliable and relevant to South Africa. The OECD has made possible recommendations with regard to this problem, none of which provides a concrete solution, in the author's view, as further research is still being conducted (OECD 2014:9-11). This may be an area where further research can be performed to determine whether there is an appropriate method for South Africa to readily obtain reliable local comparable data.

5.6. **Overall conclusion**

From the research conducted in this report, it can be seen that there are improvements which can be made to the South African transfer pricing provisions, guidance and the related administration of the transfer pricing provisions. The author has also identified areas where further research can be conducted to determine whether it is feasible for SARS to consider and implement new or amended provisions that could possibly enhance the transfer pricing legislation.

Appendix 1: South African transfer pricing legislation (s 31 of the Act)

31. Tax payable in respect of international transactions to be based on arm's length principle.—(1) For the purposes of this section—

"affected transaction" means any transaction, operation, scheme, agreement or understanding where—

(a) that transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected between or for the benefit of either or both—

(i) (*aa*) a person that is a resident; and

(*bb*) any other person that is not a resident;

(ii) (*aa*) a person that is not a resident; and

(*bb*) any other person that is not a resident that has a permanent establishment in the Republic to which the transaction, operation, scheme, agreement or understanding relates;

(iii) (*aa*) a person that is a resident; and

(*bb*) any other person that is a resident that has a permanent establishment outside the Republic to which the transaction, operation, scheme, agreement or understanding relates; or

(iv) (*aa*) a person that is not a resident; and

(*bb*) any other person that is a controlled foreign company in relation to any resident,

and those persons are connected persons in relation to one another; and

(b) any term or condition of that transaction, operation, scheme, agreement or understanding is different from any term or condition that would have existed had those persons been independent persons dealing at arm's length;

"financial assistance" includes any—

(a) debt; or

(b) security or guarantee.

(2) Where—

(*a*) any transaction, operation, scheme, agreement or understanding constitutes an affected transaction; and

(*b*) any term or condition of that transaction, operation, scheme, agreement or understanding—

(i) is a term or condition contemplated in paragraph (*b*) of the definition of "affected transaction"; and

(ii) results or will result in any tax benefit being derived by a person that is a party to that transaction, operation, scheme, agreement or understanding,

the taxable income or tax payable by any person contemplated in paragraph (*b*) (ii) that derives a tax benefit contemplated in that paragraph 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.

(3) To the extent that there is a difference between—

(*a*) any amount that is, after taking subsection (2) into account, applied in the calculation of the taxable income of any resident that is a party to an affected transaction; and

(*b*) any amount that would, but for subsection (2), have been applied in the calculation of the taxable income of the resident contemplated in paragraph (*a*),

the amount of that difference must, if that person is a resident and the other person to the affected transaction is a person as contemplated in paragraph (*a*) (i) (*bb*) or (*a*) (iii) (*bb*) of the definition of "affected transaction"—

(i) if that resident is a company, be deemed to be a dividend consisting of a distribution of an asset *in specie* declared and paid by that resident to that other person; or

(ii) if that resident is a person other than a company, be deemed, for purposes of Part V, to be a donation made by that resident to that other person,

on the last day of the period of six months following the end of the year of assessment in respect of which that adjustment is made: Provided that where the amount of that difference was prior to 1 January 2015 deemed to be a loan that constitutes an affected transaction, so much of that loan as has not been repaid before 1 January 2015 must—

(*a*) if that resident is a company, be deemed to be a dividend consisting of a distribution of an asset *in specie* that was declared and paid by that resident to that other person; or

(*b*) if that resident is a person other than a company, be deemed, for purposes of Part V, to be a donation made by that resident to that other person,

on 1 January 2015.

(4) For the purposes of subsection (2), where any transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected as contemplated in that subsection in respect of—

(*a*) the granting of any financial assistance; or

(*b*) intellectual property as contemplated in the definition of "intellectual property" in section 23I (1) or knowledge,

"connected person" means a connected person as defined in section 1: Provided that the expression "and no holder of shares holds the majority voting rights in the company" in paragraph (*d*) (v) of that definition must be disregarded.

