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University of the Witwatersrand, Johannesburg

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

The arm's length pricing for intra-group services – Transfer pricing

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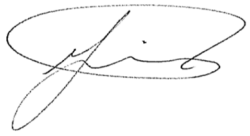
Declaration

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



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Yi Ying Lee
18 April 2017

Abstract

The purpose of this research report is to identify any improvements that can be made to the South African transfer pricing legislation for intra-group services. South Africa's transfer pricing legislation for intra-group services will be compared to *Aligning Transfer Pricing Outcomes with Value Creation, Action 8-10, 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project* ('*BEPS Action Plan*') released by the Organisation for Economic Co-operation and Development ('OECD'). The Action 10 of the *BEPS Action Plan* introduces a simplified transfer pricing approach for low value-adding intra-group services.

The simplified approach aims to reduce base erosion payments through excessive management fees and head office expenses (OECD, 2015:141). According to Verlinden and Katz (2015:1):

> '… the simplified approach lowers the burden on multinational enterprise groups to demonstrate the beneficial nature of the low value-adding activities for other MNE group members; and allows for an elective approach for reducing the administration involved in the pricing of low value-adding services. The OECD is achieving an appropriate balance between theoretical sophistication and practical application that is commensurate with the tax at stake in the countries paying and receiving the charges … .'

This approach will benefit tax authorities with limited resources in performing transfer pricing audits enabling them to verify the arm's length nature within the intra-group services charge (Watson, 2015:8).

Key words: Anti-avoidance, *BEPS Action Plan*, Transfer Pricing, Arm's Length Method, Arm's Length Price, Intra-Group Services, Low Value-Adding Intra-Group Services, Comparable Uncontrolled Price Method, Resale Price Method, Cost Plus Method, Transactional Net Margin Method, *OECD Guidelines*, OECD.

Glossary of terms and abbreviations

Allocation key	An allocation key is used to allocate the costs that cannot be specifically assigned to an actual service. An allocation key is used in the indirect-charge method. An allocation key may be based on a single factor or several factors to allocate costs such as turnover, the use of employee headcount, number of users or on some other basis. (OECD, 2010:211-213.)
Arm's length principle	Arm's length principle requires that transactions between associated enterprises be entered into under similar conditions and circumstance as transactions with independent enterprises. An adjustment may be made to the profits of associated enterprises if the conditions of the transaction are different to those between independent enterprises in similar circumstances. (OECD, 2015a:27.)
Associated enterprise	Associated enterprises are enterprises under common control, where the same persons participate directly and indirectly in the management, control or capital of both enterprises (OECD, 2014b:28).
BEPS Action Plan	*Aligning Transfer Pricing Outcomes with Value Creation, Action 8-10, 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project*.
Bilateral	When two tax jurisdictions are involved (Deloitte, 2009:12).
Centralised service	A multinational enterprise group may centralise certain business activities in the parent company or a group service centre and make it available to other group members, for their benefit (OECD, 2010:209).
Comparable uncontrolled transaction	A transaction between two independent enterprises that is similar to the controlled transaction. It can be either a similar transaction between one party to the controlled transaction and an independent enterprise (internal comparable), or between two independent enterprises (external comparable). (OECD, 2010:24.)
Controlled transactions	Transactions concluded at arm's length between two associated enterprises (OECD, 2010:25).
Connected person	For the purposes of this research report, the connected person relationship for a company that is relevant as follows: A company directly or indirectly holds at least 20% of the equity shares in another group company (Stiglingh et al, 2017: 230).
Cost plus mark-up	The direct and indirect costs incurred by a supplier of property or services in a transaction plus a margin (OECD, 2010:25).
Cost plus method	A transfer pricing method that evaluates the arm's length nature of an intra-group charge by reference to the mark-up on cost incurred by the supplier of property or services. It compares the gross profit margin earned by the tested party to the gross profit margin earned by independent enterprises. (ECOSOC, 2012b:17.)
Cost pool	The cost pool is the direct and indirect costs and any operating expenses such as supervisory, general and administrative incurred when rendering the services (OECD, 2015b:157).
Comparable uncontrolled price method	A transfer pricing method that compares the price charged for a service transferred in a controlled transaction to the price charged for a service transferred in a comparable uncontrolled transaction in similar circumstances (OECD, 2010:24).
Direct-charge method	The direct-charge method is used when intra-group services are rendered by one group member to meet the specific need of another

