SCHOOL OF ACCOUNTANCY

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PRESCRIPTIVENESS OF THE SOUTH AFRICAN TRANSFER PRICING TAX LEGISLATION IN PROVIDING GUIDANCE ON HOW TO TRANSACT AT AN ARM'S-LENGTH PRICE

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DECLARATION

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

Puleng Owen Manyaka

Signed:………………………..

Date:……………………………..

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LIST OF ABBREVIATIONS

CCA	Cost Contribution Arrangements
CGT	Capital Gains Tax
DTI	Department of Trade and Industry
IT14	Income Tax Return for Companies
IRC	Internal Revenue Codes
IRS	Internal Revenue Service
OECD	Organisation of Economic Corporation and Development
SARB	South African Reserve Bank
SARS	South African Revenue Service
UK	United Kingdom
US	United States of America

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ABSTRACT

Transfer pricing is a significant taxation problem facing both tax authorities and multinational enterprises. Tax authorities around the world regulate transfer pricing through tax legislation, which requires that cross-border transactions within multinational enterprises be at arm's-length. A number of countries in the international community have amended their transfer pricing tax legislation to be prescriptive by including regulations in their legislation on how to transact at arm's-length price.

This research study presents an argument that the South African transfer pricing tax legislation is non-prescriptive as it does not have regulations on how to transact at arm's-length price. With reference to the transfer pricing guidelines issued by the Organisation of Economic Development and Corporation and the experience of the United States of America in the enforcement of transfer pricing, this research study examines whether or not the South African transfer pricing tax legislation should be amended to be prescriptive by including regulations on how to transact at arm's-length price.

The research findings reveal that to a certain extent the South African transfer pricing tax legislation is consistent with the transfer pricing guidelines issued by the Organisation of Economic Development and Corporation, but to a certain extent it is not. The research findings also reveal that non-prescriptive legislation has in the past created a problem in certain countries. Furthermore, the research findings reveal through an analysis of the United States of America's transfer pricing enforcement experience, that prescriptive transfer pricing tax legislation in a tax system has a positive impact.

Recommendation is therefore made in this research study that the South African transfer pricing tax legislation should be amended to be prescriptive by including regulations on how to transact at arm's-length price.

Keywords of the study: arm's-length price, arm's-length principle, income tax, IRS, multinational enterprise, non-prescriptive, OECD, Practice Note 7, prescriptive, SARS, section 31, section 482, South Africa, tax legislation, taxation, tax law, tax authority, transfer pricing, transfer pricing methods, United States of America.

CHAPTER 1: INTRODUCTION

1.1 BACKGROUND OF THE STUDY

The term 'transfer pricing' refers to the situation where related parties price their transactions between themselves, without reference to the market or other legitimate commercial considerations, in order to reduce their nominal profits and thereby reduce their income tax obligations (Interim report of the Commission of inquiry into certain aspects of the tax structure of South Africa, 1994: 231).

Both the tax authorities and multinational enterprises around the world, view transfer pricing to be the dominant tax problem (Ernst & Young, 2005: 14). The abuse of transfer pricing deprives governments of their fair share of taxes from the profits generated by multinational enterprises. For this reason, transfer pricing has drawn the attention of tax authorities around the world.

In an attempt to deal with transfer pricing and obtain their fair share of tax from multinational enterprises, tax authorities are addressing transfer pricing on a formal basis. Certain tax authorities have responded with comprehensive tax legislation to regulate transfer pricing (Fernandez and Pope, 2002: 120). Research shows that there is an increase in the number of countries implementing and modifying transfer pricing tax legislation (Ernst & Young, 2005: 6).

Transfer pricing tax legislation in some countries embraces the arm's-length principle as promulgated in the transfer pricing guidelines issued by the Organisation for Economic Cooperation and Development (OECD) (Tyrrall and Atkinson, 1998: 22). The OECD transfer pricing guidelines (hereafter called the OECD guidelines), constitute the international standard and are founded on the arm's-length principle (Carlderon, 2007: 9).

The term 'arm's-length principle' refers to 'a process by which the transfer price between affiliated companies is determined by using comparables either of the same product sold by one of the affiliated parties to an unrelated party, of the same product bought by an affiliated party from an unrelated party, or of the same product sold between two parties unrelated to the affiliated parties and to each other' (Avi-Yonah, 2007: 3).

A number of countries have adopted the OECD guidelines' concepts when designing provisions on how to transact in accordance with the arm's-length principle (United Nations, 1999: 8). Although a number of countries' provisions on how to transact at arm's-length price are based on the OECD guidelines' concepts, the way in which these provisions are implemented is different in each country (Amerighi, 2004: 3). Some countries have included these provisions in their transfer pricing tax legislation and, by so doing, their legislation is considered to be 'prescriptive'[1] in providing guidance on how to transact at arm's-length price.

Meanwhile, other countries have not included these provisions in their transfer pricing tax legislation but provide them separately from the legislation as guidelines or practice notes. By so doing, their transfer pricing tax legislation is considered to be 'non-prescriptive'[2] in providing guidance on how to transact at arm's-length price.

The analysis below of the situation on how transfer practices are regulated within the international community, reveals that non-prescriptive transfer pricing tax legislation is no longer preferred and some countries are amending their legislation to be prescriptive. In other countries the analysis reveals that non-prescriptive transfer pricing tax legislation created problems, especially with regard to the court disputes between the tax authorities and taxpayers on matters involving the determination of the arm's-length price.

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[1] The Collins English Dictionary explains 'prescriptive' as the approach of telling people exactly what they should do rather than providing them with suggestions. [http://dictionary.reverso.net/english-cobuild] (12 February 2009). The *Oxford English Dictionary* explains 'prescriptive' as imposed methods, laws, rules or regulations which are legally established, direct or explicit on how something should be done. [http://www.askoxford.com/dictionaries] (12 February 2009). Therefore, prescriptive transfer pricing tax legislation refers to legislation with provisions on how to transact at arm's-length price, that is legislation which is direct or explicit on how to transact at arm's-length price.

[2] 'Non-prescriptive' means the opposite of prescriptive. Therefore, 'non-prescriptive' transfer pricing tax legislation refers to legislation with no provisions on how to transact at arm's-length price, that is legislation that is not direct or explicit on how to transact at arm's-length price.

In the year 1968, the United States of America (US) amended its section 482 of Article 4 of the Internal Revenue Code (hereafter referred to as 'section 482') to be prescriptive after the treasury department contended that the section was not effective in protecting the US tax jurisdiction against transfer pricing practices (Avi-Yonah, 2007: 6; IRS, 1999: 3; Tyrrall and Atkinson, 1998: 138).

Prior to section 482 being amended to be prescriptive, the US courts developed their own principle tests when they were analysing and deciding what constitutes an arm's-length price in the transfer pricing cases, as section 482 had no formal provisions on how to transact at arm's-length price (Avi-Yonah, 2007: 6).

This resulted in the US courts being inconsistent in reaching the decisions on transfer pricing cases involving the arm's-length price. It was after section 482 was amended to be prescriptive by having provisions on how to transact at arm's-length price, that formal basis was created which the US courts now follow when analysing and deciding transfer pricing cases dealing with the arm's-length price (Avi-Yonah, 2007: 8, 9).

In the year 1982, after the *Commonwealth Aluminium Corporation* [3] case judgment, the Australian Tax Office amended their section 136 to be prescriptive. In this case, the Australian Tax Authority applied section 136 to adjust taxpayer's profits. Section 136 at that time allowed the Australian Commissioner of Taxation to adjust the profits gained by multinational enterprises from cross border transactions involving transfer pricing. The section did not have any provision or regulations for the arm's-length calculations. The Commissioner of Taxation could not justify or prove to the court on what basis of the legislation he arrived at the transfer pricing profit adjustments. As a result, the Australian High Court gave judgment in favour of the taxpayer (Smith, 1990:12).

It was after this judgment that the Australian taxation review committee recommended that section 136 be replaced by a new section because it had been

[3] *80 ATC 4371,*

rendered less effective against transfer pricing in this case. After this judgment the arm's-length principle embodied in the OECD guidelines, was incorporated into section 136 under division 13 (Smith, 1990:12).

In the year 1997, Mexico amended its transfer pricing tax legislation to be prescriptive in providing guidance on how to transact at arm's-length price. Although the Mexican transfer pricing tax legislation required taxpayers to transact at arm's-length price, it had no regulations on how to fulfil such a transaction. The Mexican transfer pricing tax legislation is now complemented by regulations on how to transact at arm's-length price which are based on the OECD guidelines (MacGregor, 2000: 3).

Other countries on the South American continent, such as Argentina, Brazil and Venezuela, have also adopted prescriptive transfer pricing tax legislation (Deloitte Touché Tohmatsu, 2001). The same transfer pricing developments taking place on the South American continent are taking place on the European and Asian continents. A number of European and Asian continents have also amended their transfer pricing tax legislation to be prescriptive.

In the year 1996, Denmark amended its transfer pricing tax legislation to be prescriptive. In the year 1998, France and China also amended their transfer pricing tax legislation to be prescriptive. The transfer pricing tax legislation of all three countries now contains regulations on how to transact at arm's-length price which are based on the OECD guidelines (Tyrrall and Atkinson, 1998: 22).

In the year 1999, the United Kingdom (UK) replaced their old transfer pricing tax legislation with new legislation. Section 770-3 of the Income and Corporation Taxes Act was replaced with Schedule 28AA of the Income and Corporation Taxes Act (Rolfe, 2003: 501).

The reason for the amendment was that section 770-3 was regarded as discretionary rather than mandatory and therefore not effective in ensuring that taxpayers complied with the arm's-length price requirements. Schedule 28AA of the Income and

Corporation Taxes Act 88 is now complemented by regulations on how to transact at arm's-length price which are based on the OECD guidelines (Tyrrall and Atkinson, 1998:134).

In the year 2002, after the Supreme Court, *36466*[4], case judgment, the Dutch transfer pricing tax legislation was amended to be prescriptive. This case involves the taxpayer who was a car importer and had imported various products, manufactured by its international group, for resale to distributors. The Dutch tax authorities studied the import prices of independent Dutch car importers. They challenged the taxable income of the taxpayer on the basis that the results of the study showed that the realised gross margin on the import activity was lower than those of non-related car importers. The tax authority, therefore, argued that the car importer's transfer prices did not meet the arm's-length standard (Van Herksen and Van der Lander, 2002: 192; Van Dam and Sinx, 2002: 188; Rolfe, 2003: 393).

Based on this, the Dutch tax authorities adjusted the taxable income of the Dutch car importer. The Dutch transfer pricing tax legislation, at that time, lacked specific rules on how to calculate the inter-company prices and the arm's-length requirements. The Dutch supreme court ruled against the Dutch tax authority as they could not prove from the legislation, on what basis they had adjusted the car importer's profits. After the judgment in this case, the arm's-length principle embodied in the OECD guidelines was codified in the Dutch Corporate Income Tax Act (Van Herksen and Van der Lander, 2002: 192; van Dam and Sinx, 2002: 188; Rolfe, 2003: 393).

Having analysed what the situation is in the international community, the question then is: what is the situation in South Africa with regard to transfer pricing tax legislation and how does it apply to the transfer pricing practices?

[4] *36 466,* HR 28 June 2002

The South African transfer pricing tax legislation is section 31 of the Income Tax Act 58 of 1962 (hereafter referred to as 'the Act'). As in other countries' transfer pricing tax legislation, section 31 also requires that taxpayers should transact at arm's-length in certain situations. Although section 31 embraces the arm's-length principle, it is not complemented by regulations on how to transact at arm's-length price.

Guidelines on how to transact at arm's-length price are, however, contained separately in Practice Note 7. The problem is that all the practice notes issued by the South African Revenue Service (SARS) are not intended to be prescriptive and therefore cannot be legally enforced (Practice Note 7:6). As section 31 of the Act does not have provisions on how to transact at arm's-length and Practice Note 7 is not binding on taxpayers, the South Africa transfer pricing tax legislation is regarded as non-prescriptive.

This situation could result in similar problems to those identified in the above analysis happening in South Africa, whereby inconsistent decisions by the courts caused revenue authorities to lose cases because they could not justify or substantiate the basis for their adjustment from the legislation.

The question now remains whether or not section 31 of the Act should be complemented by regulations on how to transact at arm's-length price.

1.2 RESEARCH PROBLEM

1.2.1 The statement of the problem

This research study examines whether or not the South African transfer pricing tax legislation should be amended to be prescriptive by including regulations on how taxpayers should transact at arm's-length price.

1.2.2 The sub-problems

The first sub-problem relates to determining how taxpayers in South Africa are required to transact at arm's-length prices in the absence of prescriptive transfer pricing tax legislation.

In order to establish how taxpayers are supposed to transact at arm's-length price in the absence of prescriptive transfer pricing tax legislation, a normative study is conducted on the background and history of transfer pricing tax legislation in South Africa, section 31 of the Act, the arm's-length principle, guidance on how to transact at arm's-length price as is contained in Practice Note 7, the Income Tax return (IT14 return) and the South African tax treaties on business profits and associated enterprises. In analysing section 31 of the Act the issue is, what are the provisions within section 31 of the Act providing guidance on how taxpayers should transact at arm's-length price and what are the challenges in fulfilling the arm's length requirements in terms of those provisions. In analysing Practice Note 7, the South African tax treaties and the IT14 return, the issue is what are the challenges that taxpayers faces in fulfilling the requirements of Practice Note 7, the South African tax treaties and the IT14 return in order to comply with section 31 of the Act. Furthermore, an analysis is conducted of the South African tax case law on what constitute an arm's-length transaction. A comparative analysis of the South African tax case law principles is made, as applied by the courts in determining what constitutes an arm's-length transaction with the arm's length principle in Practice Note 7.

The second sub-problem relates to determining whether Practice Note 7 in its current status is consistent with the current status of the OECD guidelines, and whether, as a result of being consistent or not with the current status of the OECD guidelines, Practice Note 7 should be included as the regulations on how to transact at arm's-length price in the South African transfer pricing tax legislation, in order to amend the legislation so that it becomes prescriptive.

Should Practice Note 7 be included in section 31 of the Act as the regulations on how to transact at arm's-length price, this action will automatically result in making section 31 to be prescriptive on how taxpayers should transact at arm's-length price. Research shows that a number of countries' regulations on how to transact at arm's-length price are based on the OECD guidelines (Sauvant and Roffe, 1999: 15); as is Practice Note 7 (Practice Note 7: 6). The situation in South Africa is that, in the absence of the transfer pricing tax legislation that is non-prescriptive, taxpayers can only rely on Practice Note 7 in order to comply with section 31 of the Act. The issue, however, remains whether Practice Note 7 is consistent with the transfer pricing international standards promulgated in the OECD guidelines in their updated form.

A further argument is that the OECD guidelines recommends that although a country's transfer pricing guidelines might be based on the OECD guidelines, the country's transfer pricing guidelines should still be consistent with the country's domestic transfer pricing legislation (OECD guidelines, Para 16). The question is, to what extent is Practice Note 7 consistent with section 31 of the Act? Research further reflects that since the introduction of Practice Note 7 in August 1999, there have been several updates and developments on the OECD guidelines with the issuing of draft discussion papers suggesting changes in the OECD guidelines on certain issues that should be dealt with (OECD, Discussion Draft Part I: 2004; OECD, Discussion Draft Part II: 2008; OECD Discussion Draft Part III: 2004; OECD Discussion Draft Part IV: 2004; OECD Discussion Draft Aspect of Business Restructuring: 2008; OECD Discussion Draft Transactional Profit Methods: 2008). The question is, has Practice Note 7 noted these updates and developments? A comparable analysis between Practice Note 7 and the OECD guidelines is conducted to determine if Practice Note 7, in its current state, is consistent with the OECD guidelines.

The third sub-problem relates to determining what the implications are of having non-prescriptive transfer pricing tax legislation and of changing from non-prescriptive to prescriptive transfer pricing tax legislation by looking at the US transfer pricing experiences.

The experience of the US in the enforcement of transfer pricing is analysed to investigate the implications of having non-prescriptive transfer pricing tax legislation and the implications of changing from non-prescriptive to prescriptive transfer pricing tax legislation. The transfer pricing case law in the US prior and subsequent to the transfer pricing tax legislation being amended to be prescriptive, is analysed to assess the implications of having non-prescriptive transfer pricing tax legislation and the impact of changing from non-prescriptive to prescriptive.

The reason for selecting the US as a case study is based on the fact that the US is a significant global economic player. Secondly, it is reported that the US is the first country to implement transfer pricing tax legislation and as a result has a number of years experience in enforcing transfer pricing (Desai, 2002: 4). The third reason for the selection of the US is that the US transfer pricing tax legislation has had a significant influence to the development of similar tax legislation in a number of countries around the world, and also had a significant influence on the development of the OECD guidelines (Tyrrall and Atkinson, 1998:137).

1.3 RESEARCH METHODOLOGY

A qualitative case study research methodology is adopted to conduct this research study, with the literature review, documentation analysis and interviews used as methods of collecting the data used in this research study. A content analysis methodology was adopted to analyse the data and the research study findings. The research study included various forms of literature, ranging from books, journal articles, academic articles, policies, guidelines, court cases and income tax legislations. Interviews with certain tax law professionals were conducted to gain their views on the research question.

1.4 CHAPTER OUTLINE

The research study is divided into 7 chapters and the outline is as follows:

1.4.1 Chapter 1: Introduction

This chapter presents the background of the study, problem statement, research method and the structure of the report.

1.4.2 Chapter 2: The Transfer Pricing Tax Legislation in South Africa.

The purpose of this chapter is to address the first sub-problem by analysing the transfer pricing tax legislation in South Africa. The chapter discusses the background and the history of transfer pricing tax legislation in South Africa, section 31 of the Act, the arm's-length principle, the guidance on how to transact at arm's-length price as is contained in Practice Note 7, the IT14 returns and the South African tax treaties on business profits and associated enterprise. The chapter also discusses the South African tax case law on what constitutes an arm's-length transaction.

1.4.3 Chapter 3: Practice Note 7 and the OECD Guidelines

The purpose of this chapter is to address the second sub-problem of the research study. The chapter discusses the history and background of Practice Note 7 and the OECD guidelines, the contents of Practice Note 7 and the OECD guidelines. The chapter further discusses the developments and updates in the OECD guidelines. The chapter is concluded by conducting a comparable analysis between Practice Note 7 and the OECD guidelines.

1.4.4 Chapter 4: The Transfer Pricing Tax Legislation in the US.

The purpose of this chapter is to address the third sub-problem by analysing the transfer pricing enforcement experiences of the US.

The chapter discusses the background and history of section 482. The Chapter also discusses other transfer pricing compliance provisions put in place in the US such as penalty provisions, documentation provisions, tax return, and tax treaties provisions. The chapter discusses the relationship between the US transfer pricing regulations and the OECD guidelines, and further discusses the implications of non-prescriptive transfer pricing tax legislation in the US prior to section 482 being amended to be prescriptive, and the subsequent impact of section 482's amendment to be prescriptive. The transfer pricing case law in the US prior and subsequent to section 482 being amended to be prescriptive, is analysed to assess the implications of having non-prescriptive transfer pricing tax legislation and the effect of changing from non-prescriptive to prescriptive legislation.

1.4.5 Chapter 5: Research Methodology

The purpose of this chapter is to outline the research methodology by discussing the research designed and the specific research methods used to conduct the research study. The chapter specifically discusses the research method adopted, research type, methods adopted for data collection and methods adopted for data analysis.

1.4.6 Chapter 6: Research Findings

The purpose of this chapter is to analyse and present the research findings.

1.4.7 Chapter 7: Conclusion

This chapter concludes the research study. The chapter confirms the problem statement and sub-problems, provides a brief summary of previous chapters, interprets the research findings and provides recommendations. The conclusion discusses the contribution of this research study by comparing it with previous studies, and lastly provides areas for possible further research studies.

CHAPTER 2: TRANSFER PRICING TAX LEGISLATION IN SOUTH AFRICA

2.1 INTRODUCTION

The purpose of this chapter is to address the first sub-problem of the research study. To this end the chapter analyses the evolution of the transfer practices, background and history of the transfer pricing tax legislation in South Africa. The chapter analyses section 31 of the Act, the updates and changes and the subsections within this section of the Act. In analysing section 31 of the Act, a discussion is presented on the extent of the provisions made on how to transact at arm's-length price, and what the challenges are that face taxpayers in South Africa with regard to transacting at arm's-length price.

The chapter analyses the arm's-length principle, challenges with regard to the application thereof and some practical consideration which should be taken into account when applying this principle. The chapter illustrates through a hypothetical case study, how taxpayers in South Africa are supposed to transact at arm's-length price by following Practice Note 7. The chapter discusses also the arm's-length principle approach in the South African treaties on permanent establishment of business profit and associated profit and in the IT14 returns. In analysing Practice Note 7, the South African treaties and the IT14 returns, the chapter also highlights to what extent taxpayers in South Africa are challenged in transacting at arm's-length price.

The chapter analyses the South Africa tax case law principles on what constitutes an arm's-length transaction. A comparative analyses of the South Africa case law principles is made, as applied by the courts in determining what constitutes an arm's-length transaction with the arm's length principle in Practice Note 7.

2.2 BACKGROUND AND HISTORY OF THE TRANSFER PRICING TAX LEGISLATION IN SOUTH AFRICA

As pointed out in chapter 1, transfer pricing is one of the significant problems faced by the multinational enterprises and tax authorities. One of the reasons for transfer pricing practices is globalisation of trading. The World Trade Organisation estimates that inter-company transactions account for as much as 50% of all global trade. John Neighbour of the OECD places this figure even higher, estimating that about 60% of world trade takes place within the multinational enterprises (OECD Observer, 2002).

South Africa is also part of this global scene, and since its re-emergence into the international market, rapid expansion of international trade with wide-ranging changes in the volume and complexity of the country's commerce was brought to South Africa (Practice Note 7, Para 2.4).

Since the year 1996, the South African Trade and Industry department (DTI) has reported an increase in trading activities between South Africa and the rest of the world with the largest trading partners being Europe, Asia and America (DTI South African Trade Statistics, 2006). Although trading between South Africa and the international community is important as it creates economic growth for the country, it has also opened the way for abusive transfer pricing.

Prior to South Africa becoming a trading partner within the international community, the abuse of trading activities through tax avoidance was regulated through the exchange controls and other anti-avoidance tax laws. The following is the analysis of how the transfer pricing tax legislation evolved in South Africa.

2.2.1 The Exchange Control Regulations

Prior the year 1995, South Africa was prevented to a great extent by political pressures from trading with the international community. During this period whatever international trade occurred was regulated by the financial rand system under the exchange control regulations of the South African Reserve Bank (SARB). These regulations were designed to prevent manipulation of the currency system in South Africa (Exchange Controls Manual, Updated October, 2006:C1).

Under the financial rand system, the proceeds of local sale or redemption of assets owned by non-residents of South Africa could not be converted into foreign currency at the commercial rand rate of exchange, but had to be retained in South Africa with authorised foreign exchange dealers in the form of financial rand balances (Exchange Controls Manual, Updated October, 2006:C1).

In the year 1995, after South Africa's first democratic elections, the exchange control regulations were loosened to attract foreign investors. As a result, trade between South Africa and the international community increased (Exchange Controls Manual, updated October, 2006:C2).

2.2.2 The Income Tax Act

After the exchange control regulations were loosened the authorities in South Africa became aware that international traders, both domestic and foreign, were able to transfer profits from South Africa, a jurisdiction with high taxes, to other jurisdictions with lower rates (Interim report of the Commission of inquiry into certain aspects of the tax structure of South Africa, 1994: 231). This was because the Act had no specific section addressing transfer pricing transactions. The only relevant provision, section 31 of the Act, at that time covered only trade in commodities, and only where there was an appropriate tax treaty in force.

The general provisions for prevention of tax-avoidance, found in section 103[5] of the Act which has since been replaced by section 80A[6]of the Act, were also ineffective as the legislation against transfer pricing. A commission led by Professor Michael Katz was therefore appointed by the Minister of Finance to do the research global provisions for transfer pricing, and select the appropriate provisions which were considered suitable for South Africa.

The commission looked at a number of tax systems from various different countries and found that four approaches for countering transfer pricing abuses are commonly used. These approaches varied in stringency. (Interim report of the Commission of inquiry into certain aspects of the tax structure of South Africa, 1994: 231):

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[5] Section 103 (1) provided at that time;

'Whenever the Commissioner is satisfied that any transaction, operation or scheme (whether entered into or carried out before or after the commencement of this Act, and including a transaction, operation or scheme involving the alienation of property)–

(*a*) has been entered into or carried out which has the effect of avoiding or postponing liability for the payment of any tax, duty or levy imposed by this Act or any previous Income Tax Act, or of reducing the amount thereof; and

(*b*) having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out –

(i) was entered into or carried out by means or in a manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; or

(ii) has created rights or obligations which would not normally be created between persons dealing at arm's-length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; and

(*c*) was entered into or carried out solely or mainly for the purposes of the avoidance or the postponement of liability for the payment of any tax, duty or levy (whether imposed by this Act or any previous Income Tax Act or any other law administered by the Commissioner) or the reduction of the amount of such liability,

the Commissioner shall determine the liability for any tax, duty or levy imposed by this Act, and the amount thereof, as if the transaction, operation or scheme had not been entered into or carried out, or in such manner as in the circumstances of the case he deems appropriate for the prevention or diminution of such avoidance, postponement or reduction.'

[6] Section 80A is the new anti avoidance provision and provides that an avoidance arrangement is an impermissible avoidance arrangement if its sole or main purpose was to obtain a tax benefit. The three elements of this section are as follows:

a) Abnormality- (section 80A(a)(i), 80A(b) and 80(c)(i);
b) Lack of \commercial substance – (section 80A(a) (ii); or
c) Misuse or abuse of the provisions of the Act (section 80A(c)(ii))

a) The most stringent approach had legislative teeth backed up with formal, detailed and binding regulations as to what constitutes acceptable pricing, and is exemplified by the system of the US.

b) The second approach had legislative teeth and detailed guidelines as to acceptable pricing but does not have formal regulations, and is exemplified by the German system.

c) The third approach also had anti-transfer pricing legislation, but relied on the arm's-length principle to dictate acceptable pricing practices, and is exemplified by the systems of the UK and other countries which rely strongly on OECD guidelines.

d) The fourth approach had no specific transfer pricing legislation and relied on normal, general tax-avoidance preventions and tax law to combat transfer pricing abuse, and is exemplified by the system of the Netherlands.

Consequently, the commission considered the third approach as the most appropriate for South Africa. On 19 July 1995, section 31 of the Act was amended and later in August 1999 Practice Note 7 was also introduced as the SARS Commissioner's view on the transfer pricing practices in South Africa.

2.3 SECTION 31 OF THE ACT

Section 31 of the Act was introduced to prevent tax-avoidance and to control the flow of funds between South Africa and offshore jurisdictions. This section is divided into four subsections and regulates transfer pricing transactions on goods and services between the connected persons. Section 31 of the Act similar to other transfer pricing tax legislation around the world, requires that taxpayers who are regarded as connected persons should transact at the arm's-length price.

The challenge in applying section 31 of the Act is that the section provides meanings and definitions of certain terminologies and explanations of conditions under which this section is applicable, but does not provide the meaning and definitions with regard to the arm's-length price and provisions on how taxpayers should transact at arm's-length.

By virtue of section 31 of the Act not being complemented by these meanings and definitions and also not complemented by provisions on how taxpayers should transact at arm's-length price, it is considered to be non-prescriptive. The following is the analysis of the updates to this section and its subsections:

2.3.1 The Updates and Changes in Section 31 of the Act

Section 31 of the Act has undergone several changes and updates since the year 2007. The first change came in the form of an amendment to the connected persons definition as contained in section 1 and section 31(2) of the Act. The amendment was made by including the word 'group of companies' in the connected persons definition effective from 1 January 2007.

The second amendment constituted a restructuring of section 31 of the Act with the primary change being the removal of the term 'international agreement' effective from 1 October 2007. The third amendment was effected on 1 January 2009 with regard to subsection (1A) of section 31 of the Act.

Even though several amendments were made to section 31 of the Act, these amendments failed to address the issue on how taxpayers should transact at arm's-length price.

2.3.2 Subsection (1) of Section 31 of the Act.

Subsection (1) of section 31 of the Act defines terminologies used in the section and these terminologies are the following:

(a) Goods

Goods is defined in subsection (1) of section 31 of the Act as any corporeal movable things, fixed property, or real rights.

(b) Services

Service is defined in subsection (1) of section 31 of the Act as:

(i) the granting, assignment, cession or surrender of any right, benefit or privilege; the making available of any facility or advantage

(ii) the granting of financial assistance, including a loan, advance or debt, and the provision of any security or guarantee

(iii) the performance of any work

(iv) an agreement of insurance

(v) the conferring of rights to or the use of incorporeal property.

2.3.3 Subsection (1A) of Section 31 of the Act

Subsection (1A) of section 31 of the Act was included under section 31 of the Act to address intellectual property transactions effecting transfer pricing. The purpose for the inclusion of subsection (1A) of section 31 of the Act was to allow the SARS Commissioner to address non arm's-length or below market value transactions involving intellectual property under the transfer pricing provisions, where a company owns greater than 20% of the shares, regardless of the fact that another company holds the majority of the voting rights.

Prior to the introduction of subsection (1A) of section 31 of the Act under the transfer pricing tax legislation, where a company owns greater than 20% of the shares in another company and another company holds the majority voting rights in that other company. The company which owns 20% could not be regarded as the connected person to both the company which holds the majority voting rights, and the other company of which it owns 20% shares.

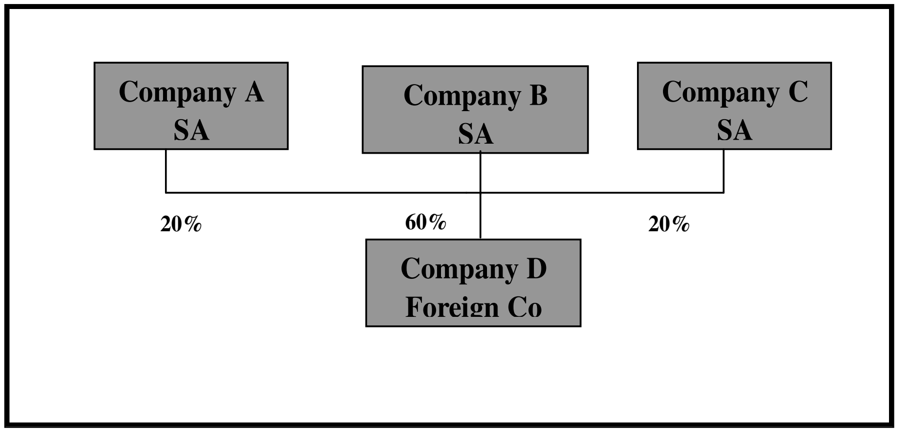
These types of transactions resulted in the abuse of the transfer pricing rules by multinational enterprises when they were entering into transfer pricing transactions involving intellectual properties.

Subsequent to the amendments subsection (1A) of section 31 of the Act provides that;

> '[where] any supply of goods or services has been effected in respect of any intellectual property as contemplated in the definition of "intellectual property" in Section 23I (1) or knowledge, "connected persons" shall mean a connected persons as defined in section 1, provided that the expression "and no shareholder holds the majority voting rights of such company" in paragraph *(d)(v)* of the connected person definition must be disregarded.'

The following hypothetical example illustrates how subsection (1A) of section 31 of the Act applies:

Table 1: Example on how subsection (1A) of section 31 of the Act applies



In this example, because Company B is the majority shareholder in Company D, Company A and C are not connected to Company D in terms of paragraph *(d)(v)* of connected person definition, only Company B and D are. Prior to the inclusion of subsection (1A) of section 31 of the Act under section 31 of the Act, any transfer pricing transaction involving intellectual property effected at values below the market value between Companies A and D, or C and D, would not be subject to section 31 of the Act. The reason being that Company A and C were not regarded as being connected persons in relation to Company D.

The connected person definition in relation to the company as it applies in section 31 of the Act, is discussed later in this chapter.

2.3.4 Subsection (2) of Section 31 of the Act

Subsection (2) of section 31of the Act is regarded as the charging subsection and it empowers the SARS Commissioner to make transfer pricing adjustments when the consideration of the transfer pricing transactions between connected persons is less than, or greater than the arm's-length price. Subsection (2) of section 31 of the Act reads as follows:

'Where any supply of goods or services has been affected -

(a) between -

(i) (aa) a resident
(bb) any other person who is not a resident;

(ii) (aa) a person who is not a resident
(bb) a permanent establishment in the Republic of any other person who is not a resident;

(iii) (aa) a person who is a resident
(bb) a permanent establishment outside the Republic of any other person who is a resident;

(b) between those persons who are connected persons in relation to one another;

(c) at a price which is either -

(i) less than the price which such goods or services might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's-length (such price being the arm's-length price);

(ii) greater than the arm's-length price,

the Commissioner may, for the purpose of this Act in relations to either the acquiror or supplier, in the determination of taxable income of either the acquiror or supplier adjust the consideration in transaction in respect of the transaction to reflect an arm's-length price for goods or services.'

A transaction is subject to subsection (2) of section 31 of the Act provided it meets three conditions. The first condition is with regard to a taxpayer's resident status and a place where the transaction happens. The second condition is that the transaction must be between connected persons. The third condition is that the consideration of the transaction between connected persons must be at arm's-length. These conditions as required in subsection (2) of section 31 of the Act are analysed as follows:

2.3.4.1 The residency status of the taxpayer and the place where a transaction happens

A transaction is subject to subsection (2)*(a)* of section 31 of the Act when it is between a non-resident and a resident, a resident and permanent establishment business activity in the Republic or between non-resident and permanent establishment business activity outside the Republic. Transactions subject to subsection (2)*(a)* of section 31 of the Act were in the past referred to as 'international agreement' transactions prior to the term 'international agreement' being removed from the Act, effective from October 2007.

In terms of subsection (2)*(a)* of section 31 of the Act, the residence status of taxpayers is an important factor that should be taken into account in determining whether a transaction is subject to section 31 of the Act. The transactions taking place between the two persons who are tax residents in South Africa will not be subject to subsection (2) of section 31 of the Act, as the profits of these persons are subject to tax in South Africa. In this situation neither of the two taxpayers can use transfer pricing to avoid tax as they are both residents in South Africa and are both subject to corporate tax in South Africa.

Therefore for this purpose, the residence test is used to determine whether or not parties in a transaction are resident in South Africa and whether as a result of this test, transfer pricing is not used to shift profits of the parties in the transaction from South Africa to the country where the other party in a transaction is resident. Subsection (2) *(a)* of section 31 of the Act provides two conditions through which the taxpayer can become a tax resident in South Africa. This is through ordinary residence status and conducting business activities through a permanent establishment. Both these tests are analysed as follows:

a) The ordinary residence test of a company

The definition of a resident in relation to a company (legal person) in the Act reads as follows:

> '"resident" means any–
>
> > (b) person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic,'

b) The permanent establishment residence test

The place where the business activities of the taxpayer are happening is used as a test to determine if a permanent establishment exists. The Act regards the place where certain business activities of a taxpayer are taking place to constitute a residence for a taxpayer. Such business activities are defined in the tax treaties in South Africa and Article 5 of the OECD Model Tax Convention (OECD Model Treaty) as permanent establishments. According to the tax treaties in South Africa and the OECD Model Treaty the permanent establishment[7] may include the following business activities;

(a) a place of management
(b) a branch
(c) an office
(d) a factory
(e) a workshop
(f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

2.3.4.2 Connected persons

A transaction is subject to subsection (2)*(b)* of section 31 of the Act if a consideration of such is a transaction taking place between connected persons. Paragraph *(d)* of section 1 of the Act defines a connected person in relation to the company as follows:

'*(d)* in relation to a company-

(i) any other company that would be part of the same group of companies as that company if the expression 'at least 70 permanent establishment r cent' in paragraphs (a) and (b) of the definition of 'group of companies' in this section were replaced by the expression 'more than 50 permanent establishment r cent';

(ii) and (iii) ......