(5) Where any transaction, operation, scheme, agreement or understanding has been entered into between a headquarter company and—

(*a*) any other person that is not a resident and that transaction, operation, scheme, agreement or understanding is in respect of the granting of financial assistance by that other person to that headquarter company, this section does not apply to so much of that financial assistance that is directly applied as financial assistance to any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting rights;

(b) any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting

rights and that transaction, operation, scheme, agreement or understanding comprises the granting of financial assistance by that headquarter company to that foreign company, this section does not apply to that financial assistance;

(*c*) any other person that is not a resident and that transaction, operation, scheme, agreement or understanding is in respect of the granting of the use, right of use or permission to use any intellectual property as defined in section 23I (1) by that other person to that headquarter company, this section does not apply to the extent that the headquarter company—

(i) grants that use, right of use or permission to use that intellectual property to any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting rights; and

(ii) does not make use of that intellectual property otherwise than as contemplated in subparagraph (i); or

*(*d) any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting rights and that transaction, operation, scheme, agreement or understanding comprises the granting of the use, right of use or permission to use any intellectual property as defined in section 23I (1) by that headquarter company to that foreign company, this section does not apply to that granting to that foreign company.

(6) Where any transaction, operation, scheme, agreement or understanding that comprises the granting of—

(*a*) financial assistance; or

(*b*) the use, right of use or permission to use any intellectual property as defined in section 23I,

by a person that is a resident (other than a headquarter company) to a controlled foreign company in relation to that resident or in relation to a company that forms part of the same group of companies as that resident, this section must not be applied in calculating the taxable income or tax payable by that resident in respect of any amount received by or accrued to that resident in terms of that transaction, operation, scheme, agreement or understanding if—

(i) . . . . . .

(ii) that controlled foreign company has a foreign business establishment as defined in section 9D (1); and

(iii) the aggregate amount of tax payable to all spheres of government of any country other than the Republic by that controlled foreign company in respect of any foreign tax year of that controlled foreign company during which that transaction, operation, scheme, agreement or understanding exists is at least 75 per cent of the amount of normal tax that would have been payable in respect of any taxable income of that controlled foreign company had that controlled foreign company been a resident for that foreign tax year: Provided that the aggregate amount of tax so payable must be determined—

(*aa*) after taking into account any applicable agreement for the prevention of double taxation and any credit, rebate or other right of recovery of tax from any sphere of government of any country other than the Republic; and

(*bb*) after disregarding any loss in respect of a year other than that foreign tax year or from a company other than that controlled foreign company.

(7) Where—

(*a*) any transaction, operation, scheme, agreement or understanding has been entered into between a company that is a resident (for purposes of this subsection referred to as "resident company") or any company that forms part of the same group of companies as that resident company and any foreign company in which that resident company (whether alone or together with any other company that forms part of the same group of companies as that resident company) directly or indirectly holds in aggregate at least 10 per cent of the equity shares and voting rights and that transaction, operation, scheme, agreement or understanding comprises the granting of financial assistance that constitutes a debt owed by that foreign company to that resident company or any company that forms part of the same group of companies as that resident company;

(*b*) that foreign company is not obliged to redeem that debt in full within 30 years from the date the debt is incurred;

(c) the redemption of the debt in full by the foreign company is conditional upon the market value of the assets of the foreign company not being less than the market value of the liabilities of the foreign company; and

(d) no interest accrued in respect of the debt during the year of assessment,

this section must not apply to that debt.

Appendix 2: Overview of the Indian transfer pricing provisions in the Indian Income-tax Act and the related rules

Description	Section of the Indian Income-tax Act	The rules
Coverage and computation in terms of the arm's length price	Section 92	N/a
Definitions	Sections 92A (Associated enterprise); 92B (International transaction); 92BA (Specified domestic transactions); and 92F (Accountant, Arm's length price, Enterprise, Permanent establishment, Specified date, Transaction)	Rule 10A
Methods of computation of the arm's length price	Section 92C(1) to 92C(2B)	Rules 10AB (any other method for determining the arm's length price), 10B and 10C
Administrative provisions	Section 92C(3) (Determination of the arm's length price with the information on hand), 92C(4) (Computation of the assessee's total income based on the determined arm's length price); 92CA (Transfer pricing officer) and 144 (Best judgement assessment)	N/a
Safe harbour rules	Section 92CB	Rules 10TA to 10TG
Advance pricing agreements	Section 92CC and 92CD (Effect of advance pricing agreement)	Rules 10F to 10T
Maintenance of information and documents	Section 92D	Rule 10D
Accountant's' Report	Section 92E	Rule 10E and Form 3CEB
Penalties	Sections 270A (Under-reporting and misreporting of income); 271AA (Failure to keep and maintain information and documents in respect of certain transactions); 271BA; 271G (Failure to furnish information or document under s 92D); and 271(1) read with explanation 7	N/a
Transaction with person located in notified jurisdictional area	Section 94A	Rule 21AC and Form 10FC
Base erosion and profit shifting	Section 286	N/a

(RSM India 2016:24)

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