	group member, and the charges for such services can be clearly identified (OECD, 2010:211).
Direct costs	Costs that are incurred specifically for rendering a service (OECD, 2010:26).
Dividend *in specie*	A dividend *in specie* refers to a distribution to shareholders in a form of assets other than cash (Stiglingh et al, 2017:536).
Double non-taxation	Double non-taxation occurs when the same source of income earned has not been taxed in two different jurisdictions.
Double taxation	Double taxation is a taxation principle that occurs in international trade when the same source of income is taxed in two different jurisdictions.
Duplicated service	A service provided to an associated enterprise, which is already performed either by itself or by an independent enterprise (OECD, 2010:208).
ECOSOC	The Economic and Social Council.
Functional analysis	The functional analysis analyses the nature of functions performed, the degree of risks undertaken and the nature and value of assets used from both the perspective of the service provider and the service recipient (ECOSOC, 2012a:8 and OECD, 2010:213).
Gross profit margin	Gross profit equals net sales minus cost of goods sold (ECOSOC, 2012b:17-18).
Income Tax Act	Income Tax Act 58 of 1962.
Indirect-charge method	A method that determines the charges for intra-group services based on cost allocation and apportionment basis using an allocation key (OECD, 2010:27).
Indirect costs	Indirect costs of producing a product or service that is closely related to the production process (for example, the costs of a repair department that services equipment, used to produce different products) (OECD, 2010:27).
Intra-group services	An intra-group service is a service provided by one member of a MNE group for the benefit of one or more group members (Przysuski, 2008:2).
Low value-adding intra-group services	The low value-adding intra-group services are defined as services that are supportive in nature and that are not part of the core business of the multinational enterprise group (OECD, 2015b:153).
MNE	Multinational enterprise.
Net profit margin	A margin added to the direct and indirect costs and operating expenses (ECOSOC, 2012b:17-18).
OECD	Organisation for Economic Co-operation and Development.
OECD Guidelines	*OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.
Practice Note 7 of 1999	*Practice Note 7, Section 31 of the Income Tax Act, 1962 (the Act): Determination of the Taxable Income of Certain Persons from International Transactions: Transfer Pricing*
Profit level indicator	A profit level indicator is a measurement of a company's profitability that is used to compare comparables with the tested party. A profit level indicator may consider profitability in relation to sales, costs or assets. (ECOSOC, 2012b:32.)
Primary adjustment	An adjustment to reflect that the taxable income or tax payable of each party to the transaction that derives a tax benefit must be calculated as if the transaction has been entered into on arm's length terms and conditions (Stiglingh et al, 2017: 627).
Resale price method	A transfer pricing method that examines the price at which the product that has been purchased from an associated enterprise is

	then resold to an independent enterprise. The resale price is reduced by an appropriate gross profit margin/resale price margin to determine an arm's length price. (OECD, 2010:28.)
Safe harbour provisions	The safe harbour provisions could be understood as thresholds granted by a tax authority for smaller taxpayers or less complex transactions covered by transfer pricing rules (OECD, 2013:9 and Sweidan, 2014:1).
SARS	South African Revenue Service.
Secondary adjustment	An adjustment such as a dividend *in specie* that arises from imposing tax on a primary adjustment (OECD, 2010:29 and Stiglingh et al, 2017: 627)
Shareholder activity	A shareholder activity is an activity that provides an economic benefit solely to the parent company or a regional holding company of a MNE group (OECD, 2010:207).
Tax benefit	The definition of tax benefit in s 1(1) of the Income Tax Act 58 of 1962 refers to any avoidance, postponement or reduction of any liability for tax.
Tested party	The tested party is generally the less complex party to the controlled transaction and must be the party where the most reliable data for comparability is available (ECOSOC, 2012a:33).
Transactional net margin method	A transfer pricing method that examines the net profit margin relative to an appropriate base (for example, costs, sales, assets) that a taxpayer realises from a controlled transaction (OECD, 2010:77-78).
Uncontrolled transactions	Transactions concluded at arm's length between two independent enterprises (OECD, 2010:30).
Unilateral	When one tax jurisdiction is involved (Deloitte, 2009:12).