(iv) any permanent establishment person, other than a company as defined in section 1 of the Companies Act, 1973 (Act 61 of 1973), who individually or jointly with any connected permanent establishment person in relation to himself, holds, directly or indirectly, at least 20 permanent establishment r cent of the company's equity share capital or voting rights;

7 The term permanent establishment may include more than the business activities mentioned above. In other tax treaties that South Africa has signed and ratified, such as the US, other business activities in addition to the above are mentioned to explain what permanent establishment means.

(v) any other company if at least 20 per cent of the equity share capital of such company is held by such other company, and no shareholder holds the majority voting rights of such company;

(vA) any other company if such other company is managed or controlled by-
(aa) any person who or which is a connected person in relation to such company; or
(bb) any person who or which is a connected person in relation to a person contemplated in item (aa) ; and

(vi) where such company is a close corporation-
(aa) any member;
(bb) any any relative of such member or any trust which is a connected person in relation to such member; and
(cc) any other close corporation or company which is a connected person in relation to-

(i) any member contemplated in item (aa) ; or
(ii) the relative or trust contemplated in item (bb) ; and

2.3.4.3 The arm's-length consideration

A transaction is subject to subsection (2)*(c)* of section 31 of the Act if a consideration of such a transaction between connected persons is less than or greater than the arm's-length price. Although section 31 of the Act requires that a transaction between connected persons should be at arm's-length price, the challenge faced by SARS and taxpayers regarding the application subsection (2)*(c)* of section 31 of the Act is that the subsection requires that transactions affected by this section should be at arm's-length, but does not provide regulations on how taxpayers should transact at arm's-length price.

Furthermore, subsection (2)*(c)* of section 31 of the Act does not provide explanations on some of the important meanings with regard to arm's-length, such as the following:

a) The meaning of the word arm's-length price

b) What is regarded as less than arm's-length price

c) What is regarded as greater than arm's-length price.

2.3.5 Subsection 31(3) of Section 31 of the Act.

Subsection (3) of section 31 of the Act deals with financial assistance transactions such as thin capitalisation transactions and the granting of loans between connected parties. These kinds of transactions are also required to be at arm's-length in terms of subsection (2) of section 31 of the Act. Subsection (3) of section 31 of the Act reads as follows:

> '(3) *(a)* Where any person who is not a resident (hereinafter referred to as the investor) has granted financial assistance contemplated in paragraph (c) of the definition of "services" in subsection (1), whether directly or indirectly, to—
>
> (i) any connected person in relation to the investor who is a resident; or
>
> (ii) any other person (in whom he has a direct or indirect interest) other than a natural person, which is a resident (hereinafter referred to as the recipient) and, by virtue of such interest, is entitled to participate in not less than 25 per cent of the dividends, profits or capital of the recipient, or is entitled, directly or indirectly, to exercise not less than 25 per cent of the votes of the recipient,
>
> and the Commissioner is, having regard to the circumstances of the case, of the opinion that the value of the aggregate of all such financial assistance is excessive in relation to the fixed capital (being share capital, share premium, accumulated profits, whether of a capital nature or not, or any other permanent owners' capital, other than permanent capital in the form of financial assistance as so contemplated) of such connected person or recipient, any interest, finance charge or other consideration payable for or in relation to or in respect of the financial assistance shall, to the extent to which it relates to the amount which is excessive as contemplated in this paragraph, be disallowed as a deduction for the purposes of this Act.
>
> *(b)* For the purposes of paragraph (a), financial assistance granted indirectly shall be deemed to include any financial assistance granted by any third person who is not a connected person in relation to the investor, a connected person contemplated in paragraph (a) or the recipient, where such financial assistance has been granted by arrangement, directly or indirectly, with the investor and on the strength of any financial assistance granted, directly or indirectly, by the investor or any connected person in relation to the investor, to such third person.'

The guideline on the application of subsection (3) of section 31 of the Act is contained in Practice Note 2. The transfer pricing matters relating to subsection (3) of section 31 of the Act is excluded from this research study. The reason for excluding these matters is that they are considered to be a topic on which another research study could be conducted.

2.4 THE ARM'S-LENGTH PRINCIPLE

As mentioned in chapter 1, an arm's-length principle simply refers to the process of determining the arm's-length price. An arm's-length price is thus the price that services or goods can be expected to have reached if the parties in the transaction had been independent persons dealing at arm's-length.

The arm's-length principle is endorsed by the OECD member countries as the appropriate standard to be used for tax purposes by multinational enterprises and tax authorities. The arm's-length principle enables taxpayers or tax authorities to analyse whether the results obtained in a cross-border controlled transaction, are comparable to the results the multinational enterprises would have obtained had the transaction been carried out between independent enterprises (Deloitte Touché Tohmatsu, 2001:9).

The genesis of arm's-length principle as an internationally accepted principle goes back to the year 1933 (Russo, 2005). The authorative statement of the arm's-length principle is found in Article 9 of the OECD Model Treaty. The OECD Model Treaty is the framework for bilateral treaties between OECD member countries and other non-member countries. The arm's-length principle in the OECD Model Treaty reads as follows:

> '[When] conditions are made or imposed between… 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.'

As already mentioned, section 31 of the Act has also adopted the arm's-length principle and guidance on how to comply the principle is provided separately in Practice Note 7. According to Practice Note 7 the arm's-length principle simply means that the transaction of multinational enterprise should have the substantive financial characteristics of a transaction between independent parties, where each party strives to gain the utmost possible benefit from the transaction (Practice Note 7

Para. 7:8). The process of how the arm's-length principle should be applied in South Africa is discussed later in this chapter.

2.4.1 The Challenges Facing Arm's-length Principle

The OECD guidelines state that there are certain cases when there could be practical difficulties in applying the arm's-length principle. Such cases are when the multinational enterprises have engaged in transactions that independent enterprises would not undertake. The following are the analysis of such cases when it could be difficult to apply arm's-length principle.

a) Intellectual Property Transactions

The intellectual property transactions within the multinational enterprises are such transactions which could be difficult to compare with similar transactions by independent parties. The OECD guidelines state that in such transactions the arm's-length principle would be difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises (OECD guidelines, Para. 1.10).

b) Difficulties in finding comparables

The second case when practical difficulties could be experienced is when the tax administration and taxpayers have difficulty in obtaining adequate information when applying the arm's-length principle. As the arm's-length principle requires that the transactions of the multinational enterprises be compared to the transactions undertaken by the independent enterprises, the difficulty of finding the comparable transactions could make the application of the arm's-length principle difficult (OECD guidelines, Para. 1.12).

2.4.2 Practical Considerations in Applying Arm's-length Principle

Chapter 1 of the OECD guidelines provides practical consideration that should be taken into account when applying the arm's-length principle (OECD guidelines, Para. 1.15 -1.70). These practical considerations are also acknowledged by Practice Note 7 (Practice Note 7, Para. 7.5 and Para. 11).

These practical considerations are as follows: comparability analysis; recognition of the actual transactions undertaken; evaluation of separate and combined transactions; use of an arm's-length range; use of multiple year data; losses; the effect of government policies; intentional set-offs; use of customs valuations; and use of transfer pricing methods. The discussion below shows how these practical considerations should be taken into account when the arm's-length principle is applied.

2.5 THE APPROACH TO THE ARM'S-LENGTH PRINCIPLE IN SOUTH AFRICA

Even though section 31(2) of the Act does not make provisions on how taxpayers should transact at arm's-length price, it requires that the consideration of goods or services supplied or acquired between connected persons should not be greater or less than the arm's-length price.

As already mentioned in this chapter, the guidance on how taxpayers should transact at arm's-length price in South Africa is achieved through the application of the arm's-length principle which is contained in Practice Note 7. The requirement to apply the arm's-length principle in Practice Note 7 is similar to the approach contained in the OECD guidelines.

In addition to Practice Note 7 the South African tax treaties on permanent establishment of business income and associated enterprises also requires that taxpayers should in certain instances apply the arm's-length principle. The IT14 returns requires that taxpayers' transfer pricing transactions which are required to be at arm's-length as required by section 31 of the Act, should be disclosed in the return.

In the absence of the non-prescriptive transfer pricing tax legislation, the question still remains how taxpayers should transact at arm's-length. The following is the analysis of Practice Note 7, South African treaties on permanent establishment business income and associated enterprises, and the IT14 return to establish how taxpayers in South Africa should transact at the arm's-length price.

2.5.1 Practice Note 7

Practice Note 7 is largely based on the OECD guidelines and it states that the determination of an arm's-length price is not an exact science but requires judgment on the part of both the taxpayer and the SARS Commissioner (Practice Note 7, Para. 7.6). An arm's-length price does not necessarily constitute a single price, but a range of prices and the facts of each case will determine where, within that range, a specific arm's-length price will lie (Practice Note 7, Para. 7.5).

The theory in determining the arm's-length price is that transactions of independent enterprises are subject to the full play of market forces and so these are, by definition, prices of the independent enterprises' arm's-length prices. As a result the prices of independent enterprises provide a benchmark against which the transactions can be evaluated by the multinational enterprises.

Endorsed by both Practice Note 7 and the OECD guidelines, the process of testing whether the transactions undertaken by the multinational enterprises reflect arm's-length nature as compared to the transactions undertaken by the independent companies, can be achieved by applying the comparability analysis, applying certain practical considerations, evaluating and selecting appropriate transfer pricing method, and calculating the arm's-length range of prices. This process is analysed as follows:

2.5.1.1 Comparability Analysis

The process of determining whether the prices or margins of multinational enterprises reflect the arm's-length nature, requires that a comparability analysis should be conducted to determine the degree of comparability between the transaction of multinational and independent enterprises.

Article 9 of the OECD Model Treaty states that an adjustment to the profit of the multinational enterprises can be made to the extent that the conditions of these enterprise transactions differ from the conditions that would have been evident between independent enterprises. Therefore, the comparability process compares the conditions of the multinational and independent enterprises to test whether a transaction between independent enterprises is sufficiently similar to those undertaken by multinational enterprises.

Practice Note 7 and the OECD guidelines state that comparability analysis should be conducted taking into account the economic relevancy with respect to the following factors (OECD guidelines, Para. 1.15):

a) Characteristics of property or services

The OECD guidelines recommend that when comparing the conditions in the transactions undertaken by the multinational enterprises to the conditions of those undertaken by the independent parties, the characteristics of property or services involved in such transactions is important. The characteristics of the property or services matters when it comes to the comparability of the prices charged by multinational enterprises and that charged by independent enterprises for the same transaction (OECD guidelines, Para. 1.19).

b) Functional analysis

In testing whether the conditions in the transactions undertaken by multinational enterprises to those in the transactions undertaken by independent enterprises are similar, the OECD guidelines recommend that it is important to look at the functions performed in such transactions (OECD guidelines, Para. 1.20-1.21).

The OECD guidelines recommend that if the same level of functions are performed by both multinational enterprises and independent enterprises in similar type transactions. Therefore, the economic return derived by the multinational enterprise should be similar to that derived by the independent enterprise in the same type of transaction.

The OECD guidelines do, however, acknowledge that in certain instances the economic rewards may be different. For example, instances where the assets utilized in the transaction and risks assumed by the multinational are different from that of the independent enterprises (OECD guidelines, Para. 1.22- 1.27). In these instances the multinational enterprises and the independent parties might be rewarded differently on the same type of transaction undertaken, because of the conditions with regard to their responsibilities in the transaction not being similar.

c) Contractual terms

The OECD guidelines state that, 'in arm's-length dealings, the contractual terms of a transaction generally define explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the parties'(OECD guidelines, Para. 1.28). The OECD guidelines further mention that in cases where the transaction takes place between the two independent enterprises, the terms and conditions in the contract will be such that each party will strive to enjoy the utmost benefit.

Therefore, in testing whether the conditions in the transactions undertaken by the multinational enterprises and those in the transactions undertaken by the independent enterprises are similar, the contractual terms and conditions are also important.

d) Economic circumstance

In testing whether the commercial conditions in the transactions undertaken by the multinational enterprises and those in the transactions undertaken by the independent enterprises are similar, the OECD guidelines recommend also that it is important to look at the economic conditions in which multinational and independent enterprises do business. The reason is that arm's-length price may vary across different markets even for transactions involving the same property or services (OECD guidelines, Para. 1.30).

e) Business strategies

The OECD guidelines recommend that business strategies must also be taken into consideration in determining comparability of the transactions undertaken by multinational and independent enterprises. The business strategy may be that the multinational enterprise will introduce their new product at a lower price than the price offered by other businesses in the same market (OECD guidelines, Para. 1.31-1.32).

The multinational enterprise will lower their price as a business strategy to penetrate the market, thereby offering lower prices than those of the independent enterprises.

2.5.1.2 Other Practical Considerations

To further achieve a high degree of comparability between the transactions of multinational and independent enterprises, the OECD guidelines recommend that certain practical considerations should be taken into account. This is done to eliminate any material differences that might be present in the commercial conditions of the multinational and the independent enterprises. Such practical considerations are as follows:

a) Recognition of the actual transaction undertaken

Practice Note 7 provides that when comparing the conditions of the actual transaction undertaken by multinational enterprises to those of independent enterprises, the economic structure and the underlying agreement of the transaction undertaken by the multinational enterprises, have to correspond with those usually adopted on the free market (Practice Note 7 Para. 11.10).

b) Evaluation of separate and combined transactions

Practice Note 7 provides that when comparing the commercial conditions of multinational and independent enterprises the principle should be that transactions should be evaluated on a transaction-by transaction basis (Practice Note 7 Para. 11.11).

Simultaneously, the guidelines recognise that there are some circumstances in which it would be appropriate to aggregate transactions. This is where separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis. A number of examples are given, such as long-term contracts for the supply of commodities or services, rights to use intangible property, and pricing a range of closely linked products where the determination of pricing for each individual product or transaction is impractical (OECD Guidelines Para. 1.43).

c) Presence of losses

The OECD guidelines suggest that when comparing the commercial conditions of multinational enterprises to those of independent enterprises, losses should also be taken into consideration. A loss-making company belonging to a profitable group may trigger special tax scrutiny. Genuine losses can be accepted in a situation where the entire group is in a loss-making situation, in a start-up cost situation, when there are unfavourable economic conditions and when losses occur as a result of the business strategy (Practice Note 7, Para. 11.9, OECD guidelines Para. 1.52-1.54).

d) Government policies

The OECD guidelines suggest that when comparing the commercial conditions of multinational and independent enterprises, government controls should also be considered. The government price controls may include; price controls and interest rate controls, anti-dumping duties, exchange rate policy, control over royalties, and management fees (OECD guidelines Para. 1.55-1.59).

e) Intentional set-offs

When comparing the commercial conditions of multinational enterprises and independent parties, the OECD guidelines provide that international set-offs is one of the issues to be considered. International set-offs occur when one associated enterprise has provided a benefit to another within the group, that is balanced to some degree by different benefits derived from that enterprise in return. In such cases it is recommended by the OECD guidelines that it is necessary to evaluate the transactions separately to check the arm's-length price (OECD guidelines Para. 1.60-1.64).

f) Customs valuations

Since pricing for customs and tax purposes may vary, customs price analysis is considered relevant when comparing the commercial conditions of multinational enterprises to the commercial conditions of independent enterprises (OECD guidelines Para. 1.65-1.67).

2.5.1.3 Evaluation and selection of the transfer pricing methods

Once the comparability analysis has been conducted and practical considerations have been taken into account, transfer pricing methods should be evaluated and the appropriate method selected and applied to determine whether or not the prices or margins of multinational enterprises reflect the arm's-length nature, as compared to the prices or margins of independent companies.

Practice Note 7 and chapter 2 and 3 of the OECD guidelines present these transfer pricing methods. The transfer pricing methods in the OECD guidelines are divided into two categories, namely; the traditional transaction methods and the transactional profit (or profit-based) methods.

Traditional transactional methods compare actual prices or other less direct indicators such as gross margins on third party transactions, with the same measures in a controlled party's transactions. The methods classed as traditional transaction methods are the comparable uncontrolled price method, the resale price method, and the cost plus method.

Transaction profit methods compare the overall net profits of intra-group transactions with the net operating profit of comparable transactions carried out by independent companies. Two transactional profit methods are the profit split method and the transactional net margin methods.

The traditional transactional methods were once considered the best methods compared to the transactional profit methods. The latter were considered methods of last resort as the OECD guidelines recommended that the use of these methods should be limited to exceptional situations where no data was available or where the available data was not of sufficient quality (OECD guidelines Para. 2.49, 3.49 and 3.54).

Although these methods are regarded as methods of last resort, in practice they are widely used as compared to the traditional transactional methods. As mentioned above, the reason being the problem of availability of data of the independent comparable transactions on other methods (Rolf, 2004/2005: 27). The OECD is in the process of reviewing whether or not the transactional profit methods should maintain their status of last resort[8].

The analysis of the traditional transactional methods and the transactional profit methods is summarized as follows:

a) Controlled Uncontrolled Price Method

The Controlled Uncontrolled Price method is the preferred among transfer pricing methods as the most theoretically pure application of the arm's-length principle. The method compares the price charged for property or services transferred in a controlled transaction to that charged for the same property or services transferred in an uncontrolled transaction in comparable circumstances.

The controlled transaction would be within the multinational enterprises and the uncontrolled transaction would be between the independent parties.

In testing whether the prices of multinational enterprises reflect the arm's-length nature as compared to the prices of the independent parties, comparability under the Controlled Uncontrolled Price method requires that there be no difference that would materially affect the open market price, or that reasonably accurate adjustments can be made to reflect any differences between the controlled and uncontrolled transactions. The extent and reliability of the necessary quantitative adjustments will affect the relative reliability of this method.

[8] See the OECD document on Transactional Profit Methods, Discussion Draft for Public Comment dated 25 January 2008. The document analysis the application of the transactional profit methods and experiences faced by countries on transactional profit methods. In the document comments are also invited from the public to provide solutions with regard to the challenges faced with the application of these methods.

b) Resale Price Method

The Resale Price method involves reselling a product purchased from an associated enterprise to an independent enterprise and comparing the prices of the two transactions (OECD guidelines, Para. 2.14). Because gross profit margins represent gross compensation after the cost of sale for specific functions performed (taking into account assets used and risks assumed), product differences are less important here than in the Controlled Uncontrolled Price method (OECD guidelines, Para. 2.17).

In testing whether the prices of multinational enterprises reflect the arm's-length nature as compared to the prices of the independent parties, comparability under the Resale Price method requires that there be no differences that would materially affect the resale price margin in the open market, or that reasonably accurate adjustments can be made to account for such differences.

The extent and reliability of adjustments will affect the relative reliability of the Resale Price method analysis. Fewer adjustments are needed to account for product differences than under the Controlled Uncontrolled Price method, but other comparability attributes such as functions generally are given more weight under the Resale Price method.

c) Cost Plus Method

Under the Cost Plus method, an arm's-length price is determined by applying an appropriate mark-up on costs incurred. The underlying rationale is that the mark-up provides an appropriate profit for the functions performed, assets employed, and risks borne by the taxpayer. This method is probably the most useful for semi-finished goods sold between related parties or if the controlled transaction is provision of services (OECD guidelines, Para. 2.32).

In testing whether the prices or margin prices of multinational enterprises reflect the arm's-length nature as compared to the prices of the independent parties, comparability under the Cost Plus method requires that no differences exists that would materially affect the cost plus mark-up in the open market, or that reasonably accurate adjustments can be made to reflect any differences.

The extent and reliability of adjustments will affect the relative reliability of the cost plus analysis. Like the Resale Price method, the fewer the differences the greater the reliability of the Cost Plus method (OECD, Para. 2.34).

d) Profit Split Method

With the Profit Split method as mentioned in the OECD guidelines in paragraph 3.5, the arm's-length price is determined by 'identifying the profit to be split for the associated enterprises from the controlled transactions [and]…then those profits between the associated enterprises on an economically valid basis that approximates the division of profit that would have been anticipated and reflected in an agreement made at arm's-length'.

The profit split method calculates the profit (either total or residual) from the controlled transactions and splits those profits based on the contribution of each entity. The OECD guidelines recommend two approaches for applying the profit split method (OECD Guidelines Para. 3.15 – 3.25):

(i) Contribution analysis

> 'Contribution analysis applies where the combined profit of the transaction is divided between the associated entities based upon the relative value of the functions performed by each of the associated enterprises participating in the controlled transactions, supplemented as much as possible by external market data that indicate how independent enterprises would have divided profits in similar circumstances.'

(ii) Residual profit analysis

> 'Residual profit analysis applies where profit is divided in two stages. In the first stage, each participant is allocated sufficient profit to provide it with a basic return appropriate for the

type of transaction in which it is engaged. (…) In the second stage, any residual profit (or loss) remaining after the first stage division would be allocated among the parties based on an analysis of the facts and circumstances that might indicate how this residual would have been divided between independent enterprises.'

e) Transactional Net Margin Profit

Under the Transactional Net Margin method, an arm's-length price is determined by examining the net profit margin that a taxpayer realises from a controlled transaction relative to an appropriate base, for example cost, sales or assets. Under the Transactional Net Margin method, comparability between the controlled and uncontrolled transactions is established through a functional analysis.

In testing whether the prices or margin prices of multinational enterprises reflect the arm's-length nature as compared to the prices of the independent parties, comparability under the Transactional Net Margin method compares the profit level indicator of the multinational enterprises with the profit level indicator(s) of comparable independent parties. According to the OECD guidelines this method, although classified as a transactional profit method, is more closely aligned to the Cost Plus and Resale Price methods than to the profit split method.

2.5.1.4 Calculating the arm's-length price or margin range

Once the methods have been selected and applied, this is the appropriate transfer pricing method, the statistical analysis is computed to calculate the arm's-length price or margin range of the independent enterprises. The computation of the statistical analysis in calculating the arm's-length price or margin range is conducted by taking into consideration two of the practical considerations, namely; the use of arm's-length range and the use of multiple year data.

a) The use of arm's-length range

In conducting the calculations to determine the arm's-length price the OECD guidelines and Practice Note 7 requires that a statistical range be computed when applying one of the prescribed methods (OECD, Para. 1.45 and Practice Note 7 Para. 11.4.2). The application of the most appropriate method or methods in computing the arm's-length range to test if prices or margins of the multinational enterprises reflect the arm's-length nature as compared to the prices or margins of the independent enterprises, normally produces a range of results that could be regarded as being at arm's-length (OECD, Para. 1.45). The OECD guidelines state that any point within the range can be considered as arm's-length.

Both Practice Note 7 and the OECD guidelines recommend that taxpayers can compute the arm's-length range using more than one transfer pricing method in order to substantiate that their prices or margins are at arm's-length. Although this approach is not compulsory in South Africa, Practice Note 7's view is that the use of more than one method could be a relevant exercise in the case where complicated transactions are involved (Practice Note 7, Para. 11.6; OECD guidelines, Para. 1.69).

The computation of the arm's-length range[9] is conducted by arranging the financial data such as the prices, gross margins and net margins of the independent enterprises. The range consists of the lowest value and the highest value of the data. The point within the lowest value and the highest value in the range is referred to as the interquartile range[10](Groenbner and Shannon, 1989).

The interquartile range consists of three points, this is the lower quartile point, median[11] which is the middle point, and the upper quartile point (Groebner and Shannon, 1989). An example of how the arm's-length range is computed is illustrated in the next section through a hypothetical case study, showing how multinational

[9] Range is the difference between the highest value and the lowest value in the set of data arrayed in the descending and ascending order.

[10] Interquartile range is the distance within the range representing the lower quartile value and higher quartile value. The lower quartile value is known as the first quartile and is the value that divides the lower 25% of the data from the upper 75%. The second value within the interquartile range is called the median, which represents the second quartile. The third value within the interquartile range represents the third quartile and divides the lower 75% of the data from the upper 25%.

[11] Median is value occupying the middle place of the data arrayed in the descending and ascending order. Median is also known as the value that divides a set of data into two halves.

enterprises in South Africa should substantiate that their prices or margins are at arm's-length.

b) The use of multiple year data

The OECD states that in order to produce a reliable arm's-length result when testing whether the prices or margins of the multinational enterprises reflect the arm's-length nature, a transaction must be observed over a period of time, so that one can gain a better understanding of facts and circumstances that may have influenced the transactions undertaken by the multinational enterprises. The OECD states that the multiple year data is useful in providing information about the relevant business and product life cycles of the comparable (OECD guidelines, Para. 1.49).

2.5.1.5 Hypothetical Case Study

This section presents a hypothetical case study to illustrate how the arm's-length price or margin range is calculated. The case study is as follows:

a) Case Study

US-Holdco is a company incorporated in the US and has a subsidiary company in South Africa called SA-Subco. US-Holdco manufactures sports shoes in the US and sells the shoes to independent retailers and wholesalers globally. In order to boost its sales figures, US-Holdco has subsidiary companies around the world; their main responsibilities are sales and marketing. SA-Subco is a US-Holdco subsidiary company. US-Holdco rewards SA-Subco with a service fee for sales and marketing activities executed in SA. The transfer pricing policy applied between US-Holdco and SA-Subco is that a 10% mark-up on total costs incurred, should be rewarded for sales and marketing activities. The following are the financial results of SA-Subco for three years:

Table 2: SA-Subco income statements

SA Subco	2008	2007	2006	Average
Turnover	30562	29877	25875	28771
Less: Total Costs	27785	27156	23518	26153
Operating Profit/Loss	**2777**	**2721**	**2357**	**2618**
Operating Margin	9.09%	9.11%	9.11%	9.10%
Total Costs Mark Up	9.99%	10.02%	10.02%	10.01%

The first issue that the management of SA-Subco will have to deal with in order to comply with the transfer pricing requirements in South Africa, is to address the following two questions:

(i) Is the sales and marketing transaction between SA-Subco and US-Holdco subject to section 31 of the Act?

(ii) Is the consideration of the sales and marketing transaction between SA-Subco and US-Holdco at arm's-length as required by section 31 of Act?

As discussed in section 2.3 in this chapter, a transaction is subject to section 31 of the Act if it involves goods and services and when it is between connected persons, and the connected persons are the non-resident and a resident taxpayer.

In this situation, SA-Subco is a connected legal person to US-Holdco because US-Holdco is a holding company to SA-Subco. The sales and marketing transaction between US-Holdco and SA-Subco constitute a service as defined under subsection 31(1) of the Act. Furthemore, US-Holdco is non-resident as it is not incorporated in South Africa but in the US, and SA-Subco is a resident in SA as it is incorporated in South Africa.

Therefore, SA-Subco is required in terms of section 31 of the Act to illustrate that the sales and marketing transaction with US-Holdco is at arm's-length. Even though section 31 of the Act does not make provision on how taxpayers should transact at arm's-length price, in addressing the second question above, SA-Subco is still required in terms of section 31 of the Act to illustrate that their sales and marketing transaction with US-Holdco is at arm's-length. SA-Subco can do that by following the arm's-length principle process contained in Practice Note 7.

As discussed previously, SA-Subco should illustrate to SARS that their transaction of sales and marketing with US-Holdco is at arm's-length. This illustration can be achieved by following the following steps:

(i) Conducting comparability analysis of SA-Subco's commercial conditions with the commercial conditions of independent enterprises involved in sales and marketing activities.

(ii) Evaluating, selecting and applying the appropriate transfer pricing methods on the financial results of the independent enterprises involved in sales and marketing activities.

(iii) Computing the statistical analysis to calculate the arm's-length price or margin range of independent enterprises involved in sales and marketing business activities. And comparing the arm's-length prices or margin range of independent enterprises to SA-Subco's prices or margins to determine if SA-Subco's prices or margin are within the arm's-length range.

a) Step 1

In the first step, SA-Subco would start by searching for the independent enterprises involved in sales and marketing activities in the public data bases, and compare the commercial conditions of these independent enterprises to their own by reviewing the following comparability factors:

(i) The characteristics of the sales and marketing services performed by the independent enterprises.

(ii) The functions performed by independent enterprises involved in sales and marketing business activities.

(iii) The contractual terms binding the independent enterprises involved in sales and marketing business activities.

(iv) The economic circumstances under which the independent enterprises are involved in sales and marketing business activities.

(v) The business strategies employed by the independent enterprises involved in sales and marketing business activities.

Other practical considerations which SA-Subco should take into account to further achieve a high degree of comparability, are the recognition of the actual transactions undertaken, evaluation of separate and combined transactions, losses, effect of government policies, intentional set-offs and use of customs valuations. Assume that after SA-Subco has searched in the public data base for independent enterprises involved in the sales and marketing activities and the search results has resulted in 10 independent enterprises found in the public data base.

The following are the financial results of the independent enterprises found in the public data base:

Table 3: Income statements of comparable sales and marketing companies

		2008			2007			2006		
No	Comparable Companies	Turnover	Total Costs	Operating Profit/Loss	Turnover	Total Costs	Operating Profit/Loss	Turnover	Total Costs	Operating Profit/Loss
1	Company A	57234	54789	2445	49968	44345	5623	42383	38561	3822
2	Company B	61373	59446	1927	56956	54234	2722	49546	46123	3423
3	Company C	58559	61867	-3308	52456	54989	-2533	47123	49786	-2663
4	Company D	43674	41678	1996	41383	39564	1819	37453	35164	2289
5	Company E	37337	38768	-1431	34893	36132	-1239	30123	31256	-1133
6	Caompay F	30571	27836	2735	29867	26897	2970	25343	22325	3018
7	Company G	66897	61632	5265	60236	51123	9113	55234	47345	7889
8	Company H	55260	53763	1497	49756	47671	2085	43167	40673	2494
9	Company I	39768	35678	4090	34145	29231	4914	29765	24876	4889
10	Company J	32157	34678	-2521	27345	23461	3884	25761	23487	2274

b) Step 2

The second step that SA-Subco would take is to evaluate each transfer pricing method and select the appropriate method suitable for SA-Subco. As discussed previously, the evaluation of these methods should be conducted taking into consideration the transfer pricing policy applied by the tested party, in this case being SA-Subco; also by taking into consideration the type of business structure of a tested party, for example whether a business is a distributor, manufacturer or service provider. As discussed previously both Practice Note 7 and the OECD guidelines make recommendations which methods are appropriate for each business structure.

The appropriate method is then selected and applied to calculating the arm's-length price or margin realised by independent enterprises involved in sales and marketing business activities. The transfer pricing policy implemented by SA-Subco, is total costs incurred plus 10% that SA-Subco charges to US-Holdco for sales and marketing service transactions. Therefore, the Cost Plus method would be the appropriate method to apply in this situation. As discussed above, the Cost Plus method is appropriate when the provision of service(s) transactions is involved and when a mark-up on costs incurred is applied in a transaction. The Cost Plus method would be applied on the financial results of the independent enterprises found in the public data base to find out what the percentage (%) mark-up is on the costs incurred by independent enterprises involved in sales and marketing business activities.

The table of figures below shows the outcome of the application of the Cost Plus method on the financial data of the independent enterprises involved in sales and marketing business activities.

Table 4: The cost plus method results on the independent enterprises involved in sales and marketing business activities

		2008			2007			2006			Average 2008 - 2006		
No	Comparable Companies	Total Costs	Operating Profit/Loss	Total Costs Mark Up	Total Costs	Operating Profit/Loss	Total Costs Mark Up	Total Costs	Operating Profit/Loss	Total Costs Mark Up	Total Costs	Operating Profit/Loss	Total Costs Mark Up
1	Company A	54789	2445	4.46%	44345	5623	12.68%	38561	3822	9.91%	45,898	3,963	9.02%
2	Company B	59446	1927	3.24%	54234	2722	5.02%	46123	3423	7.42%	53,268	2,691	5.23%
3	Company C	61867	-3308	-5.35%	54989	-2533	-4.61%	49786	-2663	-5.35%	55,547	-2,835	-5.10%
4	Company D	41678	1996	4.79%	39564	1819	4.60%	35164	2289	6.51%	38,802	2,035	5.30%
5	Company E	38768	-1431	-3.69%	36132	-1239	-3.43%	31256	-1133	-3.62%	35,385	-1,268	-3.58%
6	Caompay F	27836	2735	9.83%	26897	2970	11.04%	22325	3018	13.52%	25,686	2,908	11.46%
7	Company G	61632	5265	8.54%	51123	9113	17.83%	47345	7889	16.66%	53,367	7,422	14.34%
8	Company H	53763	1497	2.78%	47671	2085	4.37%	40673	2494	6.13%	47,369	2,025	4.43%
9	Company I	35678	4090	11.46%	29231	4914	16.81%	24876	4889	19.65%	29,928	4,631	15.98%
10	Company J	34678	-2521	-7.27%	23461	3884	16.56%	23487	2274	9.68%	27,209	1,212	6.32%

The above table of figures shows the calculations of the Total Cost Mark-Up[12] percentage (%) realised by the independent enterprises involved in the sales and marketing business activities. The Average Total Costs Mark-Up[13] percentage (%) is also shown in this calculation on a three-year period. As discussed previously the reason for the three-year average calculations is that, Practice Note 7 and the OECD guidelines recommend the use of the multiple year data information in order to address certain business aspects and product life cycles of the independent enterprises when the arm's-length price is calculated.

[12] The Total Cost Mark-Up percentage (%) is calculated by dividing Operating Profit/Loss by Turnover less Operating Profit and multiple by 100 (Total Cost Mark Up = Operating Profit/Turnover – Operating Profit x 100).

[13] The Average Total Cost Mark-Up is calculated by adding up the Total Cost Mark-Up of the number of years involved and divide the answer by the number of years (Average Total Cost Mark-Up= Total Cost Mark-Up(y1+y2+y3)/ 3).

c) Step 3

Once the appropriate transfer pricing method has been selected and applied, SA-Subco would compute the statistical range to determine the arm's-length range of prices or margins realised by the independent enterprises involved in sales and marketing business activities.

As discussed previously, this process is done to test if SA-Subco's prices or margins on Total Cost Mark-Up percentage (%) are within the same range as the prices or margins of the independent enterprises involved in sales and marketing business activities.

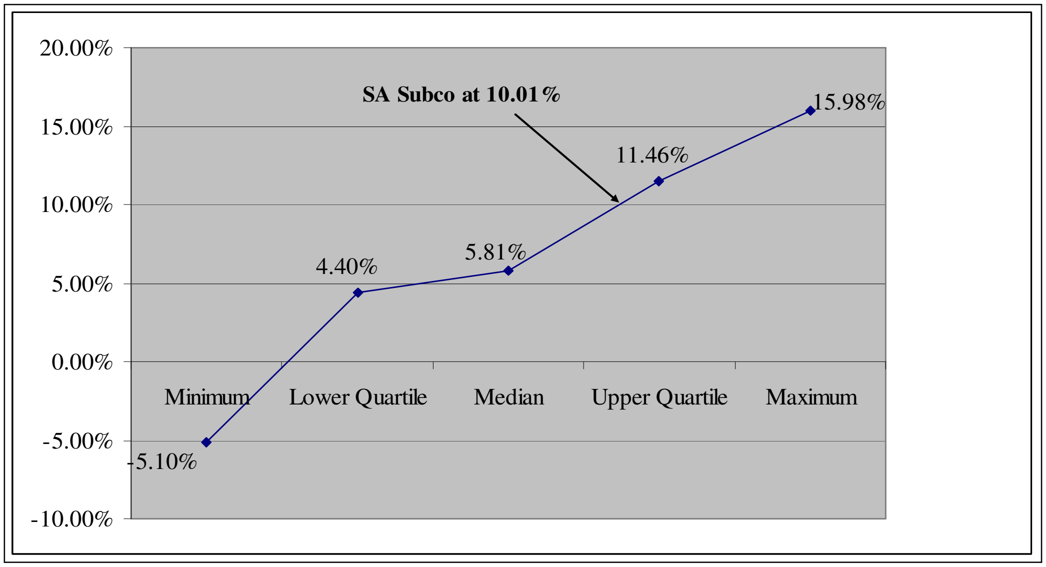
The table of figures below shows the calculations of the arm's-length range on the three-year period and on average of a three-year period of the Total Cost Mark-Up percentage (%) realised by the independent enterprises involved in the sales and marketing business activities.

Table 5: Arm's-length range calculations on cost plus method

Total Costs Mark Up (2008-2006) Inter-Quartile Range	2008	2007	2006	Simple Average
Minimum	-7.27%	-4.61%	-5.35%	-5.10%
Lower Quartile	-3.69%	4.37%	6.13%	4.43%
Median	3.85%	8.03%	8.55%	5.81%
Upper Quartile	8.54%	16.56%	13.52%	11.46%
Maximum	11.46%	17.83%	19.65%	15.98%

The result of the arm's-length range calculations shows the Minimum Point within -5.10% on average and the Maximum point of 15.98 % on average. The Lower Quartile point is 4.43% on average and the Upper Quartile point is 11.46% on average. Meanwhile, the Median point is 5.81% on average. The table below shows graphically at what point of the arms'-length range SA-Subco is at, as compared to the other independent enterprises involved in the sales and marketing business activities.

Table 6: Arms'-Length Range Graph on Total Cost Mark-Up Method



SA-Subco realised an average Total Cost Mark-Up percentage (%) of 10.01% as per their transfer pricing policy with US-Holdco. Comparing SA-Subco's Total Cost Mark-Up percentage (%) of 10.01% with the Total Cost Mark-Up percentage (%) realised by the independent enterprises involved in sales and marketing business activities, it is confirmed that SA-Subco is transacting at arm's-length with its holding company, US-HoldCo. Because the arm's-length range calculations shows that SA-Subco's Total Cost Mark-Up percentage (%) is within the arm's-length range, this position of SA-Subco is not challenged by SARS.

As suggested by Practice Note 7, SA-Subco can also compute the second arm's-length range using another transfer pricing method to support and substantiate that their prices or margins are at arm's-length. The following table of figures shows the calculations of the arm's-length range results of independent enterprises involved in sales and marketing business activities when the second transfer pricing method is applied, in this case the second method being the Transactional Net Margin.

Table 7: Arm's-length range calculations on transactional net margin method

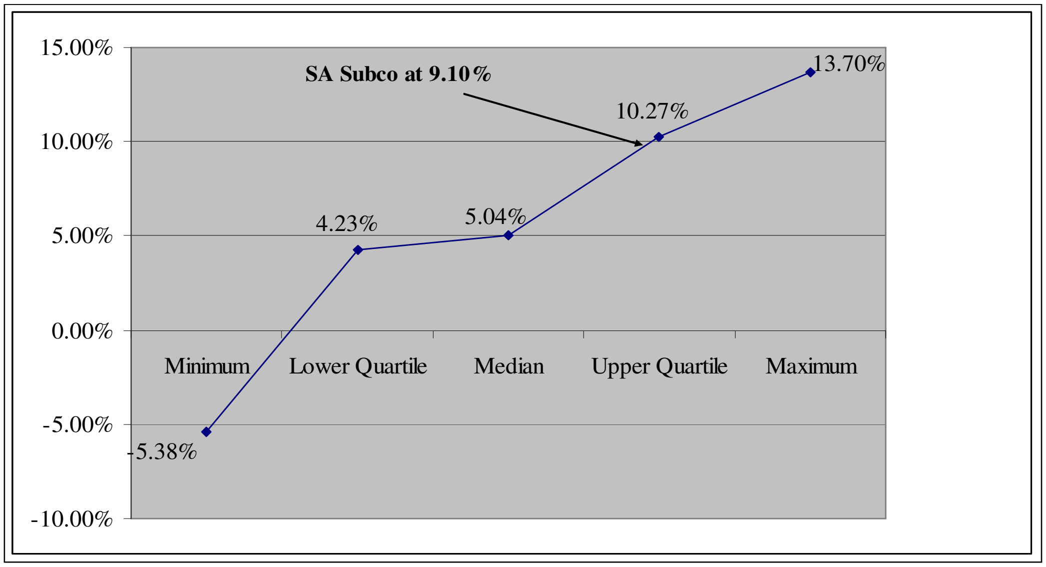
		2008			2007			2006			Average 2008 - 2006		
No	Comparable Companies	Turnover	Operating Profit/Loss	Operating Margin	Turnover	Operating Profit/Loss	Operating Margin	Turnover	Operating Profit/Loss	Operating Margin	Turnover	Operating Profit/Loss	Operating Margin
1	Company A	57234	2445	4.27%	49968	5623	11.25%	42383	3822	9.02%	49862	3963	8.18%
2	Company B	61373	1927	3.14%	56956	2722	4.78%	49546	3423	6.91%	55958	2691	4.94%
3	Company C	58559	-3308	-5.65%	52456	-2533	-4.83%	47123	-2663	-5.65%	52713	-2835	-5.38%
4	Company D	43674	1996	4.57%	41383	1819	4.40%	37453	2289	6.11%	40837	2035	5.03%
5	Company E	37337	-1431	-3.83%	34893	-1239	-3.55%	30123	-1133	-3.76%	34118	-1268	-3.71%
6	Caompay F	30571	2735	8.95%	29867	2970	9.94%	25343	3018	11.91%	28594	2908	10.27%
7	Company G	66897	5265	7.87%	60236	9113	15.13%	55234	7889	14.28%	60789	7422	12.43%
8	Company H	55260	1497	2.71%	49756	2085	4.19%	43167	2494	5.78%	49394	2025	4.23%
9	Company I	39768	4090	10.28%	34145	4914	14.39%	29765	4889	16.43%	34559	4631	13.70%
10	Company J	32157	-2521	-7.84%	27345	3884	14.20%	25761	2274	8.83%	28421	1212	5.06%

Operating Margin (2008-2006) Inter-Quartile Range	2008	2007	2006	Simple Average
Minimum	-7.84%	-4.83%	-5.65%	-5.38%
Lower Quartile	-3.83%	4.19%	5.78%	4.23%
Median	3.71%	7.36%	7.87%	5.04%
Upper Quartile	7.87%	14.20%	11.91%	10.27%
Maximum	10.28%	15.13%	16.43%	13.70%

With the Transactional Net Margin method the calculation of the arm's-length range is between -5.38% and 13.70%. SA-Subco's financial result with the Transactional Net Margin method, is 9.10%. The calculations of the arm's-length range using the Transactional Net Margin method show that SA-Subco is still within the arm's-length Range. These results still place SA-Subco in a position where it cannot be challenged by SARS.

The table below shows graphically at what point within the arms'-length range SA-Subco is at, as compared to the independent enterprises involved in the sales and marketing business activities.

Table 8: Arms'-length range graph on transactional net margin method



The issue is, what would the argument be if SA-Subco and US-Holdco decide to change their transfer pricing policy of Total Cost Mark-Up from 10% to 6%, since this initiative will reduce SA-Subco's taxable income? Could SARS argue that because SA-Subco's Total Costs Mark-Up margins have dropped by 4%, therefore the situation is a reflection that SA-Subco is not transacting at arm's-length price with US-Holdco?

In defence, SA-Subco could argue that the arm's-length range calculations on Total Cost Mark-Up above still shows that 6% is within the arm's-length range. SA-Subco could further argue that Practice Note 7 states that, 'the outcome results that fall within a properly constructed arm's-length range can still be regarded as being arm's-length. It is only when the prices or margins of the taxpayer are outside the arm's-length range that adjustments can be made' (Practice Note 7, Para. 11.4.7). Practice Note 7 further emphasises that, in situations where prices or margins of the taxpayer are outside of the arm's-length, facts and circumstances should be provided by the taxpayer to support its position. If it cannot be supported by facts and circumstances, Practice Note 7's view is that an adjustment to the midpoint will be appropriate in such cases. (Practice Note 7, Para. 11.4.7).

Another argument is that Practice Note 7 refers to the arm's-length price as a range of prices and not a single price. The range of prices consists of the lower point and the upper point. On the other hand section 31 of the Act makes reference to the arm's-length price as a single price. Section 31 of the Act also makes reference to the prices less than and greater than the arm's-length price.

The issue is, by referring to the price less than and greater than the arm's-length price, does section 31 of the Act refer to the points outside the arm's-length range, which is the point below the lower point - and the point above the upper point of the arm's-length range? The reason for this argument is that section 31 of the Act is not complemented by any meanings and explanations of what the arm's-length price is.

2.5.1.6 The critical analysis of Practice Note 7 process of determining the arm's-length price

As section 31 of the Act is not complemented by key words and terminologies on the transfer pricing subject. Taxpayers can make use of any other methods which are not recommended by Practice Note 7 or the OECD guidelines. Both Practice Note 7 and the OECD guidelines agree that the process of determining that a transaction is at arm's-length is not an exact science; meaning that there are different ways in which the arm's-length price can be determined.

In situations where taxpayers have made use of any other methods to determine the arm's-length price other than the process in Practice Note 7 and the OECD guidelines, the SARS Commissioner cannot reject such processes as section 31 of the Act does not prescribe the process on how taxpayers should transact at arm's-length price. Practice Note 7 was designed to be a practical guide and was not intended to be a prescriptive or an exhaustive discussion of every transfer pricing issue that may arise (Practice Note 7, Para. 3.1).

This simply means that Practice Note 7 cannot be binding law to both taxpayers and the SARS Commissioner. The South African case law shares the same sentiment that Practice Note 7 cannot be regarded as law.

In *ITC 1675*[14] it was said that SARS Practice Notes cannot override the law. In this case the taxpayer claimed the interest as a tax deduction. The taxpayer argued the interest deduction based on the Practice Note issued by the Commissioner. The Commissioner disallowed the interest deduction based on the Act. The court rejected the taxpayer's argument of the use of the Practice Note. The court claimed that it cannot always be assumed that the Commissioner will consider himself bound by his own practice notes and that it is not good policy if the practice constitutes a departure from the provisions of the Act.

In rejecting the taxpayer presenting the Practice Note as argument, the Judge coded *Viscount Radcliffe in Inland Revenue Commissioners v Frere*[15]when saying that,

> 'he had never understood the procedure of extra-statutory concessions in the case of a body to whom at least the door of Parliament is opened every year for adjustment of the tax code'.

The judge further coded Scott L.J. in *Absalom v Talbot*[16] case when he said

> 'The fact that such extra-legal concessions have to be made to avoid unjust hardships is conclusive that there is something wrong with the legislation.'

The court rejected the taxpayer's argument of the Practice Note by saying that the place where the deductibility of interest incurred should be regulated in these circumstances and should not be in the Practice Note but the Income Tax Act. Therefore, in situations where there are disputes between the taxpayer and SARS on whether the transaction is at arm's-length or not, it is only the court of law that can rule if the process used by taxpayers is reasonable in determining the arm's-length nature of a transaction.

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[14] (1998) 62, SATC 219
[15] (1965) AC 402 (HL) (E)) at 429A-B
[16] (1943) 1 All ER 589 (CA) at 598A-B:

The argument is, on what basis would the courts in South Africa rule that a transaction is at arm's-length or not? This argument will be addressed later in this chapter when a case law on what constitutes an arm's-length transaction in South Africa is discussed.

2.5.2 The South African Tax Treaties on Business Profits and Associated Enterprises

South Africa has signed tax treaties with a number of countries around the world. The South African tax treaties on business profits and associated enterprises require that the arm's-length principle should be applied. These tax treaties have been modelled from the OECD Model Treaty. Articles 7 of the OECD Model Treaty deals with the taxing of the business profits. Article 9 of the OECD Model Treaty deals with the taxing of associated enterprises.

These two articles read as follows (OECD, Model Tax Convention on Income and Capital, 2005: 28,30):

> 'Article 7 Business Profits
>
> 1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.
>
> 2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.
>
> 3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.
> 4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment

as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

5. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

6. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

7. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.'

'Article 9 Associated Enterprises

1. Where

a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State,or

b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State - and taxes accordingly - profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.'

The view of Article 7 is that when permanent establishment business profits are taxed, a permanent establishment should be treated as a separate legal entity from its head office. Article 7(1) establishes the main rule of taxing permanent establishment business profits and the exception. And Article 7(2) and (3) states that in order to determine the business profits attributable to a permanent establishment, the arm's-length principle should be applied (Russo, 2005). The commentary on Article 7 in the OECD Model Treaty also embraces the application of the arm's-length principle when the permanent establishment business profits are attributed.

Article 9's view is that arm's-length principle should be applied when the associated enterprises are taxed. As already mentioned in this chapter, Article 9 contains an authorative statement about the arm's-length principle and that in order to comply with the arm's-length principle the OECD guidelines should be consulted as guidance (Russo, 2005).

The OECD has also confirmed this, that in order to comply with the arm's-length principle the OECD guidelines should be consulted as guidance by inserting under Article 9 of the OECD Model Treaty a new paragraph as a commentary statement in the year 1992. The new paragraph establishes that the OECD guidelines should be followed as guidance in applying the arm's-length principle (Russo, 2005).

Due to the fact that the South African tax treaties on business profits and associated enterprises have been modelled from Article 7 and Articles 9 of the OECD Model Treaty and the fact that these articles relies on the OECD guidelines for the determination of the arm's length price. It would appear that the South African tax treaties on business profits and associated enterprises would also require taxpayers to adopt the OECD guidelines in determining the arm's length price.

The argument often raised in South Africa is whether or not the tax treaties are prescriptive on how taxpayers in South Africa should transact at arm's-length price. This argument arises because the South African tax treaties on business profits and associated enterprises require that the arm's-length principle should be applied with regard to the taxation of business profits and associated enterprises, and again because all the tax treaties in South Africa are deemed to be part of the Act in terms of section 108 of the Act read in conjunction with the section 231 of the South African Constitution. Both these sections read as follows:

Section 108 of the Act reads,

> '108 Prevention of or relief from, double taxation—(1) The National Executive may enter into an agreement with the government of any other country, whereby arrangements are made with such government with a view to the prevention, mitigation or discontinuance of the levying, under the laws of the Republic and of such other country, of tax in respect of the same income, profits or gains, or tax imposed in respect of the same donation, or to the rendering of reciprocal assistance in the administration of and the collection of taxes under the said laws of the Republic and of such other country.
>
> (2) As soon as may be after the approval by Parliament of any such agreement, as contemplated in section 231 of the Constitution, the arrangements thereby made shall be notified by publication in the Gazette and the arrangements so notified shall thereupon have effect as if enacted in this Act.
>
> (3) ......
>
> (4)......
>
> (5) The duty imposed by any law to preserve secrecy with regard to such tax shall not prevent the disclosure to any authorized officer of the country contemplated in subsection (1), of the facts, knowledge of which is necessary to enable it to be determined whether immunity, exemption or relief ought to be given or which it is necessary to disclose in order to render or receive assistance in accordance with the arrangements notified in terms of subsection (2).'

Section 231 of the South African Constitution reads as follows:

> '231. International agreements.- (1) The negotiating and signing of all international agreements is the responsibility of the national executive.
>
> (2) An international agreement binds the Republic only after it has been approved by resolution in both the National Assembly and the National Council of Provinces, unless it is an agreement referred to in subsection (3).
>
> (3) An international agreement of a technical, administrative or executive nature, or an agreement which does not require either ratification or accession, entered into by the national executive, binds the Republic without approval by the National Assembly and the National Council of Provinces, but must be tabled in the Assembly and the Council within a reasonable time.
>
> (4) Any international agreement becomes law in the Republic when it is enacted into law by national legislation; but a self-executing provision of an agreement that has been approved by Parliament is law in the Republic unless it is inconsistent with the Constitution or an Act of Parliament.
>
> (5) The Republic is bound by international agreements which were binding on the Republic when this Constitution took effect.'

The argument that tax treaties in South Africa are part of the Act is also backed by the South African tax case law. In *ITC 1544*[17], it was decided that,

> 'The terms of a double taxation agreement on which statutory status has been conferred are to be considered as any other statutory provisions to determine the extent to which these conflict with the provisions of another statute and whether such provisions have been modified thereby.'

In terms of the judgment in *ITC 1544*, this simply means that the tax treaties in South Africa are legally enforceable as part of the Act. As a result of this argument, the fact that the South African tax treaties requires that arm's-length principle as contained in the OECD guidelines should be applied on business profits and associated enterprises, makes the Act to be prescriptive on how taxpayers should transact at arm's-length price.

The SARS Commissioner has, however, a different view on this argument. The SARS Commissioner's view is that tax treaties in South Africa cannot impose tax liability. The SARS Commissioner is of the view that the tax treaties in South Africa merely allocate existing tax liabilities between countries and does not impose tax. Furthermore, the SARS Commissioner's view is that the tax treaties in South Africa do not restrict or limit the application of section 31 of the Act, regardless of the method selected to determine an arm's-length price. The SARS Commissioner's view is that no inconsistency exists between domestic law and the tax treaties, as both embody the arm's-length principle.

The argument however is that, the domestic law being section 31 of the Act in this case does not have regulations on how one should apply the arm's length principle meanwhile the tax treaties relies on the OECD guidelines in applying the arm's length principle. So inconsistency does exist between the domestic law and the tax treaties.

[17] 54 SATC 456(T)

2.5.3 The IT14 Return

The IT14 return of companies requires that transfer pricing transactions subject to section 31 of the Act be disclosed. Since 2006 tax year IT14 return probes fairly thoroughly, asking the following questions:

a) Did the company enter into any cross-border transactions in terms of an international agreement as defined in section 31?

b) Did the company receive any financial assistance from a non-resident connected person or from an investor as defined in section 31(3) and Practice Note 2 issued by the SARS Commissioner?

c) If "yes", were the provisions of section 31(3) and Practice Note 2 adhered to?

d) Does the company have a transfer pricing policy document in support of the transfer pricing policy as applied in relation to transactions as defined in section 31?

e) Does the company pay or charge management fees, licences royalties, interest or annuities to connected persons in terms of an international agreement as defined in section 31?

f) Has the company provided goods, services or anything of value to a non-resident connected person for no consideration? (Please note that "goods and services" includes a loan).

g) Have any transactions with non-resident connected persons in terms of an international agreement, as defined in section 31 been the subject of an advanced pricing agreement in another jurisdiction?

If the answer to any of these questions is yes, the taxpayer must prepare schedules and attach them to the IT14 return. For transfer pricing purposes these schedules must detail all transfer pricing transactions entered into with connected persons and the transactions must also comply with the arm's-length requirements in section 31 of the Act.

A brochure sent together with the IT14 return to taxpayers recommends that where the taxpayer has answered yes to the above questions, the following information should be attached to the IT14 return (Brochure to the IT14 return):

a) copy of the agreement entered into

b) copy of the transfer pricing policy document

c) schedule giving proof that the provisions of section 31(3) (thin capitalisation) have been complied with.

Although it is required that the above information should be submitted with the IT14 return when taxpayers have entered into transfer pricing transactions in terms of section 31 of the Act, the argument still remains that the IT14 return and the brochure to the IT14 return does not prescribe how taxpayers in South Africa should transact at arm's-length price.

The other argument is whether or not in terms of section 69 of the Act which regulates the furnishing of the tax returns, the IT14 return would be regarded prescriptive on how taxpayers should transact at arm's-length price if this return provided an explanation on how taxpayers should transact at arm's-length with regard to affected transfer pricing transactions.

In a situation where the IT14 return provided an explanation on how taxpayers should transact at arm's-length price, this situation would automatically make the Act in terms of section 69(1)*(b)* and *(f)* and section 69(2)*(b)* read in conjunction with the IT14 return to be prescriptive on how taxpayers should transact at arm's-length price. The basis of this argument is that, any information requested by the SARS Commissioner from a taxpayer through the IT14 return, is legally enforceable in terms of the above mentioned sections of the Act.

Section 69(1)*(b)* and *(f)* and section 69(2)*(b)* read as follows:

> '69. Duty to furnish information or returns. (1) Every person shall, if required by the Commissioner, furnish to him, in such form and within such time as may be prescribed or as the Commissioner may direct, returns showing -
>
> *(b)* all amounts received by or accrued to or in favour of any person in respect of any share or interest in any business carried by the person furnishing the return
>
> *(f)* all such other information in his possession with regard to the income received by or accrued to or in favour of himself or of any other person as may be required by the Commissioner.
>
> (2) In addition to the returns specified in subsection (1), every person shall, if required by the Commissioner -
>
> *(b)* supply such information and furnish such returns or such further or other returns as the Commissioner may require.'

Even though the IT14 return request extensive information on transactions effecting transfer pricing, the IT14 return do not provide taxpayers in South Africa with a solution on how they should transact at arm's-length price as section 31 of the Act requires.

2.6 TAX CASE LAW IN SOUTH AFRICA ON WHAT CONSTITUTES ARM'S-LENGTH TRANSACTION

There is currently no tax case law in South Africa on the transfer pricing subject. The reason seems to be that the transfer pricing cases challenged by taxpayers have been resolved through negotiated settlements. The other reason might be the absence of prescriptive transfer pricing tax legislation in providing guidance on how to transact at arm's-length. As a result both SARS and taxpayers have been reluctant to pursue judicial determinations in respect of transfer pricing disputes.

Even though there is no tax case law in South Africa dealing specifically with transfer pricing disputes, it is necessary to analyse the available tax case law in South Africa which deals with what constitute an arm's-length transaction. The reason for this is that should it happen that there be a transfer pricing case brought to court in South Africa, the court is likely to refer to the previous court judgment in deciding whether or not the transaction is at arm's-length.

There have been a number of tax case laws in South Africa which dealt with what constitutes an arm's-length transaction. The basis on which the majority of these cases were decided is derived from the general anti-avoidance tax legislation which is section 103 of the Act. In analysing whether or not a transaction is at arm's-length, the courts in South Africa have followed the abnormality test principle.

The courts developed a hypothesis test in analysing and reaching decisions on these cases. A hypothesis test is in the form of a question asking 'whether or not abnormal rights and obligations have arisen in the transaction between the related parties which would not have arisen if the parties in the transactions were not related'. In applying this principle test the courts have analysed the following factors:

a) The special relationship of parties involved in a transaction.

The courts would look at whether or not any special relationship of related parties involved in a transaction, have created abnormal rights and obligations for either of the parties. Would the transaction have been entered into if parties were not related?

b) The circumstances under which the transaction was entered.

The courts would further look at what the independent party would do under similar circumstances. Would a comparable independent enterprise have concluded the transaction to enhance its economic or commercial position? Is it a normal practice within the industry which the related parties operate?

c) The unusual features in the transactions.

The courts would look at whether or not any unusual features exist in the transaction undertaken by related parties.

d) The pricing or the value of the transaction.

The courts would look at whether the amount charged in a transaction reflects a fair market value as compared to the benefit derived from transaction. How much would a comparable independent party pay for the same goods or services in a comparable situation?

2.6.1 Case Law Analysis

The analysis of the following tax case law shows how the courts in South Africa have addressed the above factors in deciding whether or not a transaction is at arm's-length.

In *ITC 1546*[18], the taxpayer who was executing a business as a close corporation, claimed a wear and tear deduction on the market value of the assets and not on the costs of the assets at the time of liquidation when the taxpayer acquired the assets. The cost of the assets at the time of liquidation was less than the market value at the time of liquidation.

The Commissioner denied the taxpayer the tax deduction on the assets, on the basis that the true market value on which the deduction should have been made was the liquidation value on which the taxpayer had acquired the assets.

The taxpayer contended that the value of the assets during the time of liquidation when he acquired the assets, was not the true arm's-length price of the assets but the arm's-length was the book value during the time the assets were acquired. The reasons provided by the taxpayer for the argument, was that the circumstances under which the assets were acquired were not one of a willing buyer and willing seller. The circumstances were of forced seller and privileged buyer.

In making the judgment on this case the court analysed the circumstances under which the transaction was entered and ruled that the sale of assets by the liquidator to the taxpayer was at arm's-length, based on the fact that the transaction was a cash sale and had taken place at a market place where everyone, including the taxpayer, had a free choice to purchase the assets.

In *ITC 610*[19], a company claimed a tax deduction on directors' fees. The director's fees were considered excessive as it was more than double as compared to the previous year's amounts. In this case the court dealt with two issues when making a decision with regard to the directors' fees; the special relationship between the directors and the company and the considerations of the directors' fees. The court made the statement that,

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[18] 54 SATC 477(C)

[19] (1945) 14 SATC 377(U)

> ‘it is hardly conceivable that such a tremendous increase would have been awarded by an independent employer or company’.

The court further said that,

> ‘these figures were too remarkable not to evoke criticism’.

The court considered the award of the directors’ fees in relation to the profits and turnover of the company and ruled that the directors’ fees awarded by the company to its directors were excessive and unjustifiable. Based on these facts of the transaction, the court considered the transaction not to be at arm’s-length.

In *Smith v Commissioner for Inland Revenue*[20], the taxpayer, a sole shareholder of the company in South Africa, formed another company in Rhodesia (now Zimbabwe) and transferred the shares he owned in the South African company to the company in Rhodesia. The company in Rhodesian became the sole shareholder of the company in South Africa. During the year of assessment the South African company declared a dividend to its sole shareholder, the Rhodesian company.

The Commissioner disregarded the transfer of shares by the taxpayer to the Rhodesian company to be at arm’s-length transaction and deemed the taxpayer still to be the shareholder of the South African company; taxing the dividend declared by the South African company in the hands of the taxpayer.

In deciding on the arm’s-length nature of the transaction of the transfer of shares from the South African company to the taxpayers’ company in Rhodesia, the court considered the special relationship of parties involved in the transaction. The facts that the shares were transferred from the company in South Africa of which the taxpayer was the sole shareholder, to the company in Rhodesia of which the taxpayer was still the shareholder, the court viewed the transaction not to be at arm’s-length.

[20] 1964 (1) SA 324(A)

The court further considered the fact that the shares were transferred without any considerations, and under normal business circumstances shares would be disposed at a given price. Having considered these facts, the court considered this transaction not an arm's-length transaction.

In *Ovenstone v SIR*[21], the taxpayer being the appellant in this case, sold his shares in the private company to the trust which he formed for his children who were also the beneficiaries of the trust. The purchase price for the sale of shares was to be paid by the loan provided by the taxpayer to the trust. The interest rate charged by the taxpayer to the trust for the loan, was the same interest rate that the taxpayer was charged by the bank from where he had borrowed the money.

The commissioner was not pleased with either of the two transactions; the sale of shares to the trust and the loan provided by the taxpayer to the trust for the purchase of shares. The court analysed both transactions and came to the conclusion that they did not reflect arm's-length requirements. In relation to the sale of shares to the trust, the court stated,

> 'The creation of the rights and obligations was in itself an abnormal manner of doing business. People do not normally or usually do business in this manner. Moreover, a transaction of this magnitude, and on the terms agreed, would normally be recorded in writing, which was not done in this case'.

In relation to the loan made by the taxpayer to the trust the court came to the conclusion that the transaction lacked commercial, business or arm's-length characteristics. In analysing the transaction the court said the following:

> 'it was not a wholly business, commercial, or at arm's-length transaction without any element of bounty. Indeed, a strong element of bounty was present. That appellant was actuated by liberality, generosity, and filial affection in making the loans is indicated by his making available to his sons gratuitously the privilege (which he conceded had 'some value') of taking up some of the Buitesee shares that had been privately placed with him. He asked for no security for the loans. The terms of repayment of the loans and interest were also vague: that was to be done out of the dividends received, but nothing was apparently stipulated about by when they had to be repaid or what was to happen if the dividends were insufficient or ceased. The reason for the vagueness about the terms of the loans was probably because the

[21] 1980 (2) SA 721(A)

> appellant, as he indeed admitted, regarded them as 'a family transaction'. That all indicates that the rate of interest appellant charged his children for loans of that kind was probably, or at least possibly, unduly favourable. No evidence was adduced for appellant to prove that it was the ordinary, full or fair rate for loans of that kind prevailing at that time. That it was the same rate that the bank charged appellant does not go far enough to discharge that onus. For, having regard to appellant's business standing, wealth, and relationship with his bank, that rate might well have been a special, low rate of interest. In the absence of evidence on these important aspects the only conclusion is that appellant did not prove that these loans to his minor children were wholly commercial or business transactions without an appreciable element of bounty. They must therefore be regarded as being dispositions that were partly gratuitous and partly for consideration.'

This case shows that the analysis made by the court on both transactions in deciding on the arm's-length nature of the transactions, focused the attention on the relationship of the parties to the transaction, the behaviour of the parties in the transaction and the presence of any unusual features in the transaction. Based on the analysis of these factors the court was satisfied that the two transactions did not reflect any arm's-length nature. This kind of conclusion by the court is, however, not always easy to reach, as can be seen in the following case:

In *SIR v Geustyn, Forsyth and Joubert*[22], the facts of the case were that Geustyn, Forsyth and Joubert were partners practicing as consulting engineers and converted their partnership into an unlimited company. The three former partners now became shareholders and sole directors. At transfer of the partnership business to the company, the goodwill of the partnership business was valued at R240 000 and the amount was transferred in equal parts to the loan accounts of the former partners. Interest was levied on the outstanding balances each year. In addition, each director received a salary of R10 000 per annum and further received fees in the sum of R7 500.

The Commissioner, however, was of the opinion that the formation of the company amounted to a scheme which had been entered into with the object of reducing the liability to pay tax and that the means by which, and the manner in which the transaction had been entered, would not have been entered by parties transacting at arm's-length. The court differed with the Commissioner's opinion based on the following analyses:

[22] 1971 (3) SA 567 (A)

a) The court said there is nothing abnormal in converting an existing partnership into a company; indeed such transactions may fairly be regarded as relatively commonplace in the commercial world.

b) That professional men continuing their profession in partnership, should transfer their practice to an unlimited company may at first sight appear to be somewhat extraordinary, but the undisputed facts of the case placed a different perspective on the matter. The South African Association of Consulting Engineers expressly sanctioned its members forming unlimited companies to practice in corporate form, and more than half of the Association's members had already formed companies. More than half of the consulting engineers who were not members of the Association were also registered companies. Nor was this peculiar to the Republic, for the majority of consulting engineers in England, Canada, France, Switzerland and Japan practice in corporate form.

c) The stated case showed that the partners regarded the advantages to be derived from incorporation as considerable. Such advantages inter alia embraced the fact that a company, unlike a partnership, is not dissolved upon the death or retirement of a member, the facility of participation in consortiums of engineers engaged in large projects; the ability to increase the participation in profits by qualified employees while, at the same time, eliminating the necessity to restrict the number of partners to the legal limit of 20. In the latter connection it was also mentioned that the three original shareholders sold 1500 shares to six new shareholders who were all qualified employees of the company. The admission of more employees as shareholders was contemplated, and it was anticipated that the total number of shareholders would in the foreseeable future rise to 15.

In making a decision whether or not the transaction reflected the arm's-length nature, the court encountered greater difficulty. The court said that,

> 'the criterion of 'persons dealing at arm's-length is not easy of application in a case such as this one. For the section under which the criterion is applied, enjoins the application of that criterion in relation to a transaction, operation or scheme' of the nature of transaction, operation or scheme in question'.

The court was also concerned with partners who have, in the circumstances as outlined above, made over their practice, not to an independent third party with whom they would ordinarily deal at arm's-length, but to an unlimited company of which they are the sole shareholders and directors and whereof they have full and complete control.

It is evident in this case that the application of the arm's-length principle is not an exact science as it is mentioned by Practice Note 7 and the OECD guidelines (Practice Note 7, Para. 7.6). The analysis of facts by the court shows that the court was satisfied that the dissolving of the partnership and the formation of the company was an arm's-length transaction as this decision made business sense.

On one hand the court found it difficult to apply the arm's-length principle with regard to the transfer of goodwill transaction that took place between the partnership and the company when the partnership was dissolved. The court was not satisfied that this transaction reflected an arm's-length nature based on the relationship between the company and the partnership.

In *CIR v Louw*[23], the facts were the same as in *Geustyn*'s case. The partners dissolved the partnership and formed the company and then sold the partnership business with all the assets to the newly formed company. After the incorporation of the company, interest-free loans were made by the company to the directors who were the shareholders of the same company.

The Commissioner was of the opinion that the formation of the company amounted to a scheme which had been entered into with the object of reducing the liability to pay tax and that the means by which and the manner in which the transactions had been entered, would not have been entered by parties transacting at arm's-length.

[23] 1983 (3) SA 551(A)

In dealing with the transaction of the dissolving of the partnership and the incorporation of the company the court said,

> 'the incorporation of a professional practice is '. . . the action of a normal businessman . . . '

In passing this judgment the court applied the principle which was applied in *Geustyn*'s case. The court considered whether in applying the 'normality' yardstick, it should take account of the special relationship between the partners and the company which they had formed, or ignore it and apply the yardstick as though the company were a stranger? It was decided by the court that it was not possible to make the analysis of the transaction but ignore the special relationship between the partners and the company, and yet give proper judgment.

In reaching the judgment with regard to this transaction the court said,

> 'it must be borne in mind that in a case such as the present one, the transaction is a multipartite one to which all the partners and the company are parties; and each partner contracts both with the company and his fellow partners and seeks to extract from the transaction the best possible advantage for himself.'

Giving due regard to the facts above, the court ruled that the dissolving of the partnership and the incorporation of the new company was an arm's-length transaction. With regard to whether the transactions of interest-free loans to the directors have created rights or obligations which would not normally be created between persons dealing at arm's-length, the court said,

> 'There is no evidence, further, to show that the conduct of a Director in accepting a small salary, to be determined each year, to assist in building up the capital of the company, is an abnormal action and one that would not occur normally in a private company in which the shareholders were attempting to build up capital to enable the company to compete with large public companies alternatively to provide for the contingency of a period in which work was slack. There is no evidence that the salary which the appellant earned was small in relation to salaries earned by other construction or civil engineers – the evidence relates to his previous earnings as a partner of the firm. Assuming that there was evidence that the salary was small, there is no evidence that this is an unusual action on the part of a shareholder or a Director in a company, as the present, seeking to build up reserves.'

Having regard to these facts the court ruled that the transaction of the directors' loans, seen in the context of the amounts allocated to directors by way of salary and dividend, the court was of the opinion that the transaction did not reflect the arm's-length nature.

The analysis in both the *Geustyn* and *Louw* cases confirms that in making a decision whether or not the transaction is at arm's-length, the court would look at how the relationship of the parties has influenced the transaction. The court also looks at the behaviour of the parties in the transaction, the presence of any unusual features in the transaction and what the practice is within industry or the market in which the parties conduct their business.

The analogy of these factors in determining what constitutes an arm's-length transaction, can also be illustrated again in the following cases:

In *Hickling v SIR*[24] case, the taxpayer and two others were the sole shareholders and directors of a dormant private company. The dormant company was sold to a company, Ryan Nigel, whose main business activity was to buy dormant companies. With the purchase price money received by Ryan Nigel, the dormant company declared dividends to its shareholders.

The Commissioner was of the view that the transaction that took place between Ryan Nigel and the dormant company was a scheme which had been entered into with the objective of avoiding tax, and that the means by which the transactions had been entered would not have been entered by parties transacting at arm's-length.

In deciding whether or not the transaction in this case was at arm's-length, the court first outlined the factors that should be present in an arm's-length transaction and thereafter analysed the facts of the transaction in this case. In outlining factors that are found in an arms' length transactions, the court said that each party should be

[24] 1980 (1) SA 481(A)

independent of the other and, in so dealing, each party will strive to get the utmost possible advantage from the transaction.

In an at arm's-length transaction the rights and obligations created are more likely to be regarded as normal than abnormal. The means or manner employed in entering into it or carrying it out are also more likely to be normal than abnormal. The next observation made by the court in outlining the factors in an arm's-length transaction was that, when considering the normality of the rights or obligations so created or of the means or manner so employed, due regard should be paid to the circumstances present.

The court further mentioned that in some circumstances, what may be normal might however not be normal in other circumstances. The last observation made by the court was that facts in the transaction are also important when assessing whether or not the transaction reflects the arm's-length nature.

Based on the following facts of the transaction, the court ruled that the transaction was at arm's-length.

a) The court was satisfied that neither Reklame nor shareholders of the dormant company, as directors or otherwise, were associated with or interested in Ryan Nigel. Nor did the latter hold any sway over them.

b) The court also found that it was Ryan Nigel who drew up the agreement and tendered it to them as an offer to purchase their shares on an accept-it-or-reject-it basis. To the shareholders the advent of Ryan Nigel with its offer was the deus ex machina for solving their problem of having to keep their 'untidy', dormant company in existence.

c) The court was also satisfied that the transaction was done during Ryan Nigel's normal course of business as it was part of Ryan Nigel's business to purchase the shares of companies with capital and distributable reserves. This offer was indeed made in the ordinary course of that business.

d) Furthermore, the court learnt that the agreement between the parties obliged the shareholders to divest themselves of their shares and control of their dormant company. Against that Ryan Nigel had to pay them the purchase price. The court was therefore satisfied that the reciprocal obligations were, of course, normal incidents of such a contract of sale.