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1. Chapter 1. Introduction

The world-wide intra-group trade has grown exponentially in the past decades due to globalisation of the economy. With the growth in volume and value of intra-group trade, impact of the transfer pricing rules has become more significant for companies and tax authorities. Transfer pricing rules are concerned with the determination of conditions and pricing between related parties, these result in the allocation of profits to group companies in different countries. (OECD, 2015a:27.)

According to Mitra et al (2014:2):

> 'A multinational group is a conglomerate of multiple entities working in various geographic regions at different sizes and scale of operations. The group is regarded as a collective unit that functions by mutual cooperation and assistance, focusing on increasing its efficiency and wealth. In its endeavour to improve synergies and its market position, it is common for the ultimate parent company to render a range of services for all its group entities on a centralized basis. Usually, a range of services is provided by the ultimate parent company or through another company of the group whose primary purpose is to render such services. This is done for a number of reasons, ranging from cheaper labour and capital being available in various jurisdictions, to improving the efficiency or productivity of a group as whole by avoiding the duplication of resources for each entity on a standalone basis. These services are commonly referred to as intra-group services … .'

One of the common issues for intra-group services are whether the intra-group charge for such services satisfies the arm's length principle. Many countries use the arm's length principle as the cornerstone of transfer pricing rules. The transfer pricing principle is embedded in treaties and appears as Article 9(1) of the *OECD Model Tax Convention* and *United Nations Model Tax Convention*. The interpretation of the principle is set out in the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* first published as the *Report on Transfer Pricing and Multinational Enterprises* in 1979, revised and published as *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* ('*OECD Guidelines')* in 1995, with a further update in 2010. The arm's length principle requires that transactions between associated enterprises be accounted for as if under comparable conditions and economic circumstances as transactions with independent enterprises. Where the conditions of the transaction are different to those between independent enterprises in comparable circumstances, the necessary adjustments to the profits of associated enterprises may be needed for tax purposes. The arm's length principle is a useful standard for tax administrations and taxpayers to evaluate transfer prices between associated enterprises, and to prevent double taxation. (OECD, 2015a:27.)

South Africa has transfer pricing legislation in s 31 of the Income Tax Act 58 of 1962 ('Income Tax Act'). The main purpose of this legislation is to ensure that transactions between connected residents and non-residents reflect the terms and conditions that would have applied had the transaction been between independent parties dealing at arm's length (Stiglingh et al, 2015:629). To determine an arm's length price for intra-group services, *Practice Note 7, Section 31 of the Income Tax Act,1962 (the Act): Determination of the Taxable Income of Certain Persons from International Transactions: Transfer Pricing* ('*Practice Note 7 of 1999')* refers to Chapter VII of the *OECD Guidelines*, which deals specifically with intra-group services. The Commissioner indicates that the taxpayers should follow the guidance provided in Chapter VII of the *OECD Guidelines* in establishing arm's length conditions in international agreements between connected persons involving intra-group services (SARS, 1999:34).

On 5 October 2015, the OECD released a *BEPS Action Plan* that introduces a simplified transfer pricing approach for low value-adding intra-group services, which led to revisions in Chapter VII of the *OECD Guidelines* (OECD, 2015a:3). The goal of the Action 10 of the *BEPS Action Plan* is to provide protection against common types of base eroding payments for low value-adding intra-group services (OECD, 2015a:141). The Action 10 of the *BEPS Action Plan* also provides guidance on reaching a balance between appropriately allocating to the MNE group members charges for low value-adding intra-group services in accordance with the arm's length principle and the need to protect the payor countries' tax base (OECD, 2015a:141). Due to the OECD specifically focusing on the development of the low value-adding intra-group services under the Action 10 of the *BEPS Action Plan*, this research report will be focusing on the low value-adding intra-group services.