All of the above facts satisfied the court that both parties dealt with each other at arm's-length. In analysing the facts in this case and making a decision, the court also relied on the decision reached in the following case:

In *ITC 1636*[25], the taxpayer entered into transactions of sale and lease-back of assets with his bank. The transactions resulted in a tax benefit for both taxpayer and bank. The tax benefit for the taxpayer was that he disposed of the assets that were regarded as capital in nature, therefore he could not pay tax on them and when he leased them back from the bank he could claim the rental payments as a tax deduction. The tax benefit for the bank was that they could claim a tax deduction on the tax allowances provided on the assets purchased from the taxpayer.

The commissioner was of the opinion that the transactions between the taxpayer and the bank was a scheme which had been entered into with the objective of avoiding tax and that the means by which the transactions had been entered into, would not have been entered into by parties transacting at arm's-length.

In deciding whether or not the transactions in this case were at arm's-length, the court reached the decision that both the sale and lease of the assets transactions were concluded at arm's-length. The court based their decisions on the following facts:

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[25] (1997) 60, SATC 267

a) Both parties were independent enterprises with no special relationship. The Court was satisfied that because there was no special relationship between the parties, the terms of the agreement of the transaction could not have been influenced by the parties' special relationship.

b) The analysis of the terms of the agreements in the transactions showed that both parties were concerned businesses striving to secure the utmost possible advantage from the transactions. The court was satisfied with the clauses put by the bank in the agreement with regard to the rights and obligations in the transactions.

c) Circumstances under which both parties had entered into these transactions were common and usual as far as these kinds of transactions are concerned. This was based among other things on the fact that the taxpayer, being the party which was borrowing the money, had a solid credit rating and therefore the bank would be willing to enter into such kinds of transactions.

The analysis above establishes that when deciding what constitutes an arm's-length transaction, the courts in South Africa have followed the hypothesis statement 'whether or not abnormal rights and obligations have arisen in the transaction between the related parties which would not have arisen if the parties in the transactions were not related'.

This hypothesis statement followed by the South African tax case law is similar to the arm's-length hypothesis statement in Article 9 of the OECD Model Treaty. The arm's-length principle under Article 9 of the OECD Model Treaty requires that in establishing whether or not a transaction is at arm's-length, an analysis should be made whether or not the conditions of connected person transactions are comparable to the conditions of transactions carried out between independent enterprises. In establishing that, Article 9 of the OECD Model Treaty requires that the OECD guidelines should be applied which contain the transfer pricing methods of calculating the arm's-length price or margin realised by independent enterprises.

The tax case law in South Africa does however not provide any methods of calculating the arm's-length price, other than providing the legal evaluation to prove that a transaction is not at arm's-length. The difference between the two approaches is that the South African tax case law relies on a legal test exercise in determining whether or not the transaction is at arm's-length. In terms of the legal test approach the taxpayer can perform a self-examination of a transaction entered into with a related party without a reference or use of any comparables in proving that such a transaction is at arm's-length.

Meanwhile, the process in the Article 9 of the OECD Model Treaty of determining whether or not a particular transaction is at arm's-length, relies on the economic test exercise. The economic test exercise is achieved by following the process in Practice Note 7 or the OECD guidelines. As it was discussed in this chapter, determining arm's-length price through the economic test exercise is achieved through the analysis referring to the comparable situation or of the industry or market prices.

As discussed earlier in this chapter that Practice Note 7 is not legally binding to taxpayers and this allows taxpayers in South Africa to make use of any other methods or processes to substantiate that their transactions are at arm's-length. The argument is therefore that, if a taxpayer decides not to apply the economic test exercise but decides to apply the legal test exercise to substantiate that a particular transaction with the offshore connected person is at arm's-length; can the courts or SARS reject taxpayers' approach and require that taxpayers should conduct the economic test exercise in Practice Note 7 to substantiate that the transaction is at arm's-length?

In this situation the decision will be taken by the courts in deciding whether or not the legal test exercise is the correct approach to substantiate that a transaction is at arm's-length as opposed to the economic test exercise in the OECD guidelines and Practice Note 7. The tax case law analysis in this section has established that in certain instances the courts considered the economic test exercise in deciding whether or not a transaction was an arm's-length transaction.

Such cases are *Ovenstone* and *Geustyn*. In *Ovenstone*, the court rejected the interest rate charged by the taxpayer to his children on the basis that it was not the market interest rate charged by the banks in the market. In *Geustyn*, the taxpayer proved to the court that the change of partnership to a company was a normal practice within the engineering companies in the country and the court accepted this evidence.

This shows that to a certain extent the courts in South Africa can accept it if taxpayers have applied economic test exercise in Practice Note 7 and the OECD guidelines in substantiating that their transactions are at arm's-length. But to a certain extent the court may also reject the use of Practice Note 7 and the OECD guidelines by taxpayers in substantiating that their transactions are at arm's-length, as it has been established previously in this chapter in *ITC 1675* the courts disregarded the use of the Practice Notes as a law in South Africa.

2.7 CONCLUSION

The purpose of this chapter was to address the first sub-problem of this research study which is determining how taxpayers in South Africa are required to transact at arm's-length prices in the absence of prescriptive transfer pricing tax legislation. In addressing the research question further, the next chapter discusses the current status of Practice Note 7 and compares it to the OECD guidelines in determining whether, as a result of being consistent or not consistent with the OECD guidelines, Practice Note 7 can be included as provision on how to transact at arm's-length price in the South Africa transfer pricing tax legislation in order to amend the legislation such that it becomes prescriptive.

CHAPTER 3: PRACTICE NOTE 7 AND THE OECD GUIDELINES

3.1 INTRODUCTION

The purpose of this chapter is to address the second sub-problem of the research study. To this end this chapter analyses the background and history of the OECD guidelines, the updates and developments in the OECD guidelines, and the structure and the contents of the OECD guidelines. The chapter further provides an analysis of the background and history of Practice Note 7 and then provides an analysis of the extent that Practice Note 7 concurs with the OECD guidelines.

3.2 THE OECD GUIDELINES

3.2.1 Background and History of the OECD Guidelines

The OECD was formed in the year 1961 as an organisation of countries sharing a commitment to democratic government and market economy. The predecessor of the OECD is the Organization for European Economic Cooperation, which was established to regulate the American and Canadian aid under the Marshall plan for rebuilding of Europe after the Second World War. The OECD was formed with the aim of building strong economies in member countries; improving efficiency, market systems, expanding free trade and contributing to the development in industrialised as well as developing countries (Cernic, 2008:77).

The OECD consists of more than 30 country members and is organised in committees of member country representatives. In addition to the country members there are also countries which are not members but observers, and South Africa is one of the observers. One of the objectives of the OECD has been to strive to build an international consensus on principles of international taxation. The committee at the OECD responsible for tax policies is called Committee on Fiscal Affairs and is governed by a council of member representatives (Deloitte & Touch Tohmatsu, 2001:7).

The spread of multinational enterprises in the 1960s resulted in an increasing volume of trade between members of the same multinational enterprises and raised concerns for the tax authorities with regard to the protection of their tax base. As a result tax authorities began to review and institute certain developments on their tax legislation and administrative regulations in order to minimise possible tax avoidance opportunities that arose from the manipulation of transfer prices. Hence the reason the OECD was formed (Deloitte & Touch Tohmatsu, 2001:7).

The developments explained above were followed by tightening of tax legislation and administrative regulations and became concerns also for the multinational enterprises because of the possibility of double taxation arising from international, inconsistent tax rules. These developments led to the OECD developing the OECD guidelines to help both the multinational enterprises and the OECD country members on how to address transfer pricing practices. The purpose of introducing the OECD guidelines was to ensure that taxpayers clearly reflect income attributable to transactions carried out with related parties as if the transactions were carried out with independent companies under normal market conditions. In other words, to ensure that transactions between related parties adhere to the arm's-length principle (Deloitte & Touch Tohmatsu, 2001:7).

Although the OECD guidelines are an agreed consensus among the OECD member countries, they were not developed with the intention of being binding law or supersede the OECD member countries' national rules. The OECD recommends that local transfer pricing laws should be formed with regard to the spirit of the OECD guidelines. To date the OECD guidelines constitute the international standard that OECD member countries have agreed should be used in analyzing transfer pricing issues between multinational enterprises and tax authorities (Deloitte & Touch Tohmatsu, 2001:7).

3.3 THE UPDATES AND DEVELOPMENTS OF THE OECD GUIDELINES

The OECD issued the first transfer pricing report in the year 1979, namely Transfer Pricing and Multinational Enterprises (hereinafter called the 1979 report). The purpose of the report was to provide guidance on how multinational enterprises determine the arm's-length price with regard to transfer pricing transactions. The 1979 report addressed the following issues (United Nations, 2001: 8):

a) The arm's-length principle as an appropriate approach to adopt in arriving at profits of related entities for tax purposes.

b) The consideration that the transfer pricing problems should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes.

c) The protection of the interests of the national tax authorities involved and to prevent double taxation of the enterprises involved.

d) The ideal transfer pricing methods, the comparable uncontrolled price; and if no useful evidence is available, cost plus or resale methods should be acceptable from an arm's-length point of view.

e) That other methods are not excluded, but with respect to these other methods the report is vague and negative; profit-split method is necessarily arbitrary; profit comparison is only an indication for further investigation; the return on capital invested presents difficulties; net yield expectations are imprecise. That such methods may be used as a double-check (profit comparison) or as a solution in bilateral negotiations among countries (profit-split).

f) Global methods and formulary methods for allocating profits to affiliates are not endorsed, as they are incompatible with Articles 7 and 9 of the OECD Treaty

Model; they are arbitrary, disregard market conditions, ignore the management's own allocation of resources, do not bear a sound relationship to the economic facts, and carry the risk of double taxation.

g) That it is always useful to begin with a functional analysis (actual functions, responsibilities, risks).

h) The recognition of the actual transaction, not to substitute another transaction for it; (if required) the price for the actual transaction should be adjusted to an arm's-length price.

i) That the transfer pricing policies of multinational enterprises may in fact be market-oriented and, where the different entities within such groups have their own profit responsibility, they may be free to contract either with an associated enterprise or with a third party with the result that there is a degree of bargaining within the group which produces a price effectively indistinguishable from the arm's-length price.

The 1979 report further discusses in some detail the transfer pricing treatment of the transactions such as goods (Chapter 2), technology and trademarks (Chapter 3), services (Chapter 4) and loans (Chapter 5) (United Nations, 2001:9).

The 1979 report was followed by the report in the year 1984 (hereinafter called the 1984 report) which addressed three specific topics; the mutual agreements, transfer pricing in the banking sector, and the allocation of central costs. The 1984 report is referred to as Transfer Pricing for Multinational Enterprises - Three Taxation Issues and it was issued as an elaboration of the 1979 report (United Nations, 2001:8).

In the year 1995, the OECD revised the 1979 report and replaced it with the document Transfer Pricing Guidelines for Multinational Enterprises and Tax authorities. This document also known as the OECD guidelines contained five chapters when it was first issued (United Nations, 2001:9; Deloitte & Touch Tohmatsu, 2001:7).

Chapter I of the OECD guidelines contained the arm's-length principle and addressed its status as the international standard and includes guidelines for its application. Chapter II contained the traditional transaction methods, explains the application of the comparable uncontrolled price method, the resale price method and the cost plus method. Chapter III contained the other methods, the traditional transactional methods, namely the profit split method and the transactional net margin methods (Deloitte & Touch Tohmatsu, 2001:8).

Chapter IV contained the administrative approaches in dealing with resolving transfer pricing disputes, details penalties, corresponding adjustments, procedures to avoid double taxation, simultaneous examinations, safe harbours, advance pricing agreements and arbitration. Chapter V contained transfer pricing documentation guidelines and established the type of information that taxpayers should maintain when setting transfer prices (Deloitte & Touch Tohmatsu, 2001:8).

The last part of the OECD guidelines was the Annex which contained guidance on the advance pricing arrangements, and the Glossary defines important transfer pricing terms. Since then, the OECD guidelines were updated several times and three other chapters and an annexure have been added to the document. The following is the analysis of these updates and changes.

3.3.1 The Chapter on Intangible Property

In April, the year 1996 the OECD added Chapter VI in the OECD guidelines as an additional chapter. Chapter VI deals with the special considerations on how the arm's-length principle should be applied to intangible property transactions within the multinational enterprises. Chapter VIII also sets out the important facts and circumstances that should be taken into consideration for transfers of intangible property within the multinational enterprise (United Nations, 2001:19; Deloitte & Touch Tohmatsu, 2001:7). A brief analysis of the contents of Chapter VI is provided in the next section.

3.3.2 The Chapter on Intra-Group Service

In the same year in which Chapter VI was added, Chapter VII was also added to the OECD guidelines. Chapter VII deals with the special considerations on how the arm's-length principle should be applied to intra-group services transactions. The chapter defines the characteristics of different types of intra-group services (United Nations, 2001:19; Deloitte & Touch Tohmatsu, 2001:7). A brief analysis of the contents of Chapter VII is conducted in the next section.

3.3.3 The Chapter on Cost Contribution Arrangements

In the year 1997, the OECD added Chapter VIII in the OECD guidelines addressing the transfer pricing treatment of the cost contribution arrangements. Chapter VIII addresses how the arm's-length principle should be applied under the cost contribution arrangements within the multinational enterprises. The chapter also provides guidance on determining the participants of the cost contribution arrangements, how their respective contributions should be valued, and whether the allocation of contributions is appropriate in light of the expected benefits to be received. The tax treatment of contributions and other payments made under the cost contribution arrangements is also discussed (United Nations, 2001:19; Deloitte & Touch Tohmatsu, 2001:7). A brief analysis of the contents of Chapter VIII is conducted in the next section.

3.3.4 Annex on Advance Pricing Agreements and Mutual Agreements Procedure

In February 1998, the Annex was added to the OECD guidelines. It contained practical examples and procedures for monitoring the implementation of the guidelines. In October 1999, another Annex was added to the OECD guidelines which covered the guidelines for conducting advance pricing arrangements under the mutual agreement procedure (United Nations, 2001:19; Deloitte & Touch Tohmatsu, 2001:7).

3.3.5 Attribution of Profit to a Permanent Establishment

As discussed in chapter 2 of this research study, permanent establishment business activities exist when a multinational enterprise is conducting a business in another jurisdiction in place of management; a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

The OECD has issued a number of draft discussion papers suggesting guidance on how profits between the multinational enterprise and its permanent establishment business activities should be allocated. In the discussion draft papers, the OECD invited inputs from the general public and the business community to provide their views on the profit allocation to a permanent establishment (OECD, Discussion Draft Part I: 2001).

The purpose of the issuing of the discussion draft papers was to provide further guidance in addition to the OECD guidelines, on the treatment of transfer pricing transactions taking place within one legal entity operating in two different countries.

When the OECD issued the OECD guidelines in the year 1995, it stated that the arm's-length principle should only be applied between associated enterprises or between two legal entities related, and not within one legal entity operating in more than one country. In this instance, it means that where multinational enterprise is conducting a business through a branch or an office in another country, the OECD guidelines did not make the provision on the application of the arm's-length principle for this kind of transaction happening between a multinational enterprise and its branch in another country (Russo, 2005:10).

The reason for this was that a multinational enterprise and its branch was regarded in the OECD guidelines as one legal entity and not as two separate legal entities. The other reason for the issue of the discussion draft papers on permanent establishment business activity is that it has been established that Article 7 of the OECD Model Treaty is interpreted differently in a number of member countries (Russo, 2005:10).

The different interpretation by OECD member countries has resulted in a problem of how Article 7 of the OECD Model Treaty and the OECD guidelines is applied when the profits of a permanent establishment are allocated. Hence for these reasons, the OECD has issued a number of discussion draft papers proposing guidance on how the profits to a permanent establishment should be allocated (Russo, 2005:10).

In the year 2001 the OECD issued a discussion draft paper called Part I discussion draft paper. The revised paper on Part I was issued in 2004. The 2001 discussion draft provides that an anlysis should be done when applying the arm's-length principle within a single taxpayer. The 2001 discussion draft's view to the arm's-length approach with regard to how the profits a permanent establishment should be allocated, is based on the following two-step analysis. The first is the hypothesis of the permanent establishment as an enterprise separate from the one of which it is part, and the second step is to attribute an arm's-length amount of profits to this hypothesized separate enterprise (OECD Discussion Draft Part III: 2004; Russo, 2005:10).

The 2001 discussion draft further mentions that there are four circumstances under which this approach should be applied when allocating profit to a permanent establishment. These circumstances are as follows (Russo, 2005:10).

a) The use of a capital asset

b) The use of an intangible asset

c) The provision of internal service

d) The capital allocation and funding of a permanent establishment's operations.

The revised discussion draft issued in 2004 still emphasises the approach proposed in the 2001 discussion draft. This is substantially based on the inputs received from the general public with regard to the 2001 discussion draft. The 2004 revised discussion draft also discusses the three other issues with regard to the allocation of the profits to a permanent establishment, namely (Russo, 2005:10);

a) The allocation of functions, risks and assets to the permanent establishment.

b) The allocation of free capital to the permanent establishment.

c) The special considerations for agency permanent establishments.

In the same year that the Part I discussion draft paper was issued, Part II and Part III of the discussion draft paper were also issued. Part II and Part III of these discussion drafts were also revised later in 2003.

Part II of the discussion draft discusses how the arm's-length principle should be applied to a permanent establishment business activity involving the banking business. Part II of the discussion draft considers what might be called traditional banking activities, the borrowing and on-lending of money and provides guidance on how the income from such activities (mostly interest or interest equivalents) might be attributed to a permanent establishment of a banking enterprise (OECD, Discussion Draft Part II, 2004).

Part III of the discussion draft discusses the global trading of financial instruments (global trading), an activity that is commonly carried out by banks but also by financial institutions other than banks. In this discussion draft, particular attention is given as to how the arm's-length principle applies to a number of factual situations commonly found in enterprises carrying on a global trading business through a permanent establishment, and how the arm's-length principle should be applied to the banking business conducted through the permanent establishment (OECD, Discussion Draft Part III: 2004).

In the year 2005 the OECD issued Part IV of the discussion draft. Part IV discusses how the arm's-length principle should be applied to the insurance business conducted through the permanent establishment. Part IV of the discussion draft discusses the insurance business activities and provides guidance on how the income from such activities might be attributed to a permanent establishment of insurance enterprise (OECD, Discussion Draft Part IV: 2004).

3.3.6 Transactional Profit Methods

In the year 2008 the OECD issued the discussion draft document entitled transactional profit methods. The objective of this discussion draft document was to propose a suggestion on whether or not the transactional profit methods should maintain their status as a last resort as highlighted in the OECD guidelines. The reason for changing them from the status of last resort was due to the fact that there was an increasing number of countries indicating that in practice, transactional profit methods are being applied in a number of cases than would be expected. This was happening even though the OECD guidelines endorsed the transactional methods to be preferable as compared to profit methods (OECD, Discussion Draft Transactional Profit Methods, 2008:5).

In addressing the issue of whether or not the transactional profit methods should maintain their status as last resort, as highlighted in the OECD guidelines, the discussion draft discusses the following three points (OECD, Discussion Draft Transactional Profit Methods: 2008:5):

> 'Examination of the arguments in favour of maintaining the last resort status: what the reasons were for giving transactional profit methods a last resort status in the TP Guidelines and whether there are new concerns that have arisen since 1995; assess the validity of these old and new concerns and whether there are ways to alleviate them.

> Examination of the arguments in favour of changing the last resort status: what the reasons are for many taxpayers and tax administrations to use transactional profit methods despite their last resort status and the arguments raised in favour of changing the status of these methods.
>
> Examination of the various possible options with respect to the status of transactional profit methods: what the options are (including whether different solutions should be promoted for the profit split methods and for the transactional net margin method (hereafter "TNMM") or for specific transactions), their pros and cons, and what safeguards or conditions should be satisfied in order for these various options to be acceptable.'

When the OECD guidelines were issued in 1995, it described the transactional profit methods as methods of last resort and that the use of these methods should be limited to exceptional situations where no data is available or where the available data is not of sufficient quality to rely solely or at all on the traditional transaction methods (OECD guidelines, Para, 2.49).

The discussion draft document suggests that certain changes should be made to paragraphs 2.49, 3.49, 3.50, 3.54 and 3.56 in the OECD guidelines and emphasises that the transactional profit methods should no longer be regarded as methods of last resort. The discussion draft document states that the paragraphs mentioned above, should be updated and reworded.

The discussion draft suggests that paragraph 2.49 should be worded as follows:

> 'As noted in paragraphs 1.68 and 1.68a, the selection of a transfer pricing method always aims at finding the most appropriate method for a particular case. One essential element is to take account of the respective strengths and weaknesses of each of the OECD recognised methods. Traditional transaction methods are the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are arm's-length. As a result where, taking account of the comparability analysis of the controlled transaction under review and of the availability of information, a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method is preferable to other transactional profit methods. Moreover, where taking account of the comparability analysis of the controlled transaction under review and of the availability of information, the comparable uncontrolled price method (CUP) and another transfer pricing method can be applied in an equally reliable manner, the CUP method is to be preferred.'

The discussion draft further suggest that certain wordings in paragraph 3.49, 3.50, 3.54 and 3.56 in the OECD guidelines be deleted and such wordings are as follows:

> 'Traditional transaction methods are to be preferred over transactional profit methods as a means of establishing whether a transfer price is at arm's-length, i.e. whether there is a special condition affecting the level of profits between associated enterprises. To date, practical experience has shown that in the majority of cases, it is possible to apply traditional transaction methods.'(Para 3.49)
>
> 'Therefore, for the reasons set out in this Report and particularly those in paragraphs 3.52-3.57 below, as a general matter the use of transactional profit methods is discouraged.'(Para 3.50)
>
> 'Instead, transactional profit methods are being recognised as methods that assist in determining in cases of last resort whether transfer pricing complies with the arm's-length principle.'(Para 3.54)
>
> 'Consequently, transactional profit methods should never be used by tax administrations if they do not yet have the necessary institutional legal framework to ensure that the proper precautions are taken. This would include the existence of an effective administrative appeals mechanism. The Committee on Fiscal Affairs intends to engage the major non-Member countries in a dialogue on the application of the principles and methods set out in this Report and any revisions hereto.'(Para 3.56)

When consensus is reached on these changes and updates with regard to the transactional profit methods this will simply mean that the status of these methods will now be on the same level as the traditional transactional methods in the OECD guidelines and not regarded as methods of last resort.

3.3.7 Transfer Pricing Aspects of Business Restructuring

In the year 2005 the OECD issued the discussion draft document entitled transfer pricing aspects of business restructurings in recognition of the widespread phenomenon of business restructurings by multinational enterprises. The OECD believes that since the mid 1990s, business restructuring has taken place and such structures have transfer pricing implications as they consists of the following (OECD, Discussion Draft Aspects of Business Restructuring, 2009: 6):

a) Conversion of fully-fledged distributors into limited-risk distributors or commissionnaires for a related party that may operate as a principal.

b) Conversion of fully-fledged manufacturers into contract-manufacturers or toll-manufacturers for a related party that may operate as a principal.

c) Rationalisation and/or specialization of operations (manufacturing sites and/or processes, research and development activities, sales, services).

d) Transfers of intangible property rights to a central entity (for example, a so-called 'IP company') within the group.

The view of the OECD is that business restructurings will normally be accompanied by a reallocation of profits among the members of the multinational enterprise group, either immediately after the restructuring or over a few years (OECD, Discussion Draft Aspects of Business Restructuring, 2009:7).

The objective of this discussion draft document was to discuss the extent to which such a reallocation of profits is consistent with the arm's-length principle and more generally, how the arm's-length principle applies to business restructurings. In achieving this objective, the discussion draft document addresses the following four key issues (OECD, Discussion Draft Aspects of Business Restructuring, 2009):

a) The first issue provides general guidance on the allocation of risks between related parties and in particular the interpretation and application of paragraphs 1.26 to 1.29 of the OECD guidelines.

b) The second issue discusses the arm's-length compensation for the business restructuring itself, the application of the arm's-length principle and the OECD guidelines to the restructuring; in particular the circumstances in which at arm's-length the restructured entity would receive compensation for the transfer of functions, assets and/or risks, and/or an indemnification for the termination or substantial renegotiation of the existing arrangements.

c) The third issue examines the application of the arm's-length principle and the OECD guidelines to post-restructuring arrangements.

d) The fourth issue discusses some important notions in relation to the exceptional circumstances where a tax administration may consider not recognising a transaction or structure adopted by a taxpayer, based on an analysis of the existing guidance at paragraphs 1.36-1.41 of the OECD guidelines and of the relationship between these paragraphs and other parts of the OECD guidelines.

3.3.8 Proposed Revision of chapters I-III of the Transfer Pricing Guidelines

In the year 2009 the OECD issued the discussion draft document entitled proposed revision of chapters I-III of the transfer pricing guidelines. The objective of this discussion draft document was to address issues with regard to comparability analysis and transfer pricing profit methods. (OECD, Discussion Draft on proposed revision of chapters I-III of the transfer pricing guidelines, 2009: 2). In addressing these issues, the discussion draft document discusses the following four points:

> '-- Hierarchy of transfer pricing methods: In the existing TPG, there are two categories of OECD recognised transfer pricing methods: the traditional transaction methods (described in Chapter II of the TPG) and the transactional profit methods (described in Chapter III). Transactional profit methods (the transactional net margin method and the profit split method) currently have a status of last resort methods, to be used only in exceptional cases where there are is no or insufficient data available to rely solely or at all on the traditional transaction methods. Based on the experience acquired in applying transactional profit methods since 1995, the OECD proposes removing exceptionality and replacing it with a standard whereby the selected transfer pricing method should be the "most appropriate method to the circumstances of the case" (see paragraphs 2.1-2.9 in the attached). In order to reflect this evolution, it is proposed to address all transfer pricing methods in a single chapter, Chapter II (Part II for traditional transaction methods, Part III for transactional profit methods).
>
> -- Comparability analysis: The general guidance on the comparability analysis that is currently found in Chapter I of the TPG was updated and completed with a new Chapter III containing detailed proposed guidance on comparability analyses.
>
> -- Guidance on the application of transactional profit methods: Additional proposed guidance on the application of transactional profit methods was developed and included in Chapter II, new Part III.
>
> -- Annexes: Three new Annexes were drafted, containing practical illustrations of issues in relation to the application of transactional profit methods and an example of a working capital adjustment to improve comparability.'

3.4 THE STRUCTURE AND THE CONTENTS OF THE OECD GUIDELINES

To date, the OECD guidelines are divided into eight chapters, two Annexes and a Glossary. The following is the brief analysis of these chapters, the Annexes and the Glossary.

3.4.1 Chapter I

Chapter I of the OECD guidelines discusses the arm's-length principle and the challenges encountered when the arm's-length principle is applied. Chapter I further discusses a number of factors which should be considered when applying the arm's-length principle, such as comparability analysis which is used to compare conditions in controlled transactions with conditions in uncontrolled transactions (Deloitte & Touch Tohmatsu, 2001:9).

As discussed in chapter 2 of this research study, Chapter I of the OECD guidelines lists the five comparability factors which should be examined to determine whether the transactions might be considered comparable, namely; characteristics of property transferred or services provided; functions performed, assets used and risks assumed by the party under examination (for example, a functional analysis); contractual terms; economic circumstances such as geographic location, size of the markets, extent of competition in the markets, relative competitive positions, availability of substitute goods or services, and business strategies.

Chapter I further discusses other factors which should be considered when the arm's-length principle is applied. Such factors are the use of arm's-length range, multiple year data, arm's-length range and the use of transfer pricing methods. These factors are discussed in detail in chapter 2 of this research study.

3.4.2 Chapter II and III

The Chapter II of the OECD guidelines discusses the three transfer pricing methods classified as traditional methods. These methods are the controlled uncontrolled price method, the resale price method and the cost plus method. Chapter II of the OECD guidelines specifies how to apply these methods and the special circumstances under which the methods would likely be the best method. A detailed description of these three methods is discussed in chapter 2 of this research study (Deloitte & Touch Tohmatsu, 2001:10).

Significantly, chapter II of the OECD guidelines expresses a preference for the traditional transactional methods. This expression might however change soon as the OECD reach consensus on the issue of the discussion draft document on the profit methods. Chapter III of the OECD guidelines discusses the other transfer pricing methods classified as transactional methods. These methods are the profit methods and the transactional net margin method (Deloitte & Touch Tohmatsu, 2001:11).

The transactional profit methods are currently regarded as the methods of last resort. As already mentioned above, these methods might in future be of the same status as the traditional methods, after the OECD has reached consensus on the issue of the discussion draft document on the profit methods. A detailed description of these two methods is discussed in chapter 2 of this research study.

3.4.3 Chapter IV

Chapter IV of the OECD guidelines discusses seven administrative aspects which the OECD guidelines suggest that tax authorities of the OECD member countries should adopt, to ensure that multinational enterprises are compliant with the arm's-length principle. These administrative aspects are transfer pricing compliance practices, mutual agreement procedures, simultaneous examinations, safe harbour rules and advance pricing agreement. These aspects are analysed as follows:

3.4.3.1 Transfer pricing compliance practices

Chapter IV provides three main elements which tax authorities should consider applying when ensuring that transfer pricing practices are compliant with the arm's-length principle. These elements are; examination practices, the burden of proof, and penalty systems.

a) Examination Practices

Regarding examination practices, chapter IV encourages tax authorities to initiate their transfer pricing analysis from the perspective of the method that the taxpayer has selected in setting its prices (OECD guidelines, Para. 4.8). Chapter IV further provides that tax authorities should be flexible in their transfer pricing approaches and not demand from taxpayers an unrealistic precision on their transfer pricing results. Chapter IV also recommends that examination practices should take account of the taxpayer's commercial judgment and should avoid demanding precision (OECD guidelines, Para. 4.9).

b) Burden of Proof

Chapter IV provides that enforcement of the burden of proof differs from country to country (OECD guidelines, Para. 4.9). In some countries the burden of proof is on taxpayers and in others it is on tax authorities. In this instance where the burden of proof is on the taxpayer in one country, and is on the tax administration in another country and it happens that transfer pricing adjustment is made on a taxpayer doing business in both countries, conflict may arise (OECD guidelines, Para. 4.15). In this situation, chapter IV provides that neither countries nor taxpayers should misuse the burden of proof.

Chapter IV discusses this concept from a practical perspective, indicating that the burden of proof rules should not be used as a justification for making groundless or unverifiable assertions about transfer pricing. Both the taxpayer and tax administration should be prepared to show in good faith that the pricing asserted is consistent with the arm's-length principle (OECD guidelines, Para. 4.16).

Chapter IV reminds tax authorities that in a mutual agreement situation, the state proposes a transfer pricing adjustment as the burden of demonstrating that the adjustment is consistent with the arm's-length principle (OECD guideline, Para. 4.17).

c) Penalties

Chapter IV reflects that these penalties are classified differently in each country. The penalties are classified as interest, penalties or other classification names (OECD guideline, Para. 4.22). This chapter further provides that the penalty should encourage consistency rather than inconsistency to the arm's-length principle (OECD guideline, Para. 4.22).

Chapter IV provides that fairness requires that penalties be proportionate to the offence for which they are imposed. The guidelines state further that sizeable no-fault penalties can be too harsh, and would be unfair whether the taxpayer has made reasonable efforts in good faith to set prices consistent with the arm's-length principle (OECD guideline, Para. 4.27).

3.4.3.2 Mutual Agreement Procedure

The mutual agreement procedure is the process by which tax authorities consult with each other to resolve disputes regarding double taxation conversions. Chapter IV provides that the mutual agreement procedures can be achieved by following the principles provided in Article 25 of the OECD Model Treaty (OECD guideline, Para. 4.29).

It follows that the chapter enhances that mutual agreement procedures should apply when transfer pricing corresponding adjustments on the profits of multinational enterprises, have been made by tax authorities in different countries. Under these circumstances chapter IV recommends that tax authorities should apply paragraph 2 of Articles 9 of the OECD Model Treaty (OECD guideline, Para. 4.32).

Some concerns are highlighted with regard to the application of the mutual agreement procedures when transfer pricing corresponding adjustments have been made. These concerns are as follows (OECD guideline, Para. 4.42).

a) time limits under domestic law may make corresponding adjustments unavailable if those limits are not waived in the relevant tax treaty

b) mutual agreement procedures may take too long to complete

c) taxpayer participation may be limited

d) published procedures may not be readily available to instruct taxpayers on how the procedure may be used

e) there may be no procedures to suspend the collection of tax deficiencies or the accrual of interest pending resolution of the mutual agreement procedure.

As the corresponding adjustments happen because of the primary transfer pricing adjustments, chapter IV mentions that corresponding adjustments may take place as a result of secondary transfer pricing adjustment. It further provides that such primary adjustments could be 'whereby the excess profits resulting from a primary adjustment are treated as having been transferred in some other form and taxed accordingly. Ordinarily, the secondary transactions will take the form of constructive dividends, constructive equity contributions, or constructive loans'.

In these circumstances, chapter IV mentions that secondary adjustments will take place when withholding tax on dividends is withheld and arm's-length interest is levied on the loan by the country making the transfer pricing adjustment. It provides that in these instances mutual agreement procedures should be applied to deal with the double tax which will arise.

3.4.3.3 Simultaneous Tax Examination

Chapter IV provides further that tax authorities could perform the transfer pricing tax examination simultaneously to ensure that multinational enterprises comply with the arm's-length principle.

It defines simultaneous tax examination as 'a form of mutual assistance, used in a wide range of international issues that allows two or more countries to cooperate in tax investigations'. The OECD encourages tax authorities to perform simultaneous tax examinations as these are useful in the exchange of information and help reduce the possibilities for economic double taxation, reduce the compliance cost to taxpayers, and speed up the resolution of issues (OECD guideline, Para. 4.78).

3.4.3.4 Safe Harbours

A safe harbour is a provision that allows taxpayers to follow a simple set of rules whereby transfer prices would be automatically accepted as being at arm's-length by the tax authorities. Chapter IV provides that the objectives of safe harbours are;

> 'simplifying compliance for eligible taxpayers in determining arm's-length conditions for controlled transactions; providing assurance to a category of taxpayers that the price charged or received on controlled transactions will be accepted by the tax administration without further review; and relieving the tax administration from the task of conducting further examination and audits of such taxpayers with respect to their transfer pricing.'

It follows that Chapter IV discourages the use of safe harbours and therefore recommends they should not be used, for a number of reasons; primarily because of the potential for double taxation and inconsistency with the arm's-length principle (OECD Guideline, Para. 4.94).

The use of safe harbours could have a number of adverse consequences which should be weighed against the expected benefits. The concerns stem from the following reasons (OECD guideline, Para. 4.103):

> ‘a) the implementation of a safe harbour in a given country would not only affect tax calculations within that jurisdiction, but would also impinge on the tax calculations of associated enterprises in other jurisdictions, and
>
> b) it is difficult to establish satisfactory criteria for defining safe harbours, and accordingly they can potentially produce prices or results that may not be consistent with the arm’s-length principle.’

The conclusion is that Chapter IV discourages the use of safe harbours for a number of reasons, primarily because of the potential for double taxation and inconsistency with the arm’s-length principle (OECD guideline, Para. 4.94).

3.4.3.5 Advance Pricing Agreement

An advance pricing agreement is an agreement that determines, in advance, an appropriate set of criteria for the determination of transfer pricing for the transactions over a fixed period of time. Chapter IV provides that advanced pricing agreements can be arranged in three different cartegories namely, unilateral, bilateral and multilateral. The chapter discusses the differences among the unilateral, bilateral and multilateral advanced pricing agreements. It endorses the preference of the bilateral and multilateral advanced pricing agreements. One of the reasons bilateral and multilateral advanced pricing agreements is preferred is because of elimination of possible double taxation (OECD guidelines, Para. 4.131).

This chapter states a number of advantages and disadvantages regarding the use of advanced pricing agreements (OECD guidelines, Para. 4.143-4.159).

3.4.3.6 Arbitration

Arbitration is the process whereby a dispute between the tax authorities is resolved (OECD guidelines, Para. 4.167). Chapter IV contains a brief discussion about the arbitration on transfer pricing issues.

3.4.4 Chapter V

Chapter V of the OECD guidelines provides substantial guidance on the type and level of transfer pricing documentation to be prepared by taxpayers and submitted to the tax authorities, to ensure that their transaction complies with the arm's-length principle. The documentation serves as proof by illustrating that taxpayers have conducted their transactions with related taxpayers at arm's-length. In terms of both the taxpayers and the tax administrators, Chapter V provides that (OECD guidelines, Para. 5.4);

> 'the process of considering whether transfer pricing is appropriate for tax purposes should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance. It would be expected that the application of these principles will require the taxpayer to prepare or refer to written materials that could serve as documentation of the efforts undertaken to comply with the arm's-length principle, including the information on which the transfer pricing was based, the factors taken into account, and the method selected. It would be reasonable for tax authorities to expect taxpayers when establishing their transfer pricing for a particular business activity, to prepare or to obtain such materials regarding the nature of the activity and the transfer pricing, and to retain such material for production if necessary in the course of a tax examination. Such actions should assist taxpayers in filing correct tax returns.'

Chapter V further acknowledges that taxpayers should make reasonable efforts at the time transfer pricing is established to determine whether the transfer pricing is appropriate for tax purposes in accordance with the arm's-length principle (OECD guidelines, Para. 5.3). The level of appropriate documentation is to be determined under the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance (OECD guidelines, Para. 5.4).

The guidelines recommend that the required documents should not impose costs and burdens disproportionate to the circumstances (OECD guidelines, Para. 5.7). Non-prescriptive detail is highlighted about the type of information that may be relevant to a transfer pricing inquiry. From the OECD guidelines' point of view useful documentation includes the following items (OECD guidelines, Para. 5.18):

a) An outline of the business (general commercial and industry conditions, controlled transaction, functions performed, possible risks assumed).

b) The structure of the organisation (each associated enterprise involved in the controlled transaction under review).

c) Ownership linkages within the multinational enterprises group.

d) Financial data, at least the amount of sales and operating results from the last few years preceding the transaction.

e) The level of the taxpayer's transactions with foreign associated enterprises, e.g. the amount of sales of inventory assets, the rendering of services, the rent of tangible assets, the use and transfer of tangible property, and interest on loans.

f) Pricing practices, including business strategies and special circumstances, depend on method used.

3.4.5 Chapter VI

Chapter VI discusses special facts and circumstances that may arise when determining whether the conditions established between associated enterprises regarding the transfer of intangible property are at arm's-length.

3.4.5.1 Types of Intangible Properties

Chapter VI commences by providing definitions of the types of intangible properties that multinational enterprises use in their businesses and these include the following (OECD guidelines, Para. 6.2):

a) Rights to use industrial assets such as patents, trademarks, trade names, designs or models.

b) Literary and artistic property rights.

c) Intellectual property such as know-how and trade secrets.

This chapter focuses on the commercial intangibles and splits the commercial intangibles into trade and marketing intangibles.

a) Trade intangibles

Trade intangibles are often created through risky and costly research and development (R&D) activities, and the developer generally tries to recover the expenditure on these activities and obtain a return thereon through product sales, service contracts, or license agreements.

b) Marketing intangibles

Marketing intangibles include trademarks and trade names that aid in the commercial exploitation of a product or service, customer lists, distribution channels, and unique names, symbols, or pictures that have an important promotional value for the product concerned. Chapter VI provides that some marketing intangibles for example, trademarks, may be protected by the law of the country concerned and used only with the owner's permission for the relevant product or services. The value of marketing intangibles depends upon many factors, including the reputation and credibility of the trade name or the trademark fostered by the quality of the goods and services provided under the name or the mark in the past, the degree of quality control and ongoing R&D, distribution and availability of the goods or services being marketed, the extent and success of the promotional expenditures (OECD guidelines, Para. 6.4).

3.4.5.2 The arm's-length determination

Chapter VI further addresses the following two principal issues about the treatment of the intangible property namely; how to determine arm's-length pricing when valuation is uncertain at the time of the transaction, and how to deal with marketing activities (OECD guidelines, Para. 6.1).

a) How to determine arm's-length pricing when valuation is uncertain at the time of the transaction.

In determining the arm's-length price for intangible property Chapter VI provides that comparability should be taken into account from the perspective of both the transferor of the property and the transferee. From the perspective of the transferor, the arm's-length principle would examine the pricing at which a comparable independent enterprise would be willing to transfer the property and from the perspective of the transferee, a comparable independent enterprise may or may not be prepared to pay such a price, depending on the value and usefulness of the intangible property to the transferee in its business (OECD guidelines, Para. 6.14).

It follows that Chapter VI further reflects that (OECD guidelines, Para. 6.20);

> 'when applying the arm's-length principle to controlled transactions involving intangible property some special factors relevant to comparability between the controlled and uncontrolled transactions should be considered. These factors include the expected benefits from the intangible property (possibly determined through a net present value calculation). Other factors include: any limitations on the geographic area in which rights may be exercised; export restrictions on goods produced by virtue of any rights transferred; the exclusive or non-exclusive character of any rights transferred; the capital investment (to construct new plants or to buy special machines), the start-up expenses and the development work required in the market; the possibility of sub-licensing, the licensee's distribution network, and whether the licensee has the right to participate in further developments of the property by the licensor.'

In the sale of goods incorporating intangible property, it may also be possible to use the control uncontrolled price or resale price method (OECD guidelines, Para. 6.24). With regard to the valuation process of the intangible properties, when valuation is uncertain at the time of a transaction, the behavior of independent enterprises is a guide for pricing. This chapter points out several possibilities (OECD guidelines, Para. 6.30).

Independent enterprises might use anticipated benefits to determine pricing, where subsequent developments can be reasonably predicted. In some cases independent enterprises might use shorter term agreements or price adjustment clauses to protect against valuation uncertainty. Another possibility is that independent enterprises would bear the risk of unpredictable developments, but that major unexpected events changing the fundamental assumptions of the transaction would lead to a renegotiation.

Chapter VI in this situation states that the arm's-length pricing among associated enterprises should take into account which of these alternatives independent enterprises might choose, if faced with a comparable level of uncertainty in a comparable transaction (OECD guidelines, Para. 6.33).

Developments subsequent to the establishment of transfer pricing that materially affect the evaluation may prompt a tax administration to inquire what independent enterprises would have done to account for the valuation uncertainty, but hindsight is not allowed. Thus, although the subsequent developments may prompt an inquiry, the inquiry should relate to what independent enterprises would have done on the basis of information available to them at the time of the transaction.

b) How to deal with marketing activities

On marketing activities the guidelines address the question of determining the proper return to a distributor that markets a product but does not own the trademark (OECD guidelines, Para. 6.37). The guidelines provide that a distributor who bears marketing costs, should share in the potential benefits from the marketing activities and not as the owner of the trademark. If extraordinary marketing expenditures are incurred, an additional return may be required (OECD guidelines, Para. 6.38).

3.4.6 Chapter VII

Chapter VII makes an analysis of the transfer pricing treatment of the intra-group services between the related enterprises. Emphasis is placed on two crucial issues which should be considered when the intra-group services between the related enterprises are addressed and these issues are (OECD guidelines, Para. 7.5):

a) Whether an intra-group service has in fact been provided by one member of a multinational enterprise to other members of that group.

b) What the charge for such services should be in accordance with the arm's-length principle.

3.4.6.1 The determination of whether a service has been rendered or received

In addressing this first issue, Chapter VII provides that the following tests should be applied (OECD guidelines, Para. 7.6-7.8):

a) Whether the activity (service rendered) provides the respective group member with an economic benefit.

b) Whether the activity (service rendered) provides a respective group member with commercial value that enhances their commercial position.

c) Whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if it were performed by an independent enterprise or would have performed the activity in-house.

Based on these tests, Chapter VII concludes that where the answers to the tests are in the affirmative, an intra-group service would be evident. In cases where the answers to the tests are negative, that particular service should not be considered as an intra-group service under the arm's-length principle.

Once it has been determined that an intra-group service has been rendered, Chapter VII provides that it is crucial to determine whether the service can or cannot be charged to the service recipient. Lists of the intra-group services which are non-chargeable and those chargeable, are provided. The following is the analysis of both categories of these intra-group services:

3.4.6.2 Non-chargeable Costs

Non-chargeable costs relate to services for which no direct or measurable benefit is bestowed on the companies receiving the service. Chapter VII further states that there are, however, exceptions where certain of these services may carry a charge for example, centralised and on-call services. The following are the list and descriptions of services that cannot be charged for:

a) Stewardship

Stewardship activities include those activities that are performed even though group members do not need the activity (and would not be willing to pay for them if they were an independent enterprise). Such activities are performed by the service provider solely because of its ownership interest in one or more of the group members. Stewardship activities may also include the provision of a coordinating centre which would provide planning services, technical advice (trouble shooting) or emergency management.

b) Shareholder Services

Shareholder services relate to group members even though the respective group members do not receive any direct benefit from such services. They include duties that are performed directly for shareholders and relate to the monitoring of related companies as well as the ownership structure of the group. The service provider in this case merely performs such services because of its ownership interest. All the costs which relate to the activities that a parent company carries out in relation to its capacity as shareholder of the group, should not be charged to related affiliates.

c) Duplicate Services

Duplicate services relate to services performed by one group member that merely duplicates a service that another member is performing for itself, or that is being performed for such other group member by a third party. Chapter VII states that no charge should be made for duplicate services. The only exceptions are cases where the duplication of the service is temporary due to group restructuring or where the duplication is undertaken to reduce the risk of incorrect business decisions.

d) Services that provide an Incidental Benefit

An incidental benefit arises where an intra-group service which relates only to certain identified group members, incidentally provides benefits to other group members who are not intended to receive any benefit from the provision of the service. The incidental benefits which fall on other group members should not cause such members to be treated as receiving an intra-group service, because the services producing the benefits would not ordinarily be one that an independent enterprise would be willing to pay for.

e) Centralised Services

Centralised services relate to services that are made available to the group as a whole. They essentially refer to those services that are centralised in the parent company or are rendered by a group service centre. It should be noted that some centralised services, depending on the extent to which an independent company would have been willing to pay for the services or to perform the service for themselves, will be considered as intra-group services.

f) On-call Services

On-call services are services that would be provided by a service provider upon request of the recipient. This issue being addressed is that in determining the chargeability of such services, the question is whether the availability of such services is a separate service for which an arm's-length charge should be determined. An intra-group service would exist to the extent that it would be reasonable to expect an independent enterprise in comparable circumstances, to incur standby charges to ensure the availability of the services when the need arises. It is unlikely that an independent enterprise would be willing to pay for on-call services where: the potential need for the service is remote; where the advantage of having the service is negligible; where on-call services could be obtained promptly from other sources without the need for stand-by arrangements.

3.4.6.3 Chargeable Services

Chargeable costs are associated with services that provide an economic benefit to other group companies. Chapter VII provides that the recipient companies in this case would conceivably be willing to perform it themselves or to pay a third party to provide them with these services, if they were not provided by the related party. Chargeable services typically have related/inherent costs that fall into two major categories (OECD guidelines, Para. 7.20):

a) Directly Allocable Costs

Directly allocable costs refer to costs for services which can be directly identified as benefiting a particular group company. In this instance the service performed and the basis for payment can be clearly identified and thus allowing the costs for the provision of the service to be directly assigned to a particular recipient in determining an arm's-length fee (OECD guidelines, Para. 7.20-7.23).

b) Indirectly Allocable Costs

Indirectly allocable costs relate to those services that benefit a number of companies in a group and where the costs for such services cannot be readily identified with a specific service performed for a particular company. In such instances it is usually difficult to apply the direct-charge method (OECD guidelines, Para. 7.23).

Chapter VII suggests the use of cost allocation and apportionment method to allocate these costs, for example the use of employee headcount, number of users and/or turnover to allocate costs. Such methods are referred to as indirect-charge methods and should be allowed by revenue authorities, provided that the following have been met or considered (OECD guidelines, Para. 7.23-7.28):

a) Sufficient regard has been given to the value of the services to the recipients.

b) The extent to which comparable services are provided between independent enterprises.

c) The specific service that is provided to service recipients is not the main activity of the service provider and that the service provider does not provide the same service to third parties.

d) The service should be charged for fairly.

e) Any charging has to be supported by an identified and reasonably foreseeable benefit to the recipient.

f) The charge method selected should contain safeguards against manipulation and follow sound accounting principles.

g) The charge method selected should produce charges or cost allocations that are proportional with the expected benefits to the services recipients.

3.4.7 Chapter VIII

Chapter VIII of the OECD guidelines contains the cost contribution arrangements and discusses these arrangements between two or more associated enterprises. The OECD guidelines define cost contribution agreements as (OECD Guidelines, Para. 8.6);

> 'a contractual agreement among business enterprises to share costs and risks of developing, producing or obtaining assets, services or rights, and to determine the nature and extent of the interests of participants in those assets'.

Chapter VIII provides that, for the conditions of cost contribution arrangements to satisfy the arm's-length principle, the guidelines require that each participant's proportionate share of the overall contributions to the arrangement be consistent with the participant's proportionate share of the overall expected benefits to be received under the arrangement (OECD Guidelines, Para. 8.8).

This chapter discusses different types of cost contribution arrangements and provides that the common type of cost contribution arrangement is the joint development of intangible property. It follows that the cost contribution arrangement need not be limited to the development of intangible property type and may be extended to the pooling of resources for acquiring centralized management services or for such projects as the development of advertising campaigns. For cost contribution arrangement to satisfy the arm's-length principle, Chapter VIII states that (OECD guidelines, Para. 8.8);

> ‘A participant’s contributions must be consistent with what an independent enterprise would have agreed to contribute under comparable circumstances given the benefits it reasonably expects to derive from the arrangement. What distinguishes contributions to a CCA from an ordinary intragroup transfer of property or services is that part of all of the compensation intended by the participants is the expected benefits to each from the pooling of resources and skills.’

Chapter VIII further highlights that for the purpose of determining whether a cost contribution arrangement satisfies the arm’s-length principle, each participant’s proportionate share of the overall contributions to the cost contribution arrangement is consistent with the participant’s proportionate share of the overall expected benefits, it is necessary to measure the value or amount of each participant’s contributions to the arrangement. Under the arm’s-length principle, the value of each participant’s contribution should be consistent with the value that independent enterprises would have assigned to that contribution in comparable circumstances, and that the value of the application of the arm’s-length principle should take into account, the contractual terms and economic circumstances particular to the cost contribution arrangement (for example the sharing of risks and costs), (OECD guidelines, Para. 8.13-8.14).

In determining each participant’s expected benefits of the cost contribution arrangement, Chapter VIII provides that allocation keys is frequently used in practice and such allocation keys includes sales; gross or operating profit; units used, produced or sold; number of employees; and capital invested (OECD guidelines, Para. 8.13-8.14). For the tax treatment of the cost contribution arrangement on income, Chapter VIII states (OECD guidelines, Para. 8.23);

> ‘Contributions by a participant to a CCA should be treated for tax purposes in the same manner as would apply under the general rules of the tax system(s) applicable to that participant if the contributions were made outside a CCA to carry on the activity that is the subject of the CCA (e.g. to perform research and development, to obtain a beneficial interest in property needed to carry out the CCA activity).’

The tax treatment of the cost contribution arrangement on the tax deductible side, Chapter VIII reflects that (OECD guidelines Para. 8.23);

> ‘the contributions would be treated as deductible expenses by reference to these criteria. No part of a contribution in respect of a CCA would constitute a royalty for the use of intangible property, except to the extent that the contribution entitles the contributor to obtain only a

right to use intangible property belonging to a participant (or a third party) and the contributor does not also obtain a beneficial interest in the intangible property itself.'

Chapter VIII also provides the approach that should be followed regarding the entry into, withdrawal from, or termination of, the cost contribution arrangement. With regard to entry (or buy-in) to the cost contribution arrangement under the arm's-length principle, any transfer of pre-existing rights from participants to a new member must be compensated based on an arm's-length value of the transferred interest (OECD guidelines, Para. 8.31).

When a participant withdraws from a cost contribution arrangement (a buy-out), that participant may dispose of its interest in the results of past cost contribution arrangement activity (including work-in-progress) to other participants. Similar to buy-in transfers, the buy-out transfer should be compensated in accordance with the arm's-length principle. The principles applied in a buyout payment are not different from a buy-in payment with regard to the taxation treatment (OECD guidelines, Para. 8.33-8.34).

Chapter VIII provides that upon termination of the cost contribution arrangement, each participant should receive a beneficial interest in the results of the cost contribution arrangement activity consistent with the participant's proportionate share of contributions to the cost contribution arrangement throughout its term, or a participant could be properly compensated according to the arm's-length principle by one or more participants for surrendering its interest in the results of the activity (OECD guidelines, Para. 8.39). Chapter VIII concludes by listing the cost contribution arrangements conditions which would normally meet the arm's-length principle. Such conditions are as follows:

a) Participants would include only enterprises expected to derive mutual benefits from the CCA activity itself, either directly or indirectly (and not just from performing part or all of that activity).

b) The arrangement would specify the nature and extent of each participant's beneficial interest in the results of the CCA activity.

c) No payment other than the CCA contributions, appropriate balancing payments and buy-in payments would be made for the beneficial interest in property, services, or rights obtained through the CCA.

d) The proportionate shares of contributions would be determined in a proper manner using an allocation method reflecting the sharing of expected benefits from the arrangement.

e) The arrangement would allow for balancing payments or for the allocation of contributions to be changed prospectively after a reasonable period of time to reflect changes in proportionate shares of expected benefits among the participants.

f) Adjustments would be made as necessary (including the possibility of buy-in and buy-out payments) upon the entrance or withdrawal of a participant and upon termination of the CCA.

Chapter VIII further concludes by listing the information which would be relevant and useful with regard to the terms of the cost contribution arrangements. Such information is as follows:

a) a list of participants

b) a list of any other associated enterprises that will be involved with the CCA activity or that are expected to exploit or use the results of the subject activity

c) the scope of the activities and specific projects covered by the CCA

d) the duration of the arrangement

e) the manner in which participants' proportionate shares of expected benefits are measured, and any projections used in this determination

f) the form and value of each participant's initial contributions, and a detailed description of how the value of initial and ongoing contributions is determined and how accounting principles are applied consistently to all participants in determining expenditures and the value of contributions

g) the anticipated allocation of responsibilities and tasks associated with the CCA activity between participants and other enterprises

h) the procedures for and consequences of a participant entering or withdrawing from the CCA and the termination of the CCA

i) any provisions for balancing payments or for adjusting the terms of the arrangement to reflect changes in economic circumstances.

3.4.8 Annex and Glossary

The Annex contains guidance on how to conduct advance pricing arrangements under the mutual agreement procedure. The Annex provides guidance to tax authorities about conducting the mutual agreement procedures that involve advance pricing arrangements. The Glossary defines important transfer pricing terms that are used throughout the OECD guidelines.

3.5 THE PRACTICE NOTE 7

3.5.1 Background and History of Practice Note 7

On 6 August 1999 Practice Note 7 was introduced in South Africa. The objective of Practice Note 7 is to provide taxpayers in South Africa with guidelines about the procedures to be followed in the determination of arm's-length prices, taking into account the South African business environment. Practice Note 7 also represents the views of SARS Commissioner on other transfer pricing practical issues (Practice Note 7, Para. 2.8).

The design of Practice Note 7 is broadly based on the OECD guidelines and has also adopted the approach in chapter 5 of the Australian Tax Office's Taxation Ruling 98/11, called the Four-Step Approach. An annexure is provided at back of the end of the Practice Note 7 providing guidance on how to apply the Four-Step Approach.

3.5.2 Practice Note 7 and Section 31 of the Act

In paragraph 16 of the OECD guidelines, the OECD emphasises that member countries should follow the OECD guidelines in conjunction with their domestic transfer pricing legislations or rules. Meaning that although domestic transfer pricing guidelines of a number country might be based on the OECD guidelines, the member country transfer pricing guidelines/rules should still concur with the domestic legislation regulating transfer pricing practices. The issue is, to what extent does Practice Note 7 concurs with the South African transfer pricing tax legislation (section 31 of the Act) as the OECD guidelines recommends.

As discussed in chapter 2, section 31 of the Act was changed and updated several times since the year 2007. The first change was an amendment to the connected person definition as contained in section 1 and section 31(2) of the Act with the inclusion of the word ‘group of companies’ in the connected persons definition. The second amendment was a restructuring of section 31 of the Act with the primary change being the removal of the term ‘international agreement’, and the third change was the amendment of adding subsection (1A) of section 31 of the Act by broadening the connected person definition with regard to the intellectual property transaction.

Even though these amendments were made in section 31 of the Act, the issue still remains that the amendments in section 31 of the Act are not effected in Practice Note 7. By virtue of Practice Note 7 not being updated with the amendments of section 31 of the Act, it means that Practice Note 7 does not concur with the OECD guidelines as envisaged in the OECD guidelines that a country transfer pricing rules/guidelines should concur with the domestic transfer pricing tax legislation.

3.5.3 Practice Note 7 and the Arm’s-length Principle

Practice Note 7 concurs with the OECD guidelines as it has also adopted the arm’s-length principle embodied in paragraph 1 of the OECD Model Tax Treaty. As discussed in chapter 1 of this research study, Practice Note 7 also accepts the view of the OECD guidelines that the determination of arm’s-length price is not an exact science and that certain factors should be taken into consideration with regard to the application of the arm’s-length principle (Practice Note7, Para. 7).

Such comparability factors include the availability of information; determining the party to be evaluated in a controlled transaction; determination of an arm’s-length range; use of multiple year data confirming transfer prices through multiple methods; materiality in a practical assessment of comparability; interest-free loans to non-residents; losses incurred by a member of a multinational; recognition of actual transactions undertaken; evaluation of separate and combined transactions; intentional set-offs; arrangements common between group-companies; real bargaining at the time the transaction was entered into the use of hindsight; safe harbours; and the effect of government policies (Practice Note7, Para. 11).

3.5.4 Practice Note 7 and the Transfer Pricing Methods

Practice Note 7 does accept the use of the five transfer pricing methods for determining arm's-length price as adopted by the OECD guidelines These methods are the three traditional transactional methods which consist of the control uncontrolled price, cost plus and resale price and the transactional profit methods which consist of the transaction net margin method and profit split.

Although there have been some updates with regard to the status of the transactional profit methods, that they should not be viewed as methods of last resort through the issuing of the discussion draft document addressing the status of the transactional profit methods, these updates have not been effected in Practice Note 7.

The view of Practice Note 7 on the transactional profit methods is that they are still the methods of last resort as they are less reliable as compared to the traditional transactional methods (Practice Note 7, Para. 9.7.2).

3.5.5 Practice Note 7 and the Transfer Pricing Administrative Procedures

Practice Note 7 does not make provision for some administrative procedures used to resolve transfer pricing issues mentioned in the OECD guidelines, such as the mutual agreement procedures, the simultaneous tax examination procedures and the arbitration procedures.

Practice Note 7 does however make mention of certain administrative procedures used to resolve transfer pricing issues and ensuring that the transactions of the multinational enterprises are at arm's-length, which are mentioned in the OECD guidelines. Such administrative procedures are examination practices, burden of proof, advance pricing agreements and safe harbours. The view of Practice Note 7 on these administrative procedures is as follows:

a) Examination Practices

Practice Note 7 mentions that the SARS Commissioner may, in conducting a transfer pricing examination ensuring compliance to the arm's-length principle, follow certain procedures accessing information from the taxpayer or external sources, publicly undisclosed sources and also from the foreign person connected to the taxpayer information (Practice Note 7, Para. 12.3 -12.4).

Practice Note 7 explains further that the SARS Commissioner may also pay close attention to the transactions of the taxpayer which are with entities residing at lower tax rates jurisdictions than South Africa. In addition to the transfer pricing tax legislation, the SARS Commissioner may also apply the general anti-avoidance provisions on transfer pricing practices (Practice Note 7, Para. 12.6 -12.7).

b) Burden of Proof

The discretion to adjust the consideration in respect of a transaction that it is not at arm's-length, is with the SARS Commissioner. Should the SARS Commissioner discharge its burden of proof that a transaction is not at arm's-length, it will be up to a taxpayer to prove an appropriate transfer pricing policy, determine the arm's-length amount as required by section 31and produce documentation to evidence their analysis (Practice Note 7, Para. 12.15).

c) Penalties and Interest

The Act does not impose specific penalties and interest in respect of non-arm's-length transfer pricing practices. General penalty provisions, additional tax and offence provisions are applicable in the event of default or omission in the completion of the tax return or evasion of taxation and will also apply to default, evasion or omission relating to transfer pricing. The Act provides that interest should be levied on the underpayment of any tax and will also apply if the underpayment of tax results from non-compliance with section 31 of the Act (Practice Note 7, Para. 13).

Furthermore, the Act deems any amount adjusted or disallowed with respect to non-arm's-length transfer pricing practices in terms of section 31 of the Act to have been distributed to a recipient by the company. The recipient in this case might be a shareholder and such amount deemed to be received is subject to dividend tax (Practice Note 7, Para. 14).

d) Advance Pricing Agreements

Practice Note 7 does not make provision for advanced pricing agreement and it does mention that the advance pricing agreement process will not in the foreseeable future, be made available to South African taxpayers (Practice Note 7, Para. 16). Practice Note 7 does however mention that in the event that the taxpayer has entered into the advanced pricing agreement in a foreign country, it would be expected of the taxpayer's transactions to comply with the arm's-length requirements in terms of section 31 of the Act (Practice Note 7, Para. 12.5).

e) Safe Harbours

Practice Note 7 provides a brief explanation with regard to the use of safe harbours and concurs with the view of the OECD guidelines that safe harbours should not be used (Practice Note 7, Para. 11.16).

3.5.6 Practice Note 7 and the Transfer Pricing Documentation Requirements

Practice Note 7 concurs with the OECD guidelines for transfer pricing documentations procedures. It mentions that there is no explicit statutory requirement to prepare and maintain transfer pricing documentation in South Africa. Practice Note 7 does, however, emphasise that it is in the taxpayer's best interest to document how transfer prices have been determined, since adequate documentation is the best way to demonstrate that transfer prices are consistent with the arm's-length principle, as required by section 31 of the Act.

Even though Practice Note 7 does not specify a comprehensive pre-defined set of transfer pricing documentation which a taxpayer should prepare, it does however provide that the transfer pricing should address the following (Practice Note 7, Para. 10.3.6):

a) identification of transactions in terms of international agreements entered into with connected persons and the extent of any other commercial or financial relations with connected persons which fall within the scope of Section 31 of the Act

b) copies of the international agreements entered into with connected persons

c) a description of the nature and terms (including prices) of all the relevant transactions (including a series of transactions and any relevant off-setting transactions)

d) the method that has been used to arrive at the nature and terms of the relevant transactions (including the functional analysis undertaken and an appraisal of potential comparables)

e) the reasons why the choice of method was considered to be the most appropriate to the relevant transactions and to the particular circumstances

f) an explanation of the process used to select and apply the method used to establish the transfer prices and why it is considered to provide a result that is consistent with the arm's-length principle

g) information relied on in arriving at the arm's-length terms such as commercial agreements with third parties, financial information, budgets, forecasts etc.

h) details of any special circumstances that have influenced the price set by the taxpayer.

Furthermore, Practice Note 7 provides that the SARS Commissioner would expect that the transfer pricing documentation of a taxpayer should also address the following (Practice Note 7, Para. 10.3.7):

a) which goods or service, if any, are considered most comparable to the goods or services being reviewed

b) its major competitors

c) the competitors the taxpayer considers most comparable

d) the methodologies used and why they should be considered appropriate in the taxpayer's particular circumstances.

3.5.7 Practice Note 7 and the Transfer Pricing treatment on Intellectual Property transactions

In respect of the transfer pricing treatment on intellectual property transactions, Practice Note 7 agrees to the approach which is adopted in Chapter VI of the OECD guidelines. Practice Note 7 provides that,

> 'The Commissioner considers the guidance provided in that chapter relevant and recommends that taxpayers follow the guidance in establishing arm's-length conditions in international agreements with connected persons involving intra-group services.'

3.5.8 Practice Note 7 and the Transfer Pricing treatment on Intra-Group Services transactions

Practice Note 7 concurs with the OECD guidelines with regard to the transfer pricing treatment of the intra-group services transactions. Practice Note 7 specifically mentions that the SARS Commissioner will considers the guidance provided in Chapter VII of the OECD guidelines relevant in respect of the transfer pricing treatment on the intra-group services transactions, and recommends that taxpayers follow the guidance in establishing arm's-length conditions of such transactions.

3.5.9 Practice Note 7 and the Transfer Pricing treatment on Cost Contribution Arrangements

In respect of the transfer pricing treatment on cost contribution arrangements, Practice Note 7 agrees to the approach which is adopted in Chapter VIII of the OECD guidelines. Practice Note 7 provides that,

> 'The Commissioner considers the guidance provided in that chapter relevant and recommends that taxpayers follow the guidance in establishing arm's-length conditions in international agreements with connected persons involving cost contribution arrangements.'

3.5.10 Practice Note 7 and the Transfer Pricing treatment of Permanent Establishment

Although the OECD has issued a number of discussion draft documents with regard to the transfer pricing treatment of a permanent establishment businesses, Practice Note 7 still does not provide guidance on how the transfer pricing transactions of a permanent establishment business should be treated. This is despite the fact that section 31 of the Act requires that a transaction between a taxpayer and a permanent established business should be at arm's-length. Practice Note 7 does not make the effort of making any reference that the OECD guidelines or OECD Model Treaty should be applied in this case as it does with the intangible property, intra-group services and cost contribution arrangement transactions.

3.5.11 Practice Note 7 and the Transfer Pricing treatment on aspects of business restructuring

Practice Note 7 does not make any mention of the treatment of the business restructuring effecting transfer pricing, even after the OECD has issued a discussion draft document providing suggestions on how the arm's-length principle should be applied when business restructuring is taking place.

3.6 CONCLUSION

The purpose of this chapter was to address the second sub-problem of this research study, which is to determine whether Practice Note 7 in its current status is consistent with the current status of the OECD guidelines, and whether, as a result of being consistent or inconsistent with the current status of the OECD guidelines, Practice Note 7 can be included in the regulations on how to transact at arm's-length price in the South African transfer pricing tax legislation in order to amend the legislation, so that it becomes prescriptive.

To proceed with the argument of whether or not the South African transfer pricing tax legislation should be amended to be prescriptive on how taxpayers should transact at arm's-length, the analysis of the impact of not having prescriptive transfer pricing tax legislation and the impact of having prescriptive transfer pricing tax legislation is conducted in the next chapter.

CHAPTER 4: TRANSFER PRICING TAX LEGISLATION IN THE US

4.1 INTRODUCTION

The purpose of this chapter is to address the third sub-problem of the research study, which is the impact of having a non-prescriptive transfer pricing tax legislation and the impact of having a prescriptive transfer pricing tax legislation. This is achieved by looking at the enforcement of transfer pricing tax legislation in the US.

To this end the chapter analyses the background and the history of the US transfer pricing tax legislation (Section 482), the provisions of section 482, and the other transfer pricing compliance procedures implemented in the US such as penalty and documentation procedures, advance pricing agreements and competent authority procedures, tax returns and tax treaties. The chapter also provides an analysis of the relationship between section 482 and the OECD guidelines.

The chapter further provides an analysis of the US transfer pricing tax cases, prior to the year 1968 when section 482 was not yet prescriptive, and subsequent to 1968 after section 482 was amended to be prescriptive, to investigate the impact of having non-prescriptive transfer pricing tax legislation and prescriptive transfer pricing legislation.

4.2 BACKGROUND AND HISTORY OF THE US TRANSFER PRICING TAX LEGISLATION

The US tax law is made up of over 7,000 statutes or numbered code sections. The code sections are referred to as Internal Revenue Code Sections or IRCs. These statutes are enforced by the organisation called Internal Revenue Service (also known as the IRS) operating under the US Treasury Department. The US transfer pricing tax legislation is contained in one of the statutes or numbered code section, simply known as IRCs 482.

The section gives the IRS Commissioner authority to make adjustments and allocate the income, deductions, and credits of commonly controlled organisations, trades or business to prevent evasion of taxes or clearly reflect income (SARS, Transfer Pricing, Examining Intercompany Cross Border Transactions: Participation Guide 13). In order to have a good understanding of this legislation, the history of the enforcement of this legislation is analysed below.

4.2.1 The Period between the 1910s and 1920s.

The US transfer pricing tax legislation was introduced as early as 1917. Since the US transfer pricing tax legislation was introduced in the year 1917, it has gone through a number of updates (Ciancia, 2001:4; Eden, Dacin, and Wan, 2001:7; Steiss and Banchette, 1995:1570).

On 23 November 1921, Section 240(d) of the Revenue Act of 1921 was enacted in the IRCs (Steiss and Banchette, 1995:1570; Ciancia, 2001:5). The section provided that,

> 'In any case of two or more related trades or businesses (whether unincorporated or incorporated and whether organized in the United States or not) owned or controlled directly or indirectly by the same interests, the Commissioner may consolidate the accounts of such related trades and businesses, in any proper case, for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses.'

The introduction of section 240*(d)* came as a reaction to the concern by the US Congress, that taxpayers were able to use subsidiaries for manipulating the income of a parent corporation. The purpose of this section was to give the IRS Commissioner authority to consolidate the accounts of related parties and such authority was deemed necessary to prevent the arbitrary shifting of profits and related businesses, particularly in the case of subsidiary corporations and foreign trade corporations (Ciancia, 2001:5; Steiss and Banchette, 1995:1570).

Section 240*(d)* was revised through the introduction of section 45 in the year 1928. Section 45 of IRCs gave the IRS Commissioner a broader authority to adjust accounts of related corporations and also affirmed the IRS Commissioner authority to initiate such adjustments to a taxpayer's income as may be necessary to prevent tax avoidance and to ensure clear reflection of income among related parties in determining true tax liability (Webber, 2001: 2006; Ciancia, 2001:5).

The section provided that,

> 'In any case of two or more trades or business (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income or deductions between or among such trades or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of such trades or businesses.'

4.2.2 The Period between the 1930s and 1950s.

In the year 1935, the transfer pricing regulations in section 482 were promulgated under section 45-1*(b)* and provided the arm's-length principle as a fundamental principle and recommended that the arm's-length principle be used by the IRS Commissioner in making adjustments on income of related parties, and preventing tax evasion among related parties (Ciancia, 2001:6; Steiss and Banchette, 1995:1570).

The regulations provided that,

> 'The purpose of Section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the net income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable net incomes are thereby understated, the statute contemplates that the Commissioner shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income or deductions, or of any item or element affecting net income, between or among the controlled taxpayers constituting the group, shall determine the true net income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.'

The regulation under section 45 did however not provide any guidance on how the arm's-length price should be determined and this function was left to the US courts to be performed (Steiss and Banchette, 1995:1570). In the year 1954, section 45 was renumbered and it became section 482 in the IRC. It has since then continued as the relevant section for regulating transfer pricing practices in the US (Desai, 2002:4; Webber, 2006:14).

4.2.3 The Period between the 1960s and 1970s.

In the 1960s the business climate of the foreign multinational enterprises operating in the US changed substantially. There was a renewal of concern about the possibilities of tax avoidance offered by transfer price manipulation. This was due to the multinational enterprises in the US being active in expanding abroad. The US Treasury Department concluded that section 482 did not effectively protect the US taxing jurisdiction, and therefore, the US Congress strongly supported more active enforcement of controls over transfer pricing (IRS, 2003:27-28; Steiss and Banchette, 1995:1571).