1.1. The research problem

1.1.1. The statement of the problem

What improvements to the South African transfer pricing provisions in respect of intra-group services can be identified from a comparison with the Action 10 of the *BEPS Action Plan*?

1.1.2. Research sub-questions

There are number of sub-questions that will assist to address the main research problem as stated above.

1) What are the South African transfer pricing provisions for intra-group services?

2) What is the Action 10 of the *BEPS Action Plan* for intra-group services?

3) How do the South African transfer pricing provisions compare to Action 10 of the *BEPS Action Plan* for intra-group services?

4) What improvements can be made based on the comparison between the South African transfer pricing provisions and the Action 10 of the *BEPS Action Plan* for intra-group services?

1.2. Research methodology

The research report will be performed using a qualitative approach. This approach includes analysing relevant South African tax legislation, international case law, *OECD Guidelines*, OECD's *BEPS Action Plan* and textbooks that explain the fundamental international tax principles as well as the transfer pricing international journals which contain various legal and tax experts' views.

1.3. Chapter outline

Chapter 1 introduces the background and significance of the research, the problems and sub-problems and the research methods used.

Chapter 2 analyses the South African transfer pricing provisions and approaches to intra-group services. This chapter further illustrates how to determine whether intra-group services have been rendered and whether the amount charged for intra-group services is in accordance with the arm's length principle.

Chapter 3 summarises and analyses the changes and clarification to other paragraphs of Chapter VII on the *OECD Guidelines* on intra-group services. These changes have been developed under Action 10 of the *BEPS Action Plan.* Furthermore, this chapter analyses the simplified approach proposed under Action 10 of the *BEPS Action Plan* for low value-adding intra-group services.

Chapter 4 compares the approaches adopted by the South African transfer pricing provisions and the Action 10 of the *BEPS Action Plan* for intra-group services. This chapter further identifies any improvements that can be made based on the comparison between the South African transfer pricing provisions and the Action 10 of the *BEPS Action Plan* for intra-group services.

Chapter 5 concludes on the findings of this research report and proposes areas requiring further research.

2. Chapter 2 – South African transfer pricing legislation

This chapter analyses the South African transfer pricing legislation and approaches to intra-group services and further illustrates how to determine whether intra-group services have been rendered and whether the amount charged for intra-group services is in accordance with the arm's length principle.

2.1. Introduction to South African transfer pricing legislation

There has been a marked expansion of international trade and commerce in South Africa. An increasing proportion of international activity is carried on between the MNE group members. As the globalisation of business activity continues to expand, the protection of the South African tax base is important to South Africa's wealth and development. (SARS, 1999:5-6.)

To protect the South African tax base, s 31 of the Income Tax Act containing transfer pricing legislation was introduced into the Income Tax Act, with effect from 19 July 1995 (SARS, 1999:6). The South African Revenue Service ('SARS') issued *Practice Note 7 of 1999* on 6 August 1999 to provide guidance about the procedures to be followed in the determination of arm's length prices (SARS, 1999:6). Thereafter, the amendments to the transfer pricing legislation were introduced by *the Taxation Laws Amendments Bill, 2010*, which came effect from 1 April 2012.

Prior to its amendment in 2012 s 31(1) and s 31(2) of the Income Tax Act read as follows:

'(1) For the purposes of this section–

Goods include any corporeal movable thing, fixed property and any real right in any such thing or fixed property…

Services include anything done or to be done, including, without limiting the generality of the foregoing–

(a) the granting, assignment, cession or surrender of any right, benefit or privilege;
(b) the making available of any facility or advantage;
(c) the granting of financial assistance, including a loan, advance or debt, and the provision of any security or guarantee;
(d) the performance of any work;
(e) an agreement of insurance; or
(f) the conferring of rights to or the use of incorporeal property…