Another reason why section 482 was considered ineffective against transfer pricing practices in the US, was that it was established that the US courts were inconsistent in making judgments on what was regarded as arm's-length price, as the section had no guidelines on how to determine arm's-length price. A review of US litigation confirms that prior to the year 1968, there was a relatively broad judicial approach in interpreting the law and determining whether specific related-party transactions reflected the arm's-length principle (IRS, 2003:27-28; Aiv-Ayonah, 2007). A detailed analysis of these cases is conducted later in this chapter.

In the year 1968, regulations were issued under section 482 that divided related party transactions into five classes, and provided methods and guidelines for determining arm's-length price (Steiss and Banchette, 1995:1571; Desai, 2002:4; Ciancia,2001:7). These regulations are discussed in detail later in this chapter.

4.2.4 The Period between the 1980s and 1990s

In the 1980s, section 482 again experienced other challenges with regard to the intangible property transactions. The US Congress had a concern that high profit intangibles were being transferred outside the US tax jurisdiction without adequate consideration, and that history with regard to the application of section 482 reflected dissatisfaction with comparability analysis in some judicial decisions (IRS,1999:3; Eden, Dacin, and Wan, 2001:7; Steiss and Banchette, 1995:1575).

In the year 1986, the US Congress added a second sentence to section 482, which required related party transfers of intangible property to yield income 'commensurate with the income attributable to the intangible' (IRS,1999:3; Eden, Dacin, and Wan, 2001:7; Steiss and Banchette, 1995:1575).

After the 1986 amendments, in particular the introduction of the commensurate-with-income test, the US Congress concluded that there still remained many unresolved section 482 issues. Accordingly, it recommended that a comprehensive study of related party pricing be undertaken, with the clear objective and intent of formulating such modifications to the law as may be needed to ensure its effective application (Steiss and Banchette, 1995:1577).

In October 1988, the US government released the comprehensive document under the US Treasury Department called, A Study of Intercompany Pricing Under Section 482, also known as 'the White Paper'. The White Paper contained extensive commentary on the difficulties experienced in applying section 482 and its attendant regulations, and offered recommendations, methodology, and basic principles that should be reflected in the drafting of further amendments (White Paper,1988).

The primary motivation for the White Paper had been the need to consider how the 1986 commensurate-with-income standard should be applied in respect of intangibles. The issue of the White Paper by the US Congress has however progressed much further than its initial objective, as it addressed other aspects of transfer pricing with regard to the application of section 482 (Avi-Ayonah, 2007; Steiss and Banchette, 1995:1575).

In the years 1989 and 1990, the US Congress focused on one key area of the White Paper discussion, namely, the problems encountered by the IRS in obtaining appropriate information to enable it to pursue pricing examinations on a timely basis, particularly with respect to US activities of foreign-based entities. This resulted in the US congress responding by introducing section 6662 which was the section making provision for the IRS Commissioner to specifically levy penalties for failure to comply with information demands with regard to transfer pricing issues (Steiss and Banchette, 1995:1578; IRS,1999:4).

In the year 1993, these provisions were amended to specifically focus on whether the taxpayer generates contemporaneous documentation and analysis of its transfer pricing decisions, and provides such documentation promptly in response to a request from the IRS (IRS, 1999:4).

In mid 1990s, a draft revenue procedure was released which provided the basis for an advance determination ruling process. At the time of the release, the IRS commented that the purpose of this ruling process was to produce an understanding between the IRS and the taxpayer on an appropriate method under section 482 for determining the transfer pricing practices or cost sharing arrangements of controlled taxpayers (Steiss and Banchette, 1995:1580; IRS, 1999:3).

This initiative represented a major departure from the IRS's historical resolve to rule only on matters of legal interpretation as opposed to factual issues, such as pricing. After comments on the draft had been reviewed and considered, formal ruling procedures dealing with advance pricing agreements were released in 1991 (Steiss and Banchette, 1995:1580; IRS, 1999:3; Eden, Dacin, and Wan, 2001:8).

The introduction of the advance pricing agreements was followed by the proposed regulations in 1992, and temporary regulations in 1993, and the final regulations issued under section 482 in July 1994. The 1994 regulations represented a comprehensive restatement of the rules implementing the arm's-length standard of section 482 and commensurate with income standard added in 1986 (Steiss and Banchette, 1995:1581-82; IRS, 1999:4; Eden, Dacin, and Wan, 2001:8).

The same year in which the final regulations were issued, the IRS also issued temporary regulations on penalty provision under section 6662(e) and then the final regulations in the year 1996 (IRS,1999:4). Section 482 and its regulations are discussed in the section below.

4.3 THE US SECTION 482 AND ITS REGULATIONS

4.3.1 Section 482

The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to those transactions. Section 482 provides that,

> 'In any case of <u>two or more organizations</u>, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) <u>owned or controlled directly or indirectly by the same interests,</u> the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, <u>if he determines</u> that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license <u>shall be commensurate with the income attributable</u> to the intangible.' (Underlined emphasis added.)

4.3.2 Application of Section 482

As per the underlined above, there are four prerequisites to which section 482 can apply and these prerequisite are analysed below. The fourth prerequisite is analysed later in this chapter, when the treatment of the intangible transaction under section

482 is discussed (SARS, Transfer Pricing, Examining Intercompany Cross Border Transactions: Participation Guide:15).

a) Two or more organisations are involved in the transaction(s)

The definition specifically encompasses any organisation and intends to include sole proprietorship, partnership, trusts, estates, associations and corporations. It makes no difference whether these entities are domestic or foreign, taxable or exempt (SARS, Transfer Pricing, Examining Intercompany Cross Border Transactions: Participation Guide:15).

b) Common ownership or control

The second prerequisite, common ownership, is also broadly defined. The regulations state that any kind of control, whether or not legally enforceable and however exercised, is sufficient. The reality of control is decisive, not the form or mode of exercise. It is further determined that a presumption of control exists if clear but arbitrary shifting of income or deductions is present (SARS, Transfer Pricing, Examining Intercompany Cross Border Transactions: Participation Guide:15).

c) The IRS determination

Finally, for section 482 to apply there must be an IRS determination that a reallocation is necessary. In this case the allocation can only be made by the IRS and not the taxpayer. Taxpayers cannot compel the Service to apply section 482, nor can they file amended or untimely returns to decrease taxable income based on allocations or other adjustments to their controlled transactions. Taxpayers, however, may only use section 482 to report on a timely filed return of an arm's-length result that is different from the actual result (SARS, Transfer Pricing, Examining Intercompany Cross Border Transactions: Participation Guide:15).

4.3.3 The Subsections of Section 482

Section 482 issued in the year 1994 reflects three basic concepts, namely; comparability, flexibility, and documentation. As discussed in chapter 2, comparability means that the prices paid by the taxpayers to related parties should compare favourably to prices paid by unrelated parties in similar transactions. Flexibility means that the uncertainty inherent in this highly factual area needs to be accommodated by using transfer pricing methods that achieve the most direct reliable measure of the arm's-length result in the taxpayer's particular situation. The documentation means that the taxpayer must establish the economic justification for its transfer prices in the year the transactions occurred, and not later when the IRS auditors arrive (SARS, Transfer Pricing, Examining Intercompany Cross Border Transactions: Participation Guide:16).

Section 482 is divided into 8 main subsections and these subsections are analysed as follows:

4.3.3.1 Subsection 1.482-1

As discussed previously in this chapter, subsection 1.482-1 provides that only the IRS may make allocations under this section and again provides that the taxpayer is generally barred from invoking the provisions of this section (SARS, Transfer Pricing, Examining Intercompany Cross Border Transactions: Participation Guide:17).

This subsection further offers guiding principles for the application of the best method rule approach and comparability analysis. Under the best method rule, subsection 1.482-1 requires that the arm's-length result of a controlled transaction must be determined, under the facts and circumstances which provide the most reliable measure of an arm's-length result. There is no strict priority of methods and any method may be used without establishing the inapplicability of another method (SARS, Transfer Pricing, Examining Intercompany Cross Border Transactions:

Participation Guide:17). In selecting a method, the factors to consider in identifying the best method are:

a) The degree of comparability between controlled and uncontrolled transactions.

b) The completeness and accuracy of the data.

c) The soundness of the assumptions relied upon.

d) The sensitivity of results to deficiencies in data and assumptions.

e) Where two methods produce inconsistent results, the confirmation of the chosen result is by comparison with a third method.

Subsection 1.482-1 recognises that there will not merely be a single, but a range of possible arm's-length results of a controlled transaction (arm's-length range). The results reported by the taxpayer for a controlled transaction will not be subject to an IRS adjustment if the results fall within the arm's-length range (Deloitte & Touch Tohmatsu, 2001:46).

4.3.3.2 Subsection 1.482-2

This subsection provides guidance on the application of section 482 on the types of transactions which would be affected by section 482. These transactions are analysed below.

a) Loans and Advances

Subsection 1.482-2 requires that when one member of a group makes a loan or advance to another member of the group, either directly or indirectly, that member must charge an arm's-length rate of interest, from the day after the indebtedness arises to the day on which the indebtedness is redeemed, subject to certain exceptions. An arm's-length interest rate is defined as the rate of interest that was charged, or would have been charged at the time the debt arose, in independent transactions with or between unrelated parties under similar circumstances. The regulations include a safe harbour rate based on the applicable federal rate, but this rate does not apply to any loan or advance expressed in a currency other than US dollars (Deloitte & Touch Tohmatsu, 2001:47).

b) Services transactions

Subsection 1.482-2 states that the IRS may make adjustments under section 482 where one member of a group of controlled entities performs marketing, managerial, administrative, technical, or other services for the benefit or on behalf of, another member of the group, for less than an arm's-length charge. An arm's-length charge for services is defined as the amount that was charged or would have been charged for the same or similar services in independent transactions with, or between unrelated parties under similar circumstances, considering all the relevant facts (Deloitte & Touch Tohmatsu, 2001:47-48).

For services that are not 'integral' to the business activity of the service provider or the recipient, the regulations include a cost chargeback safe harbour. This safe harbour includes all direct and indirect costs of providing such services, and taxpayers may use any reasonable method of allocating and apportioning these expenses (for example, allocation formulas or analysis of time spent). The cost chargeback safe harbour is not available for so-called 'integral' services, which are subject to the arm's-length principle (Deloitte & Touch Tohmatsu, 2001:47-48).

One significant issue that arises in the services area is whether the particular services performed are merely a duplication of a service that the related party is performing for itself, or whether the support services are provided solely to the subsidiary. This distinction between 'stewardship' services, for which no compensation is required, and support services that require an arm's-length charge, often applies when the services involve the subsidiary's day-to-day operations (Deloitte & Touch Tohmatsu, 2001:47).

c) The use of tangible property (Leases) and Sales of tangible property transactions.

Subsection 1.482-2 requires that when a member of a controlled group, by lease or other similar arrangement, transfers the use of tangible property to another member of the group, the lease must include an arm's-length charge between the parties. Arm's-length rent is defined as the amount of rent that was charged, or would have been charged, for the use of the same or similar property, in independent transactions between unrelated parties under similar circumstances (Deloitte & Touch Tohmatsu, 2001:48).

When determining the arm's-length price on rental income or expense, the period and location of the use, the owner's investment in the property or rent paid for the property, expenses of maintaining the property, type of property involved, its condition and all relevant facts must be considered (Deloitte & Touch Tohmatsu, 2001:47-48).

4.3.3.3 Subsection 1.482-3

This subsection provides guiding principles for the use of the five specific methods and unspecified methods to determine taxable income in connection with the sale of tangible property. The six methods for determining taxable income are: the controlled uncontrolled price, resale price, cost plus, comparable profit (as discussed previously in this chapter, comparable profit method is similar to transactional net margin method in the OECD guidelines) and other unspecified methods (SARS, Transfer Pricing, Examining Intercompany Cross Border Transactions: Participation Guide:17).

4.3.3.4 Subsection 1.482-4

Subsection 1.482-4 provides guiding principles on the specific transfer pricing methods which should be used in the allocation of income on intangible property transactions. The 1968 regulations provided little guidance for the determination of arm's-length consideration for transfers of intangible property (SARS, Transfer Pricing, Examining Intercompany Cross Border Transactions: Participation Guide: 17).

They provided that (section 482):

> 'In determining the amount of an arm's-length consideration [for a transfer of intangible property], the standard to be applied is the amount that would have been paid by an unrelated party for the same intangible property under the same circumstances. Where there have been transfers by the transferor to unrelated parties involving the same or similar intangible property under the same or similar circumstances the amount of the consideration for such transfers shall generally be the best indication of an arm's-length consideration.'

After the amendments in the year 1994, subsection 1.482-4 now provides that arm's-length consideration for a transfer of intangible property must be determined using one of four methods: (a) the comparable uncontrolled transaction method, (b) the comparable profits method, (c) the profit split method, (d) any unspecified method. Subsection 1.482-4 provides that the arm's-length consideration must be determined under the method that, under the facts and circumstances, provides the most reliable measure of arm's-length results (the best method rule) (SARS, Transfer Pricing, Examining Intercompany Cross Border Transactions: Participation Guide:17).

An 'intangible' is defined as an asset that has substantial value independent of the services of any individual, including: (i) patents, inventions, formulae, processes, designs, patterns or know-how, (ii) copyrights and literary, musical or artistic compositions, (iii) trademarks, trade names, or brand names, (iv) franchises, licenses, or contracts, (v) methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists or technical data, (vi) other similar items that derive value from their intellectual content or other intangible properties, not from their physical attributes (Deloitte & Touch Tohmatsu, 2001:50).

This subsection continues that the owner of a particular intangible is either the legal owner of the right to exploit the intangible if it is legally protected, or the developer of the intangible if the intangible is not legally protected. However, if the owner received assistance (for example, loans, services, tangible or intangible property) in the development or enhancement of the intangible from a related party, then such related party may be entitled to an arm's-length consideration for such assistance (Deloitte & Touch Tohmatsu, 2001:50).

Subsection 1.482-4 provides that contractual terms of intercompany agreements, including allocations of risk, will be respected if they are consistent with the economic substance of the transactions. If the terms are inconsistent with economic substance, the IRS may disregard such terms and impute terms consistent with economic substance of the transactions (Wills, 1999: 15-16).

Furthermore, in the absence of a written intercompany agreement, the IRS may impute an agreement consistent with economic substance (Wills, 1999: 15-16).

This subsection gives guidance on the 'commensurate with income' principle with respect to transfer of intangible property. In terms of commensurate with income principle, subsection 1.482-4 authorises the IRS to adjust the consideration charged for the transfer in subsequent years, even if the charges in earlier years are determined to be arm's-length (periodic adjustments). Exceptions to the periodic adjustments rule are discussed. Among the exceptions are cases in which the consideration charged for the transfer is based on an exact comparable or, where an inexact comparable is used, the actual results do not diverge (except due to extraordinary events beyond the taxpayer's control that could not reasonably have been anticipated) from projected results by more than 20% (IRS,1999: 2.12-13).

4.3.3.5 Subsection 1.482-5

Subsection 1.482-5 provides guiding principles respectively on the application of the comparable profit method. Subsection 1.482-5 provides that a reliable application of the comparable profit method requires the selection of a profit level indicator that will produce the most reliable measure of income that the tested party would have earned had it dealt with the related party at arm's-length. Profit level indicators that may be used are: (i) the return on operating assets, (ii) financial ratios that measure relationships between profit and costs or sales revenue such as, but not limited to, the operating margin or the Berry ratio (Deloitte & Touch Tohmatsu, 2001:51-52).

4.3.3.6 Subsection 1.482-6

Subsection 1.482-6 provides guiding principles on the profit split method (SARS, Transfer Pricing, Examining Intercompany Cross Border Transactions: Participation Guide:17; Deloitte & Touch Tohmatsu, 2001:52).

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4.3.3.7 Subsection 1.482-7

Subsection 1.482-7 provides the guiding principles for sharing of costs and risks (costs sharing arrangement rules). The cost sharing regulations under subsection 1-482.7 sets forth the rules under which affiliates may share ownership of intangibles by sharing the development costs, thereby obviating the need to apply the transfer of intangible property rules to determine an arm's-length royalty (Deloitte & Touch Tohmatsu, 2001:54) (SARS,Transfer Pricing, Examining Intercompany Cross Border Transactions: Participation Guide: 17; IRS,1999:2.14).

This subsection provides that a taxpayer must satisfy formal requirements in order to claim the treatment provided under the regulations for a qualified cost sharing arrangement. In particular, there must be contemporaneous documentation of the arrangement, the methodology, the research to be undertaken, and each participant's interest in any intangible property that is developed. The IRS may apply the treatment under the regulations to what in substance constitutes a cost sharing arrangement, notwithstanding a failure to meet a formal requirement for a qualified cost sharing arrangement (IRS,1999: 2.14).

Subsection 1.482-7 provides that IRS adjustments with regard to a qualified cost sharing arrangement are limited to bringing cost shares into equivalence with benefits shares. However, if a controlled taxpayer acquires an interest in intangible property from another controlled taxpayer (other than in consideration for bearing a share of the costs of the intangible's development), then the IRS may make adjustments under the general rules governing transfers of intangible property. The participation rules generally require that a participant in a qualified cost sharing arrangement must reasonably anticipate benefits from the use of intangibles that are developed as the result of research undertaken, pursuant to the arrangement (covered intangibles) (IRS,1999: 2.14).

The regulations flexibly permit the taxpayer to define the scope of research and development to be covered (intangible development area). Thus, the intangible development area includes research and development actually undertaken under the cost sharing arrangement. Covered intangibles include any intangible that actually results from the research and development under the cost sharing arrangement (IRS,1999:2.15).

The intangible development costs to be shared under a cost sharing arrangement include all costs related to the intangible development area (for example, operating expenses, other than depreciation or amortization, plus a charge for the use of tangible property), plus cost sharing payments made, and minus cost sharing payments received. Separate consideration (the buy-in) is required for pre-existing intangible property made available to the arrangement, as determined under the general rules governing transfer of intangible property (IRS,1999:2.15).

4.3.3.8 Subsection 1.482-8

Subsection 1.482-8 provides examples of the best method rule (SARS Transfer Pricing, Examining Intercompany Cross Border Transactions: Participation Guide:17).

4.4 OTHER US TRANSFER PRICING COMPLIANCE PROVISIONS

4.4.1 Penalties and Contemporaneous Documentation

Section 6662(e) and (h) of the IRC sets forth penalties of 20% and 40% for certain increases in US income tax attributable to section 482 adjustments. One significant objective of the transfer pricing penalty was to improve taxpayer compliance with the arm's-length standard by encouraging taxpayers to make reasonable efforts to determine and document arm's-length prices for their intercompany transactions (Deloitte & Touch Tohmatsu, 2001:57). The penalty will, however, not apply to the extent that the taxpayer complies with specified contemporaneous documentation requirements. In addition, a taxpayer can avoid the imposition of the transfer pricing penalty only if contemporaneous documentation is created by the time the taxpayer files its return for each specific year (Deloitte & Touch Tohmatsu, 2001:57).

4.4.2 Tax Returns

Form 5471 is required to be filed by the US taxpayer for every foreign corporation in which the parent company holds a 50% or larger investment in the foreign corporation's voting stock. Schedule M of the form requires the taxpayer to provide reports on the transactions between the foreign corporation and the shareholders or other related persons. This form serves as a primary source that helps the IRS examiners to identify any potential transfer pricing issues and it also requires that taxpayers should comply with the arm's length principle as required by section 482 (SARS: Transfer Pricing, Examining Intercompany Cross Border Transactions: Participation Guide, 2-9,10).

4.4.3 The US Tax Treaties

The US government has signed a number of tax treaties with a number of countries, including South Africa. The US tax treaties are also modelled from the OECD Model Treaty and they incorporate the arm's-length principle for the purpose of evaluating all related party transactions. Section 482 does not violate the arm's-length principle in the US tax treaties. The US Treasury department confirms that there is no inconsistency between arm's-length principle in section 482 and in the US tax treaties (Fisher and Nooman: 2009: 6171; Webber, 2006:19).

4.4.4 Competent authority

In situations where the application of the US and foreign tax laws would result in the taxpayer being subject to double taxation, a taxpayer may invoke a tax treaty's mutual assistance procedure to request relief from double taxation. Once a taxpayer's request for relief is accepted, the competent authorities of both treaty countries will attempt to reach a settlement that eliminates double taxation through the mutual attribution of income, deductions, credits, or allowances between related taxpayers. A request for competent authority assistance may be filed under the following circumstances (Deloitte & Touch Tohmatsu, 2001:59):

a) US initiated adjustment: upon receipt of a proposed adjustment in writing.

b) Foreign initiated adjustment: As soon as the taxpayer believes that such filing is warranted based on the actions of the country proposing an adjustment.

c) Transfer pricing related adjustment: when the taxpayer can establish that there is a probability of double taxation.

4.4.5 Advance Pricing Agreements

The IRS established a procedure to issue advance determinations for pricing methods proposed by the taxpayer. This enables taxpayers to have their controlled pricing structures sanctioned by the IRS for a specified number of years in an advanced pricing agreement. The negotiation and approval of an advanced pricing agreement can be a lengthy process, so the IRS also offers a streamlined advanced pricing agreement process for smaller taxpayers (Californian Tax Board, Water's Edge Manual, 2001:i).

The advanced pricing agreement program commenced in the year 1991. By the year 1999, more than 180 advanced pricing agreements had been finalised and approximately 195 advanced pricing agreement requests were pending. A goal of the advanced pricing agreements process is to reduce the time and expense of an audit. Under the advanced pricing agreements process, the taxpayer must file a specific, detailed pricing proposal with the IRS National Office in Washington D.C. (Californian Tax Board, Water's Edge Manual, 2001:i).

The information must include detailed descriptions of the effected transactions and the methodology used by the taxpayer in arriving at prices. The methodology used in the advance pricing agreement procedures should still be in terms of section 482 (Californian Tax Board, Water's Edge Manual, 2001:i).

4.5 SECTION 482 AND THE OECD GUIDELINES

One of the significant influences to the development of the OECD guidelines is the US section 482 regulations. The OECD revised its 1979 transfer pricing guidelines and introduced the new OECD guidelines in the year 1995 after the US amended its transfer pricing regulations in 1994.

Section 482 regulations issued in 1994 and the OECD guidelines issued in 1995 are similar in structure and broadly compatible in approach. While differences remain, they are essentially differences of emphasis and their approaches are sufficiently similar. One of the more controversial aspects of the OECD guidelines issued in 1995, was the apparent yielding to the US through the sanctioning of the use of profit-based methods (Steiss and Banchette, 1995:1583).

The OECD guidelines and profit methods in the section 482 regulations are generally similar, and the OECD guidelines seem to draw upon the US section 482 regulations.

The comparable profit method endeavours to determine appropriate profit levels that should have resulted in controlled business transactions if the returns on such transactions had been realised in a comparable, uncontrolled business (Steiss and Banchette, 1995:1583).

Another similarity between section 482 regulations and the OECD guidelines is that, in the OECD guidelines, profit method is labelled a transactional net margin method whereas it is labelled comparable profit method in section 482 regulations. Both these methods are basically similar in approach, although there are differences in emphasis with respect to application (Steiss and Banchette, 1995:1583).

4.6 THE US TRANSFER PRICING TAX CASE LAW PRIOR TO SECTION 482 BEING AMDENDED IN THE YEAR 1968 TO INCLUDE REGULATIONS PRESCRIBING HOW TO TRANSACT AT ARM'S LENGTH PRICE

The concept of transacting at arm's-length price between related parties has been dealt with by the US courts from as early as the 1830s, prior to the US Congress introducing the arm's-length principle in the US tax law.

In *Estate of Delamater*[26] the court declined to rescind a transaction in part because arm's-length dealing cured any potential impropriety attributable to relationship between the parties. In *United States v. Delaware, Lackawanna and Western Railroad Company*[27] the court invalidates the contract because of facts proving that the relations between the parties was so friendly that they were not trading at arm's-length (Webber, 2006: 5).

The arm's-length principle was first introduced in the US transfer pricing tax legislation in the year 1921 through the introduction of section 45. In the year 1935 the regulations were promulgated under section 482's predecessor, section 45

[26] 1Whart. 362 (1836)

[27] 238U.S. 516, 530 (1915)

requiring that related parties should transact at arm's-length. Prior to the year 1935, section 45 did not specifically mention that taxpayers' taxable income or transactions should reflect the arm's-length principle. But the cases decided under section 45 prior to the arm's-length regulations being promulgated in the year 1935, shows that the court applied the arm's-length principle though section 45 did not contain the arm's-length principle (Webber, 2006: 6).

In *Advanced Cloak Co. v. Commissioner*[28] the Board of Tax Appeal first applied the arm's-length principle under section 45 based on the language of section 45, which required that the income of the taxpayer should reflect the true taxable income.
The court said (Webber, 2006:7),

> 'The purpose of section [section 45 (1928)] is to place transaction between related trades and business owned or controlled by the same interests upon the same basis as if such business were dealing at arm's-length with each other.'

Also in *Gordon Can Co. v. Commissioner*[29], the arm's-length principle was applied by the court so that the real income of the petitioner might be clearly reflected. In *Asiatic Petroleum Co. v. Commissioner*[30], the Board of Tax Appeal applied the arm's-length principle under section 45 and upheld the Commissioner's re-allocation of gain between the related corporations to clearly reflect their income because the sale was not an arm's-length transaction (Webber, 2006:7).

In *Tennessee-Arkansas Gravel Co. v. Commissioner*[31], the Board of Tax Appeal applied the arm's-length principle under section 45 and held that (Webber, 2006:7):

> '[t]he obvious purpose of section 45 is to place a controlled taxpayer on parity with an uncontrolled taxpayer for purposes of determining tax liability,…in order clearly to reflect petitioner's true income.'

[28] B.T.A Memo 1933-78, 1993 B.T.A.M (P-H) 33,078.
[29] 29 B.T.A 272, 275 (1933)
[30] 31 B.T.A 1152, 1159 (1935), *aff'd* 79 F.2d 234 (2d. Cir. 1935)
[31] B.T.A. Memo 1938-240, 1938 B.T.A.M (P-H) 38,240

The challenges that were experienced by the court in deciding cases after the arm's-length principle was introduced in section 482 and its predecessor, section 45, was that the arm's-length principle under section 482 regulations did not have any specific rules or methods on how taxpayers should transact at arm's-length price with related parties. As a result, this led to the US courts applying a wide variety of standards in deciding whether or not certain transactions were at arm's-length (Steiss and Blanchette, 1995:1571).

The standards applied by the US courts were that related party transactions should reflect a fair value, a fair and reasonable price, a fair price or a reasonable profit. This approach by the US courts has been seen as inconsistent (Steiss and Blanchette, 1995:1571) (Avi-Yonah, 2007).

The following is an analysis of some of these cases illustrating that the US courts applied a wide variety of standards in deciding whether or not transactions were at arm's-length under section 482.

Seminole Flavor Co. v. Commissioner[32] is one good example of the cases which illustrate the courts applying one of the various standards mentioned above. The issue in this case was whether transactions between a corporation and a partnership organised to market the corporation's products, should be adjusted to shift income from the partnership to the corporation. The court, deciding in favour of the taxpayer, stated that the arm's-length nature of the transaction should be determined by whether it was fair and reasonable, and that the question of whether unrelated parties would have entered into the same agreement was irrelevant. The court then held that the commission fixed does not appear to be out of line with petitioner's own experience (for example, its expenses for marketing prior to forming the partnership). On this basis, the court held that the transaction would seem to be fair and entitled to classification as an arm's-length transaction (Avi-Yonah, 2007).

[32] *4 T.C. 1215 (1945).*

In *Palm Beach Aero Corp. v. Commissioner*[33], the court applied the standard whether the transaction reflected fair consideration, which reflects arm's-length dealing in deciding whether the transaction was at arm's length as required by section 45 at that time.

In *Grenada Industries, Inc. v. Commissioner*[34], the standards applied by the court in deciding whether the transaction was at arm's length as required by section 45 at that time, included whether the transaction was fair on the basis of the functions performed by the parties in the transaction (Avi-Yonah, 2007).

In both *The Friedlander Corp. v. Commissioner*[35] and *Motors Securities Co., Inc. v. Commissioner*[36]cases, the court applied the standard 'whether the related party paid full fair value' in deciding whether or not the transaction was at arm's-length as required by section 45. In *Polak's Frutal Works, Inc. v. Commissioner*[37], the court however applied the standard 'whether the prices paid would have been considered fair and reasonable in the trade' in deciding whether or not the transaction was at arm's-length (Avi-Yonah, 2007).

The above cases illustrates how the courts were inconsistent by applying a wide variety of standards in deciding cases under section 482 and its predecessor, section 45. The inconsistency of the US courts in deciding whether or not a transaction was at arm's-length can also be seen in *Hall v. Commissioner*[38]case.

In *Hall* case the IRS used a comparable transaction to establish that Hall's transaction was not at arm's-length price even though the legislation did make such provision that comparable should be used. *Hall* involved sales to a Venezuelan marketing affiliate at cost plus 10% (a price which amounted to a discount of over 90% from the regular list

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[33] *17 T.C. 1169, 1176 (1952)*

[34] *17 T.C. 231, 260 (1951),* aff'd, *202 F.2d 873 (5th Cir. 1953);* aff'd, *346 U.S 819*

[35] *25 T.C. 70, 77 (1955)*

[36] *11 T.C.M. 1074, 1082 (1952).*

[37] *21 T.C. 953, 976 (1954).*

[38] *32 T.C. 390 (1959),* aff'd, *294 F.2d 82 (5th Cir. 1961).*

price) when unrelated distributors of the same product received a discount of only 20% (Avi-Yonah, 2007).

In this case, the court agreed with the IRS for using comparable in reaching the decision that the transaction was not at arm’s length, rather than applying the standards fair or reasonable and held that ‘gross income had been arbitrarily shifted to the Venezuelan corporation’, and that the IRS Commissioner's allocation reflected Hall's income as if he had been dealing with unrelated parties. The court further held that the Commissioner's allocation reflected Hall's income as if his dealings with unrelated parties was the purpose of the statute (Avi-Yonah, 2007).

The position taken by the court in *Hall* was however different from the one taken in *Frank v. International Canadian Corporation*[39]. In *Frank*, the issue was whether the arm’s-length principle should always be applied in applying section 45. The case involved transfer prices for sales of chemicals by a US parent to a Western Hemisphere Trade Corporation. The parties stipulated that the sales reflected a reasonable price and profit between the two corporations, and the district court found that the Commissioner had thereby stipulated himself out of court on the section 45 issue (Avi-Yonah, 2007).

The Commissioner appealed, arguing that the district court used the reasonable return standard instead of the proper arm’s-length principle as required by section 45 (Avi-Yonah, 2007).

The court of appeals affirmed on the following terms (Avi-Yonah, 2007):

> ‘We do not agree with the Commissioner's contention that "arm’s-length bargaining" is the sole criterion for applying the statutory language of section 45 in determining what the "true net income" is of each "controlled taxpayer." Many decisions have been reached under section 45 without reference to the phrase "arm’s-length bargaining" and without reference to Treasury Department Regulations and Rulings which state that the talismanic combination of words-"arm’s-length"-is the "standard to be applied in every case." For example, it was not any less proper for the District Court to use here the "reasonable return" standard than it was for other courts to use "full fair value," "fair price, including a reasonable profit," "method

[39] *308 F.2d 520 (9th Cir. 1962)*

> which seems not unreasonable," "fair consideration which reflects arm's-length dealing," "fair and reasonable," "fair and reasonable" or "fair and fairly arrived at," or "judged as to fairness," all used in interpreting section.'

After the decision in *Frank*, a number of cases followed in which taxpayers made use of *Frank*'s decision as an argument to shun away from the arm's-length principle in section 482 and its predecessor, section 45. Meanwhile, during this period when the US courts were experiencing challenges in making decisions on the arm's-length cases under section 482, the business and regulatory climate with regard to transfer pricing was also changing (Avi-Yonah, 2007).

In the year 1961, the US Treasury department urged that significant changes be made in the taxation of US enterprises with foreign affiliates. In particular, the US Treasury department contended that section 482 was not effectively protecting US taxing jurisdiction. In the meantime significant new developments were also taking place in the courts (Avi-Yonah, 2007).

In *Oil Base, Inc. v. Commissioner*[40]case which involved the application of the arm's-length principle to sales commissions paid by an US corporation to its Venezuelan marketing affiliate. These commissions were about twice the amount that the same corporation had paid its previous unaffiliated distributor of the same product in Venezuela, and was twice the amount it was currently paying to distributors in other countries. The taxpayer, however, based his argument on the principle in *Frank*'s case that the reasonable price principle should be applied instead of arm's-length, and that since it still retained higher profits from export sales to Venezuela even after the double commission than from domestic sales, the commissions were reasonable under *Frank*'s case (Avi-Yonah, 2007).

The court, in a memorandum decision, disagreed and held that (Avi-Yonah, 2007):

> 'It is unnecessary for us to decide whether the sole standard in cases under section 482 is one of an amount which would be arrived at in arm's-length transactions between unrelated

[40] *23 T.C.M. (CCH) 1838 (1964)*

> parties. The commissioner has been given much latitude in his use of section 482 when necessary to prevent the evasion of Federal income tax by shifting of profits between taxpayers subject to common control. The burden is on petitioner to show error in respondent's allocation....[There] is no evidence to show that the percentage return retained by petitioner on domestic sales would represent a reasonable return on export sales. There is likewise no evidence to show that the amount of commissions and discounts paid to Oil Base, Venezuela, represented a reasonable amount, a fair amount, or an amount which would meet any of the other criteria referred to by the court in Frank's case. Certainly the fact that these commissions are almost double those paid by petitioner to unrelated persons in arm's-length transactions is evidence that they were not fair and reasonable.'

The taxpayer appealed and on appeal, the taxpayer, citing *Frank*, repeated the argument that the Commissioner erred in applying the arm's-length test bargaining that was not in the statute. The court of appeals, however, held that the application of arm's-length test in this case was appropriate (Avi-Yonah, 2007).

The court said,

> 'We cannot agree. Where, as here, the extent of the income in question is largely determined by the terms of business transactions entered into between two controlled corporations it is not unreasonable to construe "true" taxable income as that which would have resulted if the transactions had taken place upon such terms as would have applied had the dealings been at arm's-length between unrelated parties.'

The court of appeals further said, *Frank* did not hold that the arm's-length principle established by regulation was improper. It held that it was not the sole criterion for determining the true net income of each controlled taxpayer (Avi-Yonah, 2007). For the fact that the court in *Oil Base* mentioned that a sole criterion cannot be used in determining that an arm's-length price is an indication that the court could allow other criterion in determining what is an arm's-length price.

Hence that is the reason their decisions were considered inconsistent on what constitutes an arm's-length price, because they applied various standards as the legislation lacked provisions of how taxpayers should transact at arm's-length. The Commissioner's victory in *Oil Base* was followed by a series of cases which applied the arm's-length principle, although not always to the Commissioner's satisfaction.

In *Johnson Bronze Company v. Commissioner*[41], the taxpayer formed an international marketing subsidiary in Panama for the majority of its foreign sales accounts. The Commissioner reallocated 100% of the subsidiary's income to the parent under section. The court held that the 100% allocation was arbitrary and unreasonable. In determining the proper allocation, the court held that 'the standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's-length with another uncontrolled taxpayer'. Again, in this case the taxpayer argued from the basis of the decision in Frank, but failed.

The court referred to *Frank* as requiring a choice between the reasonableness standard and applying the arm's-length test, but stated that 'on this subject we shall only say that, on the facts of this case, the only reasonable price charged by petitioner would be one which would have been arrived at if the parties were at arm's-length'. The court then held that the allocation should be based on the prices charged by unrelated parties that bought the same products from the taxpayer for resale in foreign markets (Avi-Yonah, 2007).

The inconsistency of the courts in deciding what constitutes the arm's-length price can again be seen in *Johnson Bronze Company* case. The court in this case equates the reasonableness standard argued in *Frank* with the arm's-length principle. Meanwhile in *Oil Base* the reasonableness standard in *Frank* was referred to as a criterion to be followed when applying the arm's-length principle.

In *Eli Lilly & Company v. Commissioner*[42], the first of several section 482 cases involving pharmaceutical manufacturers, involved transfer pricing between Eli Lilly and Company (Lilly) and its subsidiary which qualified as a Western Hemisphere Trade Corporation. The Commissioner based his reallocation on the profit earned by Lilly on sales to domestic distributors, arbitrarily divided in half to reflect volume discount (Avi-Yonah, 2007).

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[41] *24 T.C.M. (CCH) 1542 (1965)*

[42] *372 F.2d 990 (1967)*

The court agreed, holding that Lilly's contention that it should be allowed to benefit from the tax subsidy to Western Hemisphere Trade Corporation, would require the court to ignore the provisions of subsection 1.482-1, requiring the application of the arm's-length principle. The reason was that if the subsidiaries were unrelated, it would not have been able to retain all the profit on the sales. Lilly then cited *Frank*, in arguing that its allocation was motivated by business purposes and was fair and reasonable, and that the arm's-length principle should not control. The court disagreed and held (Avi-Yonah, 2007):

> 'The Ninth Circuit has since indicated that only a very narrow departure from the arm's-length standard was allowed in the particular circumstances of Frank [citing Oil Base]. Moreover, even accepting Eli Lilly's interpretation that Frank establishes a criterion of a fair and reasonable price, such a price can best be determined by hypothesizing to an arm's-length transaction. The thrust of section 482 is to put controlled taxpayers on a parity with uncontrolled taxpayers. Consequently, any measure such as "fair and reasonable" or "fair and fairly arrived at" must be defined within the framework of "reasonable" or "fair" as among unrelated taxpayers. Simply because a price might be considered "reasonable" or "fair" as a business incentive in transactions among controlled corporations, does not mean that unrelated taxpayers would so consider it. Thus, even if the arm's-length standard is not the sole criterion, it is certainly the most significant yardstick.'

The inconsistency of the courts in applying the arm's-length test is seen again in this case. Lilly tried to argue *Frank* but was also unsuccessful. The *Eli Lilly* case illustrates the problem of the absence of any comparable transactions as it becomes unclear as to how the arm's-length price should be hypothesised. To this question, the court gave no answer. It rejected the comparables offered by Lilly (bulk sales to government agencies) because the market was not comparable, yet accepted the revenue agent's arbitrary decision to cut the profits of the Western Hemisphere Trade Corporation affiliates by half, because the results were reasonable.

The case law analysis prior to section 482 being amended to contain regulations on how taxpayers should transact at arm's-length price, establishes that inconsistency happened in the application of the arm's length principle as the US courts developed various standards in applying the arm's-length principle. Under these circumstances, when section 482 regulations did not have any specific rules or methods on how related parties should transact at arm's-length price, taxpayers could conduct self-examination of their transactions without any reference to the comparable transactions and provide such examination before the IRS and the US courts as an evidence that their transactions are at arm's-length. It was the responsibility of the courts to decide whether such transactions are at arm's-length.

The situation of the US transfer pricing tax legislation prior to it being amended to be prescriptive, reflect the current situation of the South African transfer pricing tax legislation. Under this situation, taxpayers, SARS, and the courts may have a different view on the interpretation of what exactly constitute an arm's-length transaction. Hence, it is the reason the US amended section 482 in the year 1968 to be prescriptive by including regulations containing methods on how taxpayers should transact at arm's-length price to solve this problem.

4.7 THE US TRANSFER PRICING TAX CASE LAW SUBSEQUENT TO SECTION 482 BEING AMENDED IN THE YEAR 1968 TO INCLUDE REGULATIONS PRECRIBING HOW TO TRANSACT AT ARM'S-LENGTH PRICE

This section provides an analysis of the challenges and advantages when the transfer pricing tax legislation is prescriptive on how taxpayers should transact at arm's-length price.

In the year 1968, the regulations under section 482 were amended by including methods on how to transact at arm's-length. Thereafter, the regulations formed the starting point for the US courts in determining whether or not the transaction was at arm's-length or not. The regulations attempted to establish rules for applying the arm's-length principle to specific types of transactions, but with different degrees of specificity (Avi-Ayonah, 2007).

For services transactions, the regulations recited the arm's-length principle without any guidance as to its application in the absence of comparables. For intangibles property transaction, the regulations contemplated a failure to find comparables. They list twelve factors to be taken into account, but without establishing any priority or relative weight among them (Baker & McKenzie, 2005: 11).

For tangible property transactions, details were provided for transfers of tangible property. The regulations described the three methods that should be used in determining an arm's-length price: the comparable uncontrolled price method, the resale price method, and the cost plus method, in that order of priority. All three methods relied on finding comparable transactions, either directly or by reference to appropriate mark-ups (Baker & McKenzie, 2005: 11). In the absence of comparable transactions, the regulations stated that (Avi-Ayonah, 2007):

> 'Where none of the three methods of pricing . . . [c]an reasonably be applied under the facts and circumstances as they exist in a particular case, some appropriate method of pricing other than those described in subdivision (ii) of this subparagraph, or variations on such methods, can be used.'

The above provision in section 482 regulations gave the courts freedom to determine their own fourth method of determining the arm's-length price in the absence of comparable transactions. One of the advantages with section 482 regulations after it was amended to be prescriptive, was that the regulations effectively ensured that the US courts would apply the arm's-length principle as opposed to the various standards applied by the courts, prior to section 482 being amended to have regulations on how to transact at arm's-length in 1968.

The other advantage with section 482 after it became prescriptive, was that the section required taxpayers to illustrate that their transactions were at arm's-length by having comparable transactions. Therefore, where comparable transactions were available as a benchmark against the taxpayer's transaction, the litigation process could not be further pursued because the taxpayer showed compliance with legislation. As a result, a number of cases which were litigated became smaller as compared to the time the legislation was without regulations on how to transact at arm's-length (Avi-Ayonah, 2007).

The analysis of the following cases illustrates how the courts interpreted the arm's-length principle and the challenges faced by the courts subsequent to the amendments of section 482 in the year 1968. These challenges were experienced in situations where the comparable transactions were not available or inexact comparable transactions were used by taxpayers. These cases involved situations where intangible property transactions were an issue, as section 482 regulations did not prescribe which methods should be applied to determine the arm's-length price with regard to intangible property transactions.

United States Gypsum Co. v. United States[43] case, is one of the cases that illustrates clearly how the amendments made to section 482 in the year 1968, had a significant influence in the courts when deciding whether or not a transaction was at arm's-length (Avi-Ayonah, 2007).

United States Gypsum Co. case involved two section 482 issues: (i) shipping fees paid by the taxpayer to its Panamanian subsidiary, (ii) transfer pricing for goods sold by the taxpayer to its Western Hemisphere Trade Corporation. The district court held for the taxpayer on both issues. On the shipping issue, it held that the amounts were reasonable and equal to an arm's-length charge because they were within the range of unrelated party prices, as it was required by section 482 that prices of related parties should be within the price range of unrelated parties to be considered at arm's-length (based on comparables) (Avi-Ayonah, 2007).

On the transfer pricing issue, the district court held that even though the prices were arbitrarily set to shift income to the Western Hemisphere Trade Corporation, on the basis of cases like *Frank* and *Polak's Frutal* which allowed similar mark-ups, the prices were not unreasonable (which the district court considered to be automatically equivalent to arm's-length)(Avi-Ayonah, 2007).

The court of appeals affirmed the first decision by the district court and reversed the second decision. On the shipping issue, the court of appeals considered the fact as to

[43] *304 F.Supp. 627 (N.D. Ill. 1969),* aff'd in part and rev'd in part, *452 F.2d 445 (7th Cir. 1971)*

whether the alleged comparables were indeed comparable, and whether unrelated parties would not have adjusted the terms of the contract once the profits that the shipping subsidiary was making became clear, but affirmed under a clearly erroneous standard. On the transfer pricing issue, the court of appeals reversed the decision of the district court, rejecting the reliance on *Frank* and its predecessors and its application of a reasonableness standard.

The reason for the court of appeals to reject the district court's decision was that the reliance on *Frank* and its predecessors was not an option under the new section 482 regulations, as these cases were decided under the old section 482. The court of appeals held, as argued by the Commissioner, that applying the arm's-length principle was mandatory in all cases under section 482 (Avi-Ayonah, 2007).

Again, in this case the court of appeals emphasised that the application of the arm's-length principle was mandatory under section 482, and that the standards applied in section 482 cases prior the amendments in the year 1968, cannot be allowed after the section was amended to be specific on the application of the arm's-length principle.

Ross Glove Co. v. Commissioner[44] represents the application of section 482 to an inbound transaction, involving the sale of sheepskins to the taxpayer by a Bahamian corporation which also provided sewing services. The Commissioner attempted to hold the taxpayer to its representations to the Philippine authorities, regarding the mark-up on its costs for currency control purposes. The tax court rejected this argument and held that 'there is nothing in section 482 or the regulations to indicate that the arm's-length principle under section 482 is to be ignored simply because of representations made in foreign countries'. The court then determined the transfer price on the basis of arbitrary adjustments to an approximate comparable as required by section 482 (Avi-Ayonah, 2007).

[44] 60 T.C. 569 (1973)

Lufkin Foundry and Machine Co. v. Commissioner[45] case is also one of the first cases after section 482 was amended to be prescriptive, which illustrates that the court would not accept any other methods to determine what the arm's-length price of a transaction was, except the methods prescribed in section 482 after its amendment. *Lufkin* case involved the transfer pricing between the taxpayer and its subsidiary where the selling of machines and marketing arrangements transactions were an issue. The taxpayer introduced evidence to argue the reasonableness test for both these transactions. The tax court accepted the taxpayer's argument on that basis.

The Commissioner appealed, citing the need to meet the arm's-length principle in terms of the amended section 482 and arguing that no evidence regarding a taxpayer's internal operations could satisfy the arm's-length principle on its own under this section. The appeal court reversed the decision of the tax court and held for the Commissioner.

On the sale of the machine the appeal court said that the US Treasury department has promulgated regulations under section 482 to assist in the implementation of the arm's-length standard. The regulations delineate the methods by which one can calculate whether or not controlled companies dealt with each other at arm's-length.

On the marketing arrangement the appeal court said the following (Avi-Ayonah, 2007),

> 'No amount of self-examination of the taxpayer's internal transactions alone could make it possible to know what prices or terms unrelated parties would have charged or demanded. We think it palpable that, if the [arm's-length] standard set by these unquestioned regulations is to be met, evidence of transactions between uncontrolled corporations unrelated to Lufkin must be adduced in order to determine what charge would have been negotiated for the performance of such marketing services.'

The argument is that both the *Ross Glove Co*. and *Lufkin* cases illustrate how the US courts were able to decide whether the taxpayer was transacting at arm's-length based on the requirements of section 482 after the section was amended to be prescriptive,

[45] *468 F.2d 805 (5th Cir. 1972).*

as opposed to prior the amendments in the year 1968 when the section was not prescriptive. In both these cases, the courts made decisions whether the taxpayers were transacting at arm's-length without developing different standards, but by making reference of what is required in terms of amended section 482.

Further analysis of the following court cases also illustrates that the decisions of US courts on section 482 after it was amended to be prescriptive, were consistent with the arm's-length requirements in the section, although there were some challenges that the courts experienced.

As mentioned in this chapter the US courts still faced some challenges in applying section 482 after it was amended in the year 1968. Such challenges are evident when the US courts applied section 482 in the situation where taxpayers used inexact comparable transactions in proving that their transfer pricing transactions were at arm's-length, or in situations where taxpayers had no comparable transactions available at all. The following is a further analysis of the US transfer pricing case law with challenges as mentioned above.

R.T. French Co. v. Commissioner[46] is one of the cases which show that the US courts were consistent with the language of section 482 even though they experienced challenges with regard to inexact comparable transactions. In the *French* case, the taxpayer, a US subsidiary of a UK parent, negotiated a royalty rate for the parent's valuable patented process for producing instant mashed potatoes in the year 1946, for a 21 year period. This was before the profitability of the process was known and when there was an unrelated 49% minority shareholder in the parent. In the year 1960, when the minority shareholder had been bought out and the process had proved highly profitable, the licensing contract was amended, but the royalty rate remained unchanged for the duration of the contract (Avi-Ayonah, 2007).

[46] *60 T.C. 836*

The taxpayer's argument was that the contract was comparable to what the unrelated parties could have done. The IRS argued that unrelated parties would have amended the royalty rate to be commensurate with the income derived from the patent, and that the low rates of the contract resulted in constructive dividends to the UK parent, which should be subject to withholding. The tax court disagreed with the argument of the IRS and held that the original contract in the year 1946 was negotiated at arm's-length because of the 49% minority shareholder in the UK parent (Avi-Ayonah, 2007). The tax court said (Avi-Ayonah, 2007),

> 'The position of [the minority shareholder] in the scheme of things in all likelihood assured the arm's-length character of the transaction." Thereafter, the fact that profitability changed "in no way detracted from the reasonableness of the agreement when it was made," and there was no basis for a section 482 adjustment "so long as the "arm's-length' test is met. ... There is no reason to believe that an unrelated party in [the parent's] position would have permitted petitioner to avoid its contractual obligations.'

Again *French* illustrates how the court became consistent with the decisions in other cases when it was against the IRS in this case to depart from the arm's-length requirements in section 482.

Baldwin-Lima-Hamilton Corp. v. United States[47] case involved transfer pricing between the taxpayer and its Western Hemisphere Trade Corporation. The Commissioner reallocated all of the income of the subsidiary to the taxpayer. The district court held that the reallocation was arbitrary, and upheld the taxpayer's allocation based on pricing studies using assumptions that were tipped in the taxpayer's favour, by using inappropriate comparables (Avi-Ayonah, 2007).

The court of appeals reversed in part, and remanded to the district court for partial reallocation on the basis of the arm's-length principle, stating that the district court should reject those aspects of the taxpayer's theories which do not meet the arm's-length standard (Avi-Ayonah, 2007). Baldwin is one of the cases where even the taxpayer applied section 482, but the use of comparables in determining the arm's-length price was a challenge for the court.

[47] 435 F.2d 182 (1970)

The U.S. Steel Corp. v. Commissioner[48] case is another case which illustrates that the court applied the arm's-length principle in section 482 but had difficulty in comparing intragroup transactions with unrelated party transactions, even where the same product or service is involved as section 482 required that comparable transactions of independent parties should be used to proof that the taxpayer's transaction is at arm's length.

US Steel owned a Liberian subsidiary, Navios, which was used to ship steel from Venezuela to the US. The prices charged by Navios were set at a level that would make the steel price equal to the price of domestic steel manufactured by US Steel, and the same price was charged by Navios for shipping for unrelated corporations, albeit at much lower quantities. As a result Navios had high profits which were totally exempt from tax. In the tax court, IRS successfully upheld its reallocation of $52 million in profits to the taxpayer. The taxpayer appealed and the court of appeals reversed the decision of the tax court (Avi-Ayonah, 2007). The court of appeals held that,

> 'We are constrained to reverse because, in our view, the Commissioner has failed to make the necessary showings that justify reallocation under the broad language of section 482 . . . The Treasury Regulations provide a guide for interpreting this section's broad delegation of power to the Secretary, and they are binding on the Commissioner . . . [citing the ALS] This "arm's-length" standard . . . [i]s meant to be an objective standard that does not depend on the absence or presence of any intent on the part of the taxpayer to distort his income . . . [W]e think it is clear that if a taxpayer can show that the price he paid or was charged for a service is "the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties" it has earned the right, under the Regulations, to be free from a section 482 reallocation despite other evidence tending to show that its activities have resulted in a shifting of tax liability among controlled corporations.'

The appeal court concluded that the only issue in this case was the comparability of Navios' transactions with those of unrelated parties. It held that they were comparable, despite the differences in volume and the assurance of continued service as a result of the parties' relationship, and despite the taxpayer's ability to manipulate the prices of the steel so as to leave a larger profit to the tax exempt shipper. In particular the court went further to state the following (Avi-Ayonah, 2007):

[48] *617 F.2d 942 (2nd Cir. 1980)*

> 'Attractive as this argument is in the abstract, it is a distortion of the kind of inquiry the Regulations direct us to undertake. The Regulations make it clear that if the taxpayer can show that the amount it paid was equal to "the amount which was charged . . . [f]or the same or similar services in independent transactions" he can defeat the Commissioner's effort to invoke section 482 against him.'

The court of appeals rejected the Commissioner's argument that transactions with independent parties are only relevant in a competitive market and not where US Steel had a *de facto* monopoly, holding that this would impose an unfair burden on the taxpayer (Avi-Ayonah, 2007). Although section 482 was correctly applied by the taxpayer, the comparable transactions used by the taxpayer to proof that the transaction was at arm's length was not accepted by the Commissioner. This is one of the areas were section 482 was not prescriptive enough to provide clarity after it was amended.

In *Bausch & Lomb, Inc. v. Commissioner*[49], the taxpayer licensed its unique process for manufacturing soft contact lenses to an Irish tax haven manufacturer and charged a royalty of 5%. The Irish subsidiary manufactured the lenses for $1.50 each and sold them to the taxpayer for $7.50 each, the same price charged by unrelated parties with much higher manufacturing costs for the same product (Avi-Ayonah, 2007).

Even though the resale price of lenses to Bausch & Lomb in the US was comparable to the prices in the market, the Commissioner's proposed adjustments included eliminating the royalty (on the theory that Bausch & Lomb Ireland was a contract manufacturer assured of a market for its sales) but adjusting the income to give Bausch & Lomb Ireland its costs, plus a profit of 20% (Avi-Ayonah, 2007).

The tax court held in favour of the taxpayer and said that these adjustments were an abuse of discretion. The tax court held that the transfer price was correct on the basis of the unrelated sales, despite the economic differences (volume differences, integrated business differences, and the fact that Bausch & Lomb Ireland had far

[49] *92 T.C. 525 (1989)*

lower production costs than its competitors) between the alleged comparables (Avi-Ayonah, 2007). The tax court further said,

> 'We find that use of the comparable-uncontrolled-price method of determining an arm's-length price is mandatory. The third-party transactions identified by petitioner provide ample evidence that the $7.50 per-lens price charged by B&L Ireland is equal or below prices which would be charged for similar lenses in uncontrolled transactions . . . [W]e place particular reliance on the Second Circuit's opinion in U.S. Steel . . . To posit that B&L, the world's largest marketer of soft contact lenses, would be able to secure a more favorable price from an independent manufacturer who hoped to establish a long-term relationship with a high volume customer may be to recognize economic reality, but to do so would cripple a taxpayer's ability to rely on the comparable uncontrolled price method in establishing transfer pricing by introducing to it a degree of economic sophistication which appears reasonable in theory, but which defies quantification in practice.'

Therefore the tax court rejected the argument from disparities of volume and from the taxpayer's lower costs, holding that the $7.50 price was a market price and therefore the taxpayer had earned the right to be free of adjustment. The Commissioner appealed to the court of appeals and the court of appeals affirmed the decision of the tax court. The court of appeals admitted that the Commissioner's position is not without force, but held that under section 482 regulations and the arm's-length principle, applying the comparable uncontrolled price method was mandatory, even though economic reality may differ.

Although the US courts were able to apply the arm's-length principle as required by section 482 in the *French*, *US. Steel* and *Bausch & Lomb* cases, it is also illustrated in these cases that the US courts had a problem in applying the arm's-length principle when inexact comparable transactions were used by the taxpayer as the section was not prescriptive enough on how to deal with such situations. The US courts had also experienced problems in applying section 482 where comparable transactions were rejected by the court or there were not available as the section was not prescriptive enough on how to deal with such situations. Hence the section was further amended to be prescriptive to address these kinds of situations. The following cases illustrate how the US courts dealt with those challenges.

The *Cadillac Textiles v. Commissioner*[50] case which was decided prior to the *French, U.S. Steel* and *Bausch & Lomb* cases shows the inconsistency of the decisions by the US courts even after section 482 was amended to be prescriptive. As mentioned above the reason of the inconsistency of the decisions by the US courts was that the section was still not prescriptive in certain areas on how one should comply with the arm's length requirements. The case involved commissions paid by the taxpayer to a related entity for weaving. The taxpayer relied on the comparability of these commissions to those paid to unrelated entities (Avi-Ayonah, 2007).

The tax court held that the alleged comparables were dissimilar because of volume differences and because there was no commitment for a continuing relationship. In determining what the arm's-length transfer price was, the tax court applied the profit split method which was not prescribed as the method of determining the arm's length in section 482 at that time (Avi-Ayonah, 2007). With these same facts as in *French*, *US. Steel* and *Bausch & Lomb* cases, one would have expected the court to accept the comparable transactions used by the taxpayer, but that was not the case (Avi-Ayonah, 2007).

In another case where court has rejected comparable transactions of the taxpayer, is in *E.I. DuPont de Nemours & Co. v. Commissioner*[51] case. The facts in *Du Pont* were particularly favorable to the IRS, since the taxpayer admitted that it had set transfer prices with its tax haven (Swiss) marketing subsidiary, DISA, with no reference to anything but maximising DISA's profitability. The court rejected the taxpayer's comparable transactions drawn largely from general industry averages and the IRS sourcebook of statistics of income. The court was faced with the necessity of either determining its own transfer price, or accepting the allocation made by the IRS. Unlike in *Cadillac Textiles*, the court decided to take the easier route and accept the position of the IRS (Avi-Ayonah, 2007).

[50] 34 T.C.M. (CCH) 295 (1975)
[51] *608 F.2d 445 (Ct. Cl. 1979)*

Hospital Corporation of America v. Commissioner[52] case where the taxpayer formed a Cayman Islands subsidiary to perform a contract to manage a hospital in Saudi Arabia. The subsidiary (LTD) performed minimal functions, and all the substantial work on the contract was done by the taxpayer. The Commissioner argued that LTD was a sham, or alternatively, that all of its income should be allocated to the taxpayer. Applying section 482 to the transactions of the taxpayer, the court held that the Commissioner abused his discretion by the 100% allocation. Since there were no comparable transactions from the unrelated parties suggested by any side, the court was forced to make an arbitrary profit split determination (Avi-Ayonah, 2007). The courts said that,

> 'Even though we have rejected respondent's 100-percent allocation of taxable income from LTD to petitioner, the evidence indicates overwhelmingly that an allocation is necessary and proper in this case. . . . [U]nfortunately, there is little quantitative evidence in this record upon which we can determine what a reasonable allocation of profits would be. Neither party has been particularly helpful to the Court in this regard. However, we must do the best with what we have. . . . [U]sing our best judgment on the lengthy and inconclusive record before us, we have concluded and found as a fact that 75 percent of the taxable income of LTD in 1973 was attributable to petitioner.'

In *G.D. Searle & Co. v. Commissioner*[53] case, Searle transferred drug patents to its Puerto Rican subsidiary (SCO) for no consideration. SCO subsequently manufactured and sold the drugs to unrelated parties so no transfer price issue was involved. The tax court rejected the attempt by the IRS to ignore the transfer of the intangibles and allocate the income to the taxpayer by treating SCO as a contract manufacturer (Avi-Ayonah, 2007).

The court then held that some consideration for the transfer was necessary as the intangibles accounted for 80% of the taxpayer's income, and transferring the patents to an unrelated party solely for stock would be the height of corporate mismanagement. As there were no comparable transactions and section 482 did not make any provisions on what should be done in such situations, the tax court was required to use its arbitrary best judgment. The court applied profit split method

[52] *81 T.C. 520 (1983)*

[53] *88 T.C. 252 (1987)*

though the percentage was more lenient as compared to the extreme profit split allocation that was done by the IRS (Avi-Ayonah, 2007).

Ciba-Geigy Corp. v. Commissioner[54] is another case where the court could not find comparable to apply section 482. The case involved the appropriate rate of royalty to be paid by the taxpayer to its Swiss parent under an exclusive license in which all the significant research and development had been done at the parent level. The IRS argued that the taxpayer was engaged in a joint venture with the parent and should have paid a lower royalty than 10% or, alternatively, the arm's-length rate was lower. The taxpayer argued for a higher royalty than 10% (Avi-Ayonah, 2007).

The tax court rejected the attempts by the IRS to deflect the thrust of its own transfer or use of intangible property regulations. Having rejected the proposed comparables of both parties because of different degrees of risk and the uniqueness of the relationship, the court held that the 10% rate was reasonable, based on the substantial negotiations between the related parties and based on the testimony of an unrelated party who would have paid between 10% and 12.5% for a nonexclusive license (Avi-Ayonah, 2007).

Sundstrand Corp. v. Commissioner[55] case involved the license of valuable manufacturing technology for aircraft spare parts to the taxpayer's Singapore subsidiary which in turn sold the parts to the taxpayer for distribution. The IRS as in *Bausch & Lomb* attempted to apply its contract manufacturer analysis which seems appropriate because the subsidiary did not develop the product and was guaranteed, although not formally, to sell its products to the taxpayer (Avi-Ayonah, 2007).

The tax court, relying on *Bausch & Lomb*, rejected this analysis and also rejected all proposed comparables of both the taxpayer and the IRS. The court made its own best estimate of the appropriate transfer price, relying on the discounts given by the taxpayer on other products and on its representations to US Customs. With respect to

[54] *85 T.C. 172 (1985)*
[55] *96 T.C. 226 (1991)*

the royalty, the court again rejected all comparables of both the taxpayer and the IRS and accepted a fixed rate of 10%. (Avi-Ayonah, 2007).

The other case where the availability of comparables was an issue is *Perkin-Elmer Corp. v. Commissioner*[56]. The case involved facts similar to *Bausch & Lomb* and *Sundstrand* cases. In *Perkin-Elmer*, the US parent licensed its possessions corporation (PECC) to manufacture certain instruments, accessories and lamps in Puerto Rico. PECC manufactured the products in Puerto Rico and sold them to its parent for resale. On audit, the IRS collapsed the license and sales transactions and characterized PECC as a contract manufacturer. Shortly before trial and in light of the opinion of the tax court in *Bausch & Lomb* and Sundstrand, the IRS, however, abandoned its contract manufacturer argument. Instead, the IRS directed its arguments to the arm's-length terms for each separate transaction. The tax court determined the arm's-length royalty rate for the license based on comparable transactions with unrelated parties. (Avi-Ayonah, 2007).

The transfer pricing US case law analysis subsequent to section 482 being amended in 1968, establishes that when a transfer pricing tax legislation which is prescriptive on how taxpayers should transact at arm's-length price, has positive impact as it has resulted in helping taxpayers, the IRS and the courts in the US interpret what constitutes the arm's-length transaction as required by section 482 without using different standards. To be specific, the advantage is that the US courts are now obligated to follow the methods provided in the legislation when they decide on whether or not a taxpayer's transaction is at arm's-length.

With regard to the challenges that arose subsequent to the amendments in the year 1968; for example, where section 482 did not prescribe what process should be adopted in certain situations where the comparable transactions were not available, or inexact comparable transactions were used by taxpayers. Also in situations involving intangible property transactions because section 482 was not prescriptive which methods should be applied to determine the arm's-length price.

[56] 66 TCM 634 (1993)

Section 482 was further amended several times subsequent to 1968 amendments to be more prescriptive in addressing these issues. In the year 1986, the US Congress amended section 482 to provide as follows;

> 'In the case of any transfer (or license) of intangible property . . . [t]he income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.'

In the year 1994, section 482 was again amended and provided that arm's-length consideration for a transfer of intangible property must be determined using one of four methods: (a) the comparable uncontrolled transaction method, (b) the comparable profits method, (c) the profit split method, (d) any unspecified method (Avi-Ayonah, 2007).

In September 2003, the IRS issued proposed section 482 regulations with regard to intercompany services. The proposed services regulations modify the rules regarding joint development of intangible property. The purposes of the proposed rules is to separate the determination of the ownership of intangible property from the determination of the allocation of the income from the intangible property (Lemein, 2005:26).

In August 2005, the IRS issued proposed section 482 regulations for costs sharing arrangements. According to Lemein (2005: 43) the proposed cost sharing arrangements regulations are a complete restatement of the current cost sharing arrangements regulations. They constitute a radical departure from the current regulations and if finalized in their current form, would substantially reduce the attractiveness of cost sharing arrangements to taxpayers.

4.8 CONCLUSION

The purpose of this chapter was to address the third sub-problem of the research study, which is the impact of having a non- prescriptive transfer pricing tax legislation and the impact of having a prescriptive transfer pricing tax legislation with reference to the enforcement of transfer pricing tax legislation in the US. To further argue the question of whether or not the South African transfer pricing tax legislation should be amended to be prescriptive on how taxpayers should transact at arm's-length, the next chapter develops a research methodology.

CHAPTER 5: THE RESEARCH METHODOLOGY

5.1 INTRODUCTION

This chapter discusses how the research study was designed and the specific research methods used to conduct the study. The chapter specifically discusses the research method adopted, research type, methods adopted for data collection and for data analysis.

5.2 RESEARCH DESIGN AND METHODS

The research design is actually a plan or blueprint of how one intends conducting the research. This includes focusing on the end product, formulating a research problem as a point of departure and focus on the logic of the research. (De Vos, 2002:137). Research projects are conducted by adopting either one or both quantitative or qualitative research approaches (Glatthorn, 1988:33).

In order to address the research question whether or not the South African transfer pricing tax legislation should be amended to be prescriptive by having regulations on how to transact at arm's-length, a qualitative research approach was adopted.

Glatthorn (1988:33) explains the difference between quantitative and qualitative research by stating that, quantitative research approach holds that there is an objective reality that can be expressed numerically. As a consequence, the quantitative perspective emphasis studies that are experimental in nature, emphasise measurement and search for relationships. Such studies can be identified to be quantitative if they use the language such as variable, controls, validity, reliability, hypothesis, or statistically significant language.

Glatthorn (1988:34) further explains the difference between quantitative and qualitative research approaches by stating that the studies derived from qualitative perspective, focus on meaning and understanding, taking place in naturally occurring situations. Further, that such studies derived from qualitative perspective can be identified by adoption of the language such as naturalistic, field study, case study, context, situational, constructivism, meaning, or multiple realities.

This research study is not aiming at resolving any numerical measurements or relationships, but it is aimed at providing descriptive analysis of certain situations. Hence it is the reason qualitative research approach is chosen to conduct this research study.

5.3 THE RESEARCH TYPE

According to Glatthorn (1988:35), research types can be identified by looking at whether they tend to use a quantitative or qualitative perspective, although there may sometimes be overlaps of some research types. Glatthorn (1988:33) mentions that qualitative research approach can be conducted using either case study research type, ethnography research type, or action research type. According to Maree (2007:71) there are three other qualitative research types in addition to the above. These are conceptual studies, historical, and grounded research types.

Among these a case study type has been adopted in conducting this research study. The reason for this was that to a certain extent, this research study involves unit analysis. Citing Bromley, Maree (2007:75) explains case study research as a systematic inquiry into an event or a set of related events which aims to describe and explain the phenomenon of interest. Maree (2007:75) further explains that unit analysis is a critical factor in case study research and explains that case study research often focuses on a system of action rather than an individual or group of individuals.

Maree (2007:75) also mentions that one of the advantages of case study research is its flexibility as it allows the use of multiple sources and techniques in the process of data gathering. Merriam (1998:31) states that case study research approach is the best for answering the research question and that its strengths outweigh its limitations. Merriam (1998:31) also mentions that case study plays an important role in advancing knowledge base in the field being researched, as it helps structure future research. For these reasons, case study research has been adopted to conduct this research study.

In conducting case study research, a heuristic and multiple case approach was adopted. Merriam (1998:31) explains that case study research is heuristic in nature when it is as follows:

a) Explains the reason for a problem, the background of a situation, what happened, and why.

b) Explains why an innovation worked or failed to work.

c) Discusses and evaluates alternatives not chosen.

d) Evaluates, summarises, and concludes, thus increasing its potential applicability.

Merriam (1998:40) further mentions that case study research is multiple in nature when it involves collecting and analysing data from several cases and the data is distinguished from a single case study. The adoption of this approach is illustrated in chapter 1 where the problem statement was formulated by analysing the transfer pricing developments in certain countries and also in the entire research study where the OECD guidelines and the transfer pricing situation in the US is analysed and distinguished from the South African transfer pricing situation. This approach was adopted by addressing the following sub-problems of the research study:

a) Determining how taxpayers in South Africa are required to transact at arm's-length price and what are some of the challenges in South Africa in the absence of prescriptive transfer pricing tax legislation.

b) Determining whether Practice Note 7 in its current status is consistent with the current status of the OECD guidelines, and whether, as a result of being consistent or inconsistent with the current status of the OECD guidelines, Practice Note 7 can be included as the regulations on how to transact at arm's-length price in the South African transfer pricing tax legislation, in order to amend the legislation to become prescriptive.

c) Determining what the implications are of having non-prescriptive transfer pricing tax legislation and of changing from non-prescriptive to prescriptive transfer pricing tax legislation by looking at the experiences of the US in the enforcement of transfer pricing.

5.4 DATA COLLECTION METHODS

The methods used to collect the data in this research study are the literature review; documentary analysis; and semi-structured interviews. These methods are analysed as follows:

5.4.1 Literature Review

The literature review was conducted in developing the background of the study and the context of the research study. Merriam (1998:49) acknowledges that one way of identifying and establishing the theoretical framework of a qualitative research study is through the literature review.

Merriam (1998:50) further mentions that as there is literature available on the subject being researched, it confirms that the problem needs to be researched and that conducting a literature review will eliminate the problem of duplicating a research study already conducted, and also provide the foundation for contributing to the knowledge base.

Huysamen (1994:190) is of the opinion that the importance of literature review is that it creates awareness of inconsistencies and hiatuses which may justify further research. As a result this could enable the researcher to indicate exactly where his/her proposed research fits. Creswell (2003: 30) shares the same view. Creswell (2003: 30) mentions that literature review allows the researcher to fill in gaps left by prior studies and also extends such studies.

Therefore, both the South African literature and international literature on the subjects of transfer pricing and arm's-length principle, were broadly consulted in conducting this research study. The consultation included publications such as books, dissertations, and periodicals and were searched in libraries and various internet sites.

5.4.2 Documentary Analysis

The documentation analysis is one of the methods of data collection used in this research study. According to Maree (2007:81) this method involves gathering written data which may includes published and unpublished documents, company reports, memoranda, agendas, administrative documents, reports and newspaper articles. Maree (2007:81) also expresses the view that it is important that one should distinguish between the documentation analysis and literature review. Maree (2007:75) mentions that both these methods overlap in the sense that both deal with data sources in written format. But documentation is something distinct from literature review.

Maree (2007:81) makes a distinction between literature review and documentation analysis by explaining that the literature review involves an overview of scholarship in a certain discipline through analysis of trends and debates. Maree (2007:81) maintains that documentation analysis could be done by gathering primary documents and secondary documents. According to Maree (2007:81) primary documents represent original source documents and secondary documents represent materials generated from the original source documents.

In conducting this research study, a wide range of documents from libraries and various internet sites was gathered for analyses. Outstanding primary documents which were collected include income tax legislations, court cases, policy documents, commission reports, handbooks and guidelines relating to the transfer pricing and arm's-length principle subject.

A wide range of secondary documents in the form of books and articles was also gathered from libraries and various internet sites. These documents provided insightful information on the transfer pricing and the arm's-length principle subject.

5.4.3 Semi-structured Interviews

Interviews were also conducted to collect data in addition to the documentation and literature review analysis. Maree (2007:81) describes the interview as a two-way conversation in which the interviewer questions the participant in order to collect data and learn about the ideas, beliefs, views, opinions and behaviours of the participant. Maree (2007:81) further explains the purpose of interviews in a qualitative research study as aiming to see the world through the eyes of the participant and thereby source valuable information. Merriam (1998:71) mentions that the purpose of interviews is to collect a special kind of information.

In conducting this research study, a semi-structured interview was adopted. Merriam (1998:74) explains semi-structured interviews as a mixture of both structured and unstructured interviews, and that the semi-structured interviews are more open ended and less structured. Merriam (1998:74) explains that this type of interview is flexible, and why this type of interview is important and mentions that this format allows the researcher to respond to the situation at hand, to the emerging worldview of the participant, and to new ideas on the topic.

Merriam (1998:83) says that collecting data through interviews requires that the researcher select participants on the bases of what they can contribute to the phenomenon being studied. Merriam (1998:83) further states that unlike the quantitative research study scenario where the number of interview participants is crucial, in the qualitative research study the number of interview participants is not crucial but the potential of each of the interview participants to contribute insight and understanding to the phenomenon being studied, is of vital importance.