(2) Where any supply of goods or services has been effected-

(a) between–
  (i) (aa) a resident; and
    (bb) any other person who is not a resident;
  (ii) (aa) a person who is not a resident; and
    (bb) a permanent establishment in the Republic of any other person who is not a resident; or
  (iii) (aa) a person who is a resident; and
    (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; and
(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); or
  (ii) greater than the arm's length price,

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

The reason for the amendment of the previous s 31 of the Income Tax Act is that the literal wording was causing structural problems and uncertainties (National Treasury, 2010:75). The previous s 31 of the Income Tax Act was focusing on separate transactions instead of focusing on the overall economic substance and commercial objective of the arrangement (National Treasury, 2010:75). In order to eliminate the problems and uncertainties, the National Treasury decided to amend s 31 of the Income Tax Act from 2012 so that South African transfer pricing legislation can be modernised to align closely with the wordings of Article 9 of the *OECD Model Tax Convention* and *United Nations Model Tax Convention* and also in accordance to the tax treaties and other international tax principles (National Treasury, 2010:76 and Edward Nathan Sonnenbergs, 2010:2). The South African transfer pricing legislation has adopted the arm's length principle which is the international norm (SARS, 1999:8). The Commissioner is of the view that the application of the internationally accepted principle will minimise the potential risk of double taxation (SARS, 1999:8).

The current s 31(1) and s 31(2) of the Income Tax Act read as follows:

'(1) For the purposes of this section–

Affected transaction means any transaction, operation, scheme, agreement or understanding where–

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

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

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

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

(iv) (aa) a person that is not a resident; and
(bb) any other person that is a controlled foreign company in relation to any resident,

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

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

(2) Where–

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

(b) any terms or condition of that transaction, operation, scheme, agreement or understanding–

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

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

the taxable income or tax payable by any person contemplated in paragraph (b)(ii) that derives a tax benefit contemplated in that paragraph must be calculated as if that transaction, operation, scheme, agreement or understanding had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm's length.'

The main purpose of the revised s 31 of the Income Tax Act is to focus on the economic substance of the arrangements between cross-border connected parties, rather than the pricing of specific transactions (Sonnenbergs, 2010:3). The current transfer pricing legislation requires the taxpayer to account for transfer pricing on an arm's length basis without the intervention by SARS (National Treasury, 2010:76). Should a transaction not have arm's length terms and conditions, SARS will have the power to adjust and reassess the transaction on an arm's length basis (Olivier & Honiball, 2011:665).

The South African transfer pricing adjustment consists of a primary and secondary adjustment. SARS has the authority to make a primary adjustment to reflect that the taxable income or tax payable of each party to the transaction that derives a tax benefit must be calculated as if the transaction has been entered into on arm's length terms and conditions. In addition, SARS may make a secondary adjustment whereby the primary adjustment is deemed to be a dividend *in specie* declared and paid by the South African resident entity. The effect of this is that this resident entity will be liable for dividend tax at a rate of 20% (previously 15%) on the deemed dividend *in specie.* (Stiglingh et al, 2017: 627.)

Practice Note 7 of 1999 states that the *OECD Guidelines* have become a globally accepted standard and the *OECD Guidelines* are followed by many countries that are not members of the OECD (SARS,1999:6). *Practice Note 7 of 1999* further states that even though South Africa is not a member of the OECD, the *OECD Guidelines* should be followed in the absence of specific guidance in the *Practice Note 7 of 1999* (SARS:1999:6). The current *Practice Note 7 of 1999* is outdated and does not refer to the revised s 31 of the Income Tax Act, but the National Treasury indicates that South Africa will continue to follow the *OECD Guidelines* when implementing transfer pricing rules (National Treasury, 2010:76).

To determine the arm's length price for intra-group services, *Practice Note 7 of 1999* refers to Chapter VII of the *OECD Guidelines* which deals specifically with connected persons involving intra-group services (SARS, 1999:34).

2.2. Introduction to the *OECD Guidelines*

Chapter VII of the *OECD Guidelines* provide guidance on the application of the arm's length principle with regard to intra-group services. On 23 May 2016, the OECD approved the amendments to Chapter VII of the *OECD Guidelines* as set out in Action 10 of the *BEPS Action Plan* (OECD, 2