Therefore, semi-structured interviews were conducted with two of the top tax professionals in South Africa to hear their views on the research subject. These tax professionals interviewed includes, the leading tax law expert and tax law practitioner in South Africa and the other tax professional is an employee of SARS. A brief background of these tax professionals is provided below.

a) Professor Emil Brincker

Professor Emil Brincker is a director at Cliffe Dekker Hofmeyr law firm's tax practice. He is also a member of the Special Board for Income Tax Appeals hearing tax matters for 10 years and member of the Executive Committee of the South African Fiscal Association. His experience includes the areas of corporate finance, corporate reorganisation and restructuring, export finance, funding, general banking and commercial including derivative transactions, empowerment transactions, JSE Limited and Securities Regulation Panel, project finance and tax law including income tax, VAT, stamp duties, PAYE, capital gains tax (CGT) and other fiscal statutes. He holds BCom (cum laude), LLB (cum laude) LLM (cum laude), LLD, from the University of Stellenbosch and HDip (Tax) (cum laude) from Rand Afrikaans University.

b) Mr Franz Tomasek

Franz Tomasek is a general manager, legislative policy, at SARS Head Office and he has been with SARS since the start of his career. His past experience includes being manager, tax research and assistant general manager, legislation - comprising customs policy, legislative drafting, international treaties, and tax research. He is an admitted chartered accountant. He holds a BCom and a BAcc from Wits.

Three interview questions were designed from the research problem. A brief background was provided prior to each question being put to the interviewees. The following is how these questions are structured with a brief background to each of the questions:

a) Question No. 1

Section 31 of the South African income tax Act (the Act) requires that taxpayers should transact at arm's-length, but it is not complemented by regulations providing methods on how to transact at arm's-length. The guidelines on how to transact at arm's-length are contained separately from the Act in Practice Note 7, which was not designed to be prescriptive on how to transact at arm's-length. As a result the Practice Note 7 is not legally binding to taxpayers and it has also been proven in certain court cases such as *ITC 1675*, that Practice Note is not regarded as a law that could be enforceable. Hence for this reason section 31 of the Act is regarded as not prescriptive on how taxpayers should transact at arm's-length, as it does not have regulations on how taxpayers should transact at arm's-length.

In your view, what are the advantages and disadvantages of having a transfer pricing tax legislation which is not prescriptive, such as section 31 of the Act?

b) Question No. 2

Practice Note 7 is broadly based on the OECD guidelines and its main objective is to serve as a guideline for taxpayers in South Africa on how they should comply with section 31 of the Act. The issue is that Practice Note 7 is consistent to a certain extent with section 31 of the Act and the OECD guidelines, but at other times it is inconsistent. For example, Practice Note 7 is not consistent in respect of the updates and changes made to section 31 of the Act concerning the deletion of the words 'international agreement', the two connected person amendments and again on updates. Practice Note 7 is inconsistent with developments and changes made in the

OECD on certain transfer pricing issues such as the transactional profit methods, permanent establishment, and aspects of business restructuring.

What is your general view about the status of Practice Note 7?

c) Question No. 3

Many countries around the world are moving away from transfer pricing tax legislation which is not prescriptive, by not having rules or regulations on how to transact at arm's-length. These countries are amending their transfer pricing tax legislation to be prescriptive. One of the main reasons is that during the time they had non-prescriptive transfer pricing tax legislation, problems arose especially in the courts. It was difficult for the courts to rule whether or not a transfer pricing transaction was at arm's-length as the legislation did not make provision on how to transact at arm's-length. The courts applied various standards in deciding whether a transaction was at arm's-length or not.

The US was the first country to experience such problems and also the first country to amend their transfer pricing tax legislation by including regulations in their legislation, providing guidance on how to transact at arm's-length. Other countries such as Argentina, Australia, Brazil, China, Denmark, France, UK, Netherlands, and Venezuela have since followed the example of the US by amending their legislation to prescriptive.

By the time South Africa needed to introduce transfer pricing tax legislation, the Commission led by Professor Michael Katz recommended that the prescriptive transfer pricing tax legislation such as the US approach, was not suitable for South Africa. The Commission recommended the legislative approach adopted by the UK which did not have any specific transfer pricing regulations but relied on the arm's length principle contained in the OECD guidelines to combat transfer pricing. However, shortly after the Commission recommended that South Africa should adopt the UK legislative approach, the UK also followed the example of the US by amending their transfer pricing tax legislation to be prescriptive.

Do you think South Africa also needs a prescriptive transfer pricing tax legislation which has regulations on how taxpayers should transact at arm's-length, or is the current transfer pricing tax legislation still suitable for South Africa?

5.4.4 Data Analysis

In conducting the data analysis in this research study, the content analysis approach was used. According to Merriam (1998:160) all qualitative research studies automatically use the content analysis approach to analyse the data collected. Maree (2007: 101) explains content analysis as an inductive and iterative process where similarities and differences in the text identified and collected, is analysed and tested to establish if it would corroborate or disconfirm the theory investigated. According to Merriam (1998:160) content analysis process involves the simultaneous coding of raw data and the construction of categories that capture relevant characteristics of the document's contents.

In terms of data analysis, the researcher analyses the data by organising it into categories based on themes or concepts, which will directly answer the main research question. The research findings are organised in terms of major themes and concepts.

5.5 CONCLUSION

This chapter discussed the research methodology which was applied in conducting this research study. To mention but a few things that was addressed; various literatures, ranging from books, journal articles, academic articles, policies, guidelines, court cases and income tax legislations were used. Interviews with certain tax law professionals were conducted. Therefore, the main objective of the next chapter is to present findings of the research study as well as to analyse them. The interpretation of the research study and recommendations to this research study is provided in the last chapter. Nevertheless, this research is qualitative. The next chapter presents and analyses the research findings

CHAPTER 6: RESEARCH FINDINGS.

6.1 INTRODUCTION

The purpose of this chapter is to present the research findings. The primary objectives of this research study was to examine whether or not the South African transfer pricing tax legislation should be amended to be prescriptive by including regulations on how to transact at arm's-length price.

The objective of the problem statement was achieved by addressing the following sub-problems:

a) Determining how taxpayers in South Africa are required to transact at arm's-length price in the absence of prescriptive transfer pricing tax legislation.

b) Determining whether Practice Note 7 in its current status is consistent with the current status of the OECD guidelines, and whether, as a result of being consistent or not consistent with the current status of the OECD guidelines, Practice Note 7 can be included as the regulations on how to transact at arm's-length price in the South African transfer pricing tax legislation, in order to amend the legislation to become prescriptive.

c) Determining what the implications are of having non-prescriptive transfer pricing tax legislation and of changing from non-prescriptive to prescriptive, by looking at the experiences of the US in the enforcement of transfer pricing.

6.2 RESEARCH FINDINGS

As stated above, the research findings were achieved by answering the above sub-problems and the results are analysed as follows:

6.2.1 First Sub-problem

In the absence of the prescriptive transfer pricing tax legislation in South Africa, this study has established that taxpayers are following the Practice Note 7 to transact at arm's length price even though the legislation (section 31 of the Act) does not prescribe Practice Note 7 to be followed. This study has also established that there is no common view on the application of the arm's length principle among section 31 of the Act, Practice Note 7, tax treaties, IT14 return and the tax case law. In general the following has been established under this sub-problem.

It was established when the transfer pricing practices in South Africa were first regulated under the exchange control regulations and general anti-avoidance provisions. Section 31 of the Act was later introduced in the year 1995 and requires that transfer pricing transactions between connected persons should be at arm's-length. Furthermore, these transactions between connected persons should not be less than or more than arm's-length. The analysis has further established that section 31 of the Act is not prescriptive in providing guidance on how to transact at arm's-length as it does not have regulations on how taxpayers should transact at arm's-length price. Even though the section was updated several times since its introduction, the issue of the section being prescriptive by having regulations providing guidance on how to transact at arm's-length, has not been addressed. The other issue with regard to section 31 of the Act is that, though it requires that transfer pricing transactions should be at arm's-length price and not be less than or greater than arm's-length, it does not explain what is regarded as arm's-length and what is less than or greater than the arm's-length price.

It was established that in the year 1999, Practice Note 7 was introduced as guidelines on how taxpayers in South Africa should transact at arm's-length price and was not intended to be prescriptive, meaning that Practice Note 7 cannot be regarded as binding law to enforce transfer pricing practices for both taxpayers and the SARS Commissioner. The case law in South Africa shares the same sentiment that Practice Note 7 cannot be regarded as law, as it was said by the court that SARS Practice Notes cannot override the law. In providing guidance on how to transact at arm's-length price, Practice Note 7 has adopted the OECD guidelines approach. Practice Note 7 provides that arm's-length price does not necessarily constitute a single price, but a range of prices that independent parties charge. Meanwhile, section 31 of the Act makes reference to arm's-length price as a single price.

Furthermore, section 31 of the Act also makes reference to the price that is less than and greater than arm's-length. The argument is whether section 31 of the Act, by making reference to the prices which are less than and greater than arm's-length price, is referring to the points outside the arm's-length range which are the points below and above this range.

It was established that tax treaties on business profits and associated enterprises requires that the arm's-length principle be applied. South Africa has signed and ratified double tax treaties with a number of countries. The tax treaties in South Africa are modelled from the OECD Model Treaty and are deemed to be part of the Act in terms of section 108 of the Act, section 231 of the South African Constitution. The tax case law also confirms that tax treaties in South Africa are part of the Act. The argument exists that, due to the fact that the interpretation in terms of section 108 of the Act, section 231 of the South African Constitution and the tax case law, that the tax treaties in South Africa are part of the Act. As the tax treaties relies on the OECD guidelines in complying with the arm's length principle, this makes the tax treaties in South Africa to be prescriptive in requiring that an arm's-length principle should be applied when business profits and associated enterprises are taxed. The SARS Commissioner, however, has a different view on this argument. In Practice Note 7, the SARS Commissioner mentions that the tax treaties in South Africa are not prescriptive on how taxpayers in South Africa should transact at arm's-length price and that there is no conflict between section 31 of the Act and the South African tax treaties.

It was also established that the IT14 return does not provide taxpayers with a solution with regard to how taxpayers should transact at arm's-length price. The IT14 return requires that certain information and documents with regard to the transfer pricing transactions in terms of section 31 of the Act should be disclosed.

It was established that to a certain extent the tax case law in South Africa does make provisions of what constitute arm's-length transactions. The tax case law analysis in this research study established that the hypothesis statement adopted by the South African tax case law in determining what constitutes an arm's-length transaction, and the arm's-length hypothesis statement in Article 9 of the OECD Model Treaty, is similar. In applying its hypothesis statement, the tax case law in South Africa has applied the legal test other than the economic test which is adopted by Article 9 of the OECD Model Treaty in applying the arm's-length hypothesis statement.

The OECD Model Treaty requires that in applying the economic test the OECD guidelines should be applied which is also adopted in Practice Note 7. Meanwhile in applying the legal test, the tax case law has looked at the special relationship of parties involved in a transaction, the circumstances under which the transaction was entered, the unusual features in the transactions and the pricing or the value of the transaction.

It has been established that in certain court cases when the courts were determining whether or not a transaction is an arm's-length transaction, the court accepted the similar approach to the economic test which taxpayers applied in proving that their transactions were at arm's-length. Therefore, in as far as the courts in South Africa can rely on the legal test to determine whether or not a transaction is at arm's-length, the courts can also accept the economic test outlined in Practice Note 7 and the OECD guidelines if it used by taxpayers to determine whether or not a transaction is at arm's-length.

6.2.2 Second Sub-problem

It has been established that the current status of Practice Note 7 is not satisfactory as it has been established that although to a certain extent it is consistent with the current status of the OECD guidelines, to a certain extent it is not consistent. In respect of the following issues, it has been found that Practice Note 7 does concur with the OECD guidelines:

a) Arm's-length principle

b) Transfer pricing administrative procedures

c) Transfer pricing documentation procedures

d) Transfer pricing treatment on intra-group service transaction

e) Transfer pricing treatment on intellectual property transaction

f) Transfer pricing treatment on cost contribution arrangement.

With regard to the following issues, it has been established that Practice Note 7 does not concur with the OECD guidelines:

a) The updates and changes made to the South African domestic transfer pricing tax legislation (Section 31 of Act).

b) Certain updates and developments made by the OECD on transfer pricing issues in respect of; (i) the transactional profit methods (ii) permanent establishment (iii) aspects on business restructuring. Although these updates and developments made by the OECD have not been finalised, the question remains whether Practice Note 7 will be affected with these changes when the OECD implement these changes in their guidelines. The reason for this question is that, as mentioned above, changes have been made in section 31 of the Act which affects the application of Practice Note 7, which has not been updated with regard to these changes.

6.2.3 Third Sub-problem

It is established that when the US transfer pricing tax legislation was still not prescriptive on how taxpayers in the US should transact at arm's-length, inconsistency existed in the US courts on what constitutes the arm's-length price with regard to transfer pricing. The courts developed various standards in reaching decisions on what constitutes the arm's-length price on a number of transfer pricing cases.

It is established that the situation of the US transfer pricing tax legislation prior to it being amended to be prescriptive, reflects the current situation of the South African transfer pricing tax legislation. Under these circumstance taxpayers, SARS, and the courts can have a different interpretation of what constitutes an arm's-length transaction. Hence, it is the reason section 482 was amended in 1968 to be prescriptive by including regulations containing methods on how taxpayers should transact at arm's-length price to solve this problem.

It is further established that the US congress amended the legislation to be prescriptive by introducing regulations which provided guidance on how taxpayers in the US should transact at arm's-length. The results of the amendments of the US transfer pricing tax legislation to be prescriptive was seen in the US courts, as legislation became the starting point for the US courts when making decisions on what constituted an arm's-length price in resolving transfer pricing cases.

Another advantage as a result of the US transfer pricing tax legislation being made prescriptive was that taxpayers, IRS, and the US courts could now use single approach to interpret what constitutes arm's-length price in the transfer pricing cases. Another advantage resulting from the US transfer pricing tax legislation being made prescriptive was that, it was easy to prove prior the litigation process that the transactions of taxpayers were complying with the arm's-length principle as it was required by section 482. As a result, fewer transfer pricing cases were litigated.

It has been established that there were some challenges, subsequent to section 482 being amended in the year 1968, to be prescriptive. These challenges were in situations where section 482 was not sufficiently prescriptive on how certain transfer pricing issues should be dealt with. For example, section 482 did not make provision on what should be done when exact comparable transactions of unrelated parties were unavailable as the benchmark against the transactions of taxpayers, since it was required by the section that in order to comply with the arm's-length principle, comparable transactions of unrelated parties should be used as the benchmark. Another challenge was that the legislation was not prescriptive on what methods should be used in determining the arm's-length price with regard to intangible property transactions.

It is established that the US government addressed these challenges by further amending the US transfer pricing tax legislation several times subsequent to the 1968 amendment, in order to make the legislation to be more prescriptive on how to transact at arm's-length. These amendments were in 1986, 1993 and 1994 years and since these amendments, proposed changes were issued in 2003 and 2005 years.

It is also established that the regulation providing guidance on how to transact at arm's-length price in the US transfer pricing tax legislation is consistent with the OECD guidelines. In fact, the OECD guidelines were revised in the year 1995 to be in line with US regulations. It is further established that in addition to the US transfer pricing tax legislation (section 482), the US government has other transfer compliance measures to regulate transfer pricing practices. Such measures include the tax returns form, the tax treaties, competent authority, advance pricing agreements and penalty provisions for non-compliance. These measures also require that the taxpayer should comply with the arm's-length requirements in section 482.

6.2.4 Interview Results

Table 9: Interview Results from participants

	Mr Franz Tomasek	Professor Emil Brincker
Q1: What do you think are the advantages and disadvantages of having transfer pricing tax legislation which is not prescriptive as it has no regulations on how to transact at arm's-length?	The advantage is that the legislation is flexible such that it caters for the South African business environment. And the disadvantage is that it is uncertain as to what is regarded as an arm's length-price in terms of the legislation.	The advantage is that the legislation is flexible. And the disadvantage is that it is uncertain as to what is regarded as an arm's length-price in terms of the legislation. It creates uncertainties as to what constitute arm's-length price.
Q2: What is your view on the current status of Practice Note 7?	Practice Note 7 should address the changes made in section 31 of the Act. With regard to the OECD developments, they can only be noted once consensus has been reached by the OECD.	Practice Note 7 should make note of the developments within the international environment, especially the OECD development.
Do you think the South African transfer pricing tax legislation should be amended to be prescriptive by including regulations on how to transact at arm's-length, or should it remain as it is?	It is not necessary for it to be amended. The South African transfer pricing tax legislation is similar to the UK approach and it works just fine. Again to amend it to be prescriptive might create administrative burdens which would require the Act to be substantially large like the US one.	Yes, the South African transfer pricing tax legislation should be more specific in requiring how taxpayers should transact at arm's-length.

6.3 CONCLUSION

This chapter presented and analysed the findings of this research study. Conclusion and recommendations to this research study is provided in the next chapter.

CHAPTER7: CONCLUSION AND RECOMMENDATIONS

7.1 INTRODUCTION

The purpose of this chapter is to conclude this research study. The chapter restates the problem statement and sub-problems, provides a brief summary of previous chapters, interprets the research findings and provides recommendations. The chapter concludes by discussing the contribution made by this research study by comparing it with previous research studies, and lastly providing areas for possible future research studies.

7.2 THE STATEMENT OF THE RESEARCH PROBLEM

As stated in chapter 1, the primary objective of this research study is to examine whether or not the South African transfer pricing tax legislation should be amended to be prescriptive by including regulations on how to transact at arm's-length price. This was achieved by addressing the following sub-problems:

a) Determining how taxpayers in South Africa are required to transact at arm's-length price in the absence of prescriptive transfer pricing tax legislation.

b) Determining whether Practice Note 7 in its current status is consistent with the current status of the OECD guidelines, and whether, as a result of being consistent or inconsistent with the current status of the OECD guidelines, Practice Note 7 can be included as the regulations on how to transact at arm's-length price in the South African transfer pricing tax legislation, in order to amend the legislation to become prescriptive.

c) Determining what the implications are of having non-prescriptive transfer pricing tax legislation and of changing from non-prescriptive to prescriptive transfer pricing tax legislation by looking at the experiences of the US in the enforcement of transfer pricing.

7.3 SUMMARY REVIEW OF CHAPTERS

Chapter 1 provided the introduction which consists of the background of the study, the research problem with its sub- problems, research methods and chapter outline. Chapter 2 addressed the first sub-problem by discussing the South African transfer pricing tax legislation. Chapter 3 addressed the second sub-problem by discussing the OECD guidelines and Practice Note 7. Chapter 4 addressed the third sub-problem by discussing the transfer pricing tax legislation in the US. Chapter 5 discussed the research methodology applied in conducting this research study. Chapter 6 presented and analysed the findings of the research study. Chapter 7 concluded this research study.

7.4 SUMMARY REVIEW OF THE RESEARCH METHODOLOGY

A qualitative case study research methodology was adopted to conduct this research study and the literature review; documentation analysis and interviews were adopted as methods of data collection. A contend analysis methodology was adopted to analyse the data and the research study findings. The research study used various literatures, ranging from books, journal articles, academic articles, policies, guidelines, court cases and income tax legislations. The research study has used interviews whereby certain tax law professionals were interviewed.

7.5 THE INTERPRETATION OF RESEARCH FINDINGS

This research study has established that the South African transfer pricing tax legislation (section 31 of the Act) is not prescriptive on how taxpayers should transact at arm's-length. It has also been established that in the absence of prescriptive transfer pricing tax legislation in South Africa, there is a disconnection and gaps between section 31 of the Act and other remedies used in South Africa to address transfer pricing practices, such as Practice Note 7, the tax treaties and the IT14 return. This is due to the fact that section 31 of the Act, Practice Note 7, tax treaties, IT14 return and the tax case law does not hold a common view on the application of the arm's length principle.

As this research study addressed the research question by also making reference to the OECD guidelines and the US transfer pricing tax legislation, the study has established that the South African transfer pricing tax legislation is to a certain extent consistent with the OECD guidelines but to a certain extent it is not. With regard to the US transfer pricing tax legislation, the research study reveals that the legislation was at some stage in a similar situation as the South African transfer pricing tax legislation, and the legislation has since been updated several times to make it more prescriptive on how taxpayers should transact at arm's-length.

Furthermore, the research study reveals that there is no disconnections and gaps between the US transfer pricing tax legislation, section 482 and the other remedies used to address transfer pricing practices such as the tax treaties and tax returns. Both section 482 and the other remedies hold a common view on the application of the arm's length principle. As compared with the South African transfer pricing tax legislation, the US transfer pricing tax legislation is considered to be conformed without any vagueness. The South African transfer pricing tax legislation is therefore considered to be vague and lacking conformity as it is uncertain how one should transact at arm's length.

Professor Emil Brincker and Mr Franz Tomasek also hold the view that, although the South African transfer pricing legislation is flexible such that it carters for the needs of the South African business enviroment. The disadvantage with this legislation is that it is also uncertain as it does not have provisions on how one should transact at arm's length.(Telephone Interview, Johannesburg: October 2009). This situation creates an environment whereby SARS, taxpayers and the courts in South Africa are free to make use of any methods or processes to determine or interpret what is an arm's length price of a particular transaction, as section 31 of the Act is not prescriptive on how taxpayers should transact at arm's-length price.

Smith (1990:18) describes this situation whereby transfer pricing tax legislation of a particular country is not prescriptive on how taxpayers should transact at arm's-length, as an omission of serious deficiency. The reason provided by Smith (1990:18) is that both taxpayers and revenue officers alike are entitled to a reasonable degree of certainty as to the manner in which taxable income is to be computed. Smith (1990:29) further states that such a situation leaves much room within the legislation for uncertainty and argument in the ascertainment of arm's-length considerations.

Vasconcellos (2007:13) mentions that where a tax law is uncertain there could be less investment, lower returns to investments, and slower economic growth for the economy as a whole. Vasconcellos (2007:13) argues that the uncertainty of the tax law should not disadvantage taxpayers whereby high penalties are levied, and taxpayers are forced to spend large sums of money on tax opinions in order to gain interpretation on the tax law. Vasconcellos (2007:13) further argues that if the legislation is to be applied to everyone, it should be made simple so that people can understand it without having to spend more time and money. Vasconcellos (2007:13) believes that although this situation could be harmful and unfair to the taxpayers, it could also be an advantage to them as they could use the uncertainty of the tax as an argument in courts of law, against any tax defaults claimed against them by tax authorities.

De Waegenaere, Sansing, and Wielhouwer (2003:19) concur with Vasconcellos that the ambiguity of the tax law has a negative implication. De Waegenaere, Sansing, and Wielhouwer mention that the ambiguity of the tax law can decrease the taxpayer's expected tax liability. It could also decrease government tax revenues and thirdly, it may increase social welfare by decreasing the deadweight losses associated with tax audit costs.

Markham (2004:166) also shares the same view that it is necessary for a country to have clear transfer pricing rules. Markham (2004:166) citing the OECD guidelines, provides three reasons why a country's transfer pricing rules should be clear. The first reason is to ensure that there is a fair application of the arm's-length principle. The second reason is to adequately protect taxpayers and thirdly, to ensure that revenue is not shifted to the countries with overly harsh procedural rules, thus resulting in pricing distortion. Markham (2004:166) further argues that prescriptive transfer pricing tax legislation will result in the elimination of the vagueness and the lack of conformity of the legislation and will provide certainty of compliance as to what is required of taxpayers.

Baistrocchi (2005:8) shares the view that the application of the arm's-length principle will be a problem when the legal system in which it works, is unable to produce case law capable of guiding taxpayers on how they are expected to behave in transfer pricing, or something functionally the same as the case law. Baistrocchi (2005:8) mentions that a situation where a country does not have the prescriptive transfer pricing tax legislation, is a common problem in both developed and developing countries.

The analysis above illustrates that a situation where a country does not have prescriptive transfer pricing tax legislation has a negative impact on the tax system. Hence certain countries around the world such as Argentina, Australia, Brazil, China, Denmark, France, Netherlands, UK, US, and Venezuela have amended their transfer tax legislation to be prescriptive. Some of these countries have adopted legislative approach similar to the US' approach. In coming to the conclusion of this research study, the question still remains whether or not the South African transfer pricing tax legislation should be amended to be prescriptive. Through the analysis in this research study, it is illustrated that South Africa needed prescriptive transfer pricing tax legislation which has regulations on how to transact at arm's-length, from the time section 31 of the Act was introduced.

Professor Emil Brincker also believes that, the South African transfer pricing legislation should be amended to be more specific and clear on what constitute an arm's length price as it requires transactions of connected persons to be at arm's length price. Mr Franz Tomasek has however a different view on this argument. Mr Franz Tomasek's view is that the amendment of the South African transfer pricing tax legislation to be prescriptive will create administrative burdens for SARS. (Telephone Interview, Johannesburg: October 2009).

The view of Mr Franz Tomasek's was the issue also raised by the Commission led by Professor Michael Katz when the Commission recommended that the transfer pricing tax legislation should be introduced in South Africa. The Commission said that the prescriptive transfer pricing tax legislation such as the US approach was not suitable for the South African situation. The reasons provided by the Commission in rejecting the US transfer pricing tax legislative approach were that; (Interim report of the Commission of inquiry into certain aspects of the tax structure of South Africa, 1994: 231);

(a) A rigid, codified system lay outside the administrative capacity and experience of the revenue authorities, and to pass laws which cannot be enforced effectively would be to weaken the very core of South African legal system.

(b) Such a rigid approach would be too restrictive in South Africa with the circumstances which needed to regain and extend its share of world markets, both as regards purchasing and selling.

(c) Although it is the duty of the tax system to protect the fiscus against pricing practices that continue gross abuse of pricing mechanisms, while South African nominal tax rates are materially higher than those of its major investment source and competitor countries, care needed to be exercised so as not to push legitimate protection against abuse to a level which would discourage foreign investment and trade.

The Commission then recommended the approach adopted by the UK, which did not have any specific transfer pricing regulations but relied on the arm's length principle contained in the OECD guidelines to combat transfer pricing. As it has been mentioned in chapter 1 of this research study, the UK has however also followed the example of the US by amending their transfer pricing tax legislation to be prescriptive, a few years later after South Africa had adopted their legislative approach.

As it was also mentioned in chapter 1 that South Africa adopted the UK legislative approach in dealing with transfer pricing, the developments in the UK and around the world is a clear illustration that South Africa also needs to move with the rest of the world by having a transfer pricing tax legislation which is prescriptive rather than the current one which is non-prescriptive.

In considerate of Mr Franz Tomaseck and the Commission led by Professor Michael Katz's view that the amendments of the South African transfer pricing legislation to be prescriptive will create some administrative burdens for SARS. The question is can those administrative burdens outweigh the benefits which will results from the amendments being made to the South African transfer pricing tax legislation to be prescriptive on how taxpayers should transact at arm's length price.

Based on the research findings and the analyses above of situation where legislation is uncertain or ambiguous. And that in such situation as it has been proven taxpayers, revenue authorities and the courts have encountered problems in ascertaining what was the arm's length price in certain transaction because the legislation was not prescriptive or providing methods or ways of how to ascertaining an arm's length price.

Therefore, in my opinion the administrative burdens which will be encountered by the revenue authority in South Africa as a result of the amendments of the South African transfer pricing tax legislation to be prescriptive on how taxpayers should transact at arm's length price would not outweigh the benefits of amending the legislation to be prescriptive.

The reason for my argument is that similar problems which has been encountered by taxpayers, revenue authorities and the courts in other parts of the world, as mentioned above, in ascertaining what is the arm's length price of a particular transaction would not be present in South Africa as this was the situation in the US after the US' transfer pricing tax legislation was amended to be prescriptive.

Although to a certain extend this research study has answered the question of whether or not the administrative burdens which will be encountered by the revenue authority resulting from the South African transfer pricing legislation being amended to be prescriptive will outweigh the benefits of amending the legislation. I still propose that a research study be conducted in this respect to further explore this argument.

7.6 RECOMMENDATIONS

This research study has established that prescriptive transfer pricing tax legislation is appropriate in regulating transfer pricing practices, and that the non-prescriptive transfer pricing tax legislation has been proven not to be appropriate in a number of countries, including South Africa. It is therefore recommended that section 31 of the Act should be amended so that it has regulations prescribing how taxpayers should transact at arm's-length price, as the legislation currently requires that taxpayers should transact at arm's length.

Should the South African government through the department of National Treasury decide not to amend section 31 of the Act to have regulations prescribing how taxpayers should transact at arm's-length price, Practice Note 7 should still be updated to be consistent with section 31 of the Act and the OECD guidelines, as it is currently not consistent.

The following is the template proposing how section 31 of the Act should be in order for it to be prescriptive. The proposed legislation is based on section 482 regulations of the US transfer pricing tax legislation and the Canadian transfer pricing tax legislation (section 247).

<u>Table 10: Template on proposed section 31 of the Act</u>

Section 31(1) and (1A): Definitions	The subsection contains definitions of certain words used in the application of the section. The subsection should remain as it is.
Section 31(2) *(a)*; *(b)*; and *(c)*: Application of the law	The subsections outline conditions under which the section will apply. The subsections should also remain as they are. The following additional subsections should however be added in section 31 of the Act to make it prescriptive on how should taxpayers transact at arm's length price.
Section 31(2) *(d)*: Arm's-length principle	The subsection should reflect the arm's-length principle expressed in paragraph 1 of Article 9 of the OECD Model Tax Convention. This will eliminate any differing views between the tax treaties, IT14 returns and section 31 of the Act. Furthermore, as the arm's-length principle can be achieved generally based on the comparison of prices and margins, the subsection should outline comparability factors as expressed in Chapter I of the OECD guidelines, namely; characteristics of property or services; functional analysis, contractual terms; economic circumstance; and business strategies. Other additional factors that should be considered expressed in Chapter I of the OECD guidelines such as; recognition of the actual transactions undertaken; evaluation of separate and combined transactions; use of an arm's-length range; use of multiple year data; losses; the effect of government policies; intentional set-offs; use of customs valuations; and use of transfer pricing methods.
Section 31(2) *(e)*: Methods for applying arm's-length principle	As the above subsection would be reflecting the arm's-length principle as expressed in the OECD guidelines, therefore this subsection should outline the five methods outlined in Chapter II and III in the OECD guidelines. These methods are; the controlled uncontrolled price, resale price, cost plus, profit split, and transactional net margin method.
Section 31(2) *(f)*: Services transactions	This subsection should provide guiding principles for the use of specific methods to determine arm's-length price in connection with the services transactions.
Section 31(2) *(g)*: Tangible transactions	This subsection should provide guiding principles for the use of specific methods to determine arm's-length price in connection with the tangible property transactions.
Section 31(2) *(h)*: Intangible transaction	This subsection should provide guiding principles for the use of specific methods to determine arm's-length price in connection with the transactions involving intangible properties.
Section 31(2) *(i)*: Cost Contribution Arrangement	This subsection should provide the guiding principles for sharing of costs and risks (costs sharing arrangements rules) This subsection should also set forth the rules under which affiliates may share ownership of intangibles by sharing the development costs, thereby obviating the need to apply the transfer of intangible property rules to determine an arm's-length royalty
Section 31(2) *(j)*: Documentation Requirement	This subsection should provide guiding principles on what the transfer pricing documentations should contain.

7.7 THE RELATIONSHIP BETWEEN THIS RESEARCH STUDY AND THE PREVIOUS RESEARCH STUDIES CONDUCTED.

The question outstanding in this research study is to what extent this study has this research study contributed to the knowledge base in relation to the other research studies conducted in the subject of transfer pricing. The previous academic research studies have researched transfer pricing with a scope limited to certain aspects.

Richardson (2000) addressed the application of arm's-length principle in transactions involving services, tangible assets, loans and E-commerce just after the transfer pricing tax legislation and Practice Note 7 was introduced.

Cridlan (2001) in a comparative study, addressed South Africa and other countries such as Australia, UK and US. He discussed the arm's-length principle and administrative approaches for dealing with transfer pricing problems, but did not discuss some important aspects of the South African transfer pricing tax legislation, such as the vital components of section 31, most importantly the definitions of 'international agreement' and 'connected persons', and how they apply in practice. The other important aspects of the South African transfer pricing tax legislation which Cridlan did not discuss, were the investigative/audit procedures, disclosure and documentation requirements, cost contribution arrangements and mutual agreement procedures.

Makola (2003) explored section 31 and its components, documentation requirements, investigative procedures, penalties and advance pricing agreement, but did not address recent changes and developments.

Van der Linde (2004) evaluated and compared the legislative, judicial and administrative approaches to transfer pricing of outbound interest free loans as adopted by SARS with approaches adopted by other revenue authorities in other countries such as Australia, Netherlands, UK and US.

Steyn (2004) focused only on the intellectual property transactions, and evaluated the suitability of existing acceptable transfer pricing methods and their application to international transactions between related parties, involving intangible property; more specifically intellectual property that is legally protected.

Allan (2007) evaluated the OECD guidelines with the view of examining the manner and extent to which South Africa has adopted them in its current transfer pricing policy. Allan did not address the recent changes and developments in the OECD guidelines and the South African transfer pricing tax legislation which took place prior the year 2007 as mentioned in this study.

In addressing the research question, this research study explored the South African transfer pricing tax legislation relative to recent changes and developments in both the South African transfer pricing tax legislation and the OECD guidelines. These changes and developments include:

a) Section 31 amendments with regard to the changes made on the international agreement definition, connected person definition with the inclusion of the word group of companies, and the broadening of connected person definition on the intellectual property transactions.

b) The updates and developments by the OECD, which include the issuing of the four draft discussion documents discussing the transfer pricing treatment of the permanent establishment, the issuing of the draft discussion documents on the transfer pricing profit methods, the issuing of the draft discussion document on transfer pricing business restructuring transactions, and the issuing of proposed revision of chapters I-III of the transfer pricing guidelines.

This study has also analysed the recent transfer pricing changes and developments within the international community illustrating that in a situation where a country does not have prescriptive transfer pricing tax legislation, problems will be encountered. A brief analysis of the transfer pricing developments in countries such as

Argentina, Australia, Brazil, China, Denmark, France, Netherlands, UK, and Venezuela and a detailed analysis of the transfer pricing developments in the US was conducted.

7.8 CONCLUSION

In concluding this research study, the question remains whether there are other possible transfer pricing areas which have not been researched. If so, what are these other areas?

After many years of sustained economic growth, the global economic growth is experiencing a highly complex and turbulent economic period which started in 2008. This economic downturn resulted in multinational enterprises experiencing losses instead of profits. Research studies are encouraged to investigate the following questions:

- To what extent did the economic downturn affect multinational enterprises transfer pricing practices?

- To what extent did the economic downturn affect the revenue collection on income tax assessments raised in respect of transfer pricing?

Furthermore, the argument which could be encountered as a result of the economic downturn is that Article 9 of the Treaty Model Conversion and relevant treaty in other countries, can be applied to make profit adjustments as the article makes reference only to profit. The argument which could arise is; can Article 9 be applicable to adjust losses?

With this economic downturn, tax authorities around the world could find themselves applying Article 9 against multinational enterprises which have realised business losses as a result of the economic downturn. The research study is therefore encouraged to investigate the following question:

- Whether Article 9 of the Treaty Model Conversion can also be applied to adjust losses of multinational enterprises?

Another argument is the issue around the transfer pricing treatment on the intellectual property transactions. In the year 2009, SARS issued Interpretation Note: No. 50 which provides guidance on how expenses in relation to the intellectual property should be deducted for tax purposes, in terms of section 11D of the Act. The research study is therefore encouraged to investigate the following:

- The application of section 11D of the Act and the Interpretation Note: No. 50 to the intellectual property transactions, when these transactions affect transfer pricing.

Lastly, transfer pricing is known to be a corporate tax issue which could also affect indirect tax. In particular, indirect taxes could be affected by transfer pricing, especially custom duties. The research study is therefore encouraged to investigate the following:

- To what extent is the impact of transfer pricing to custom duties and vice versa?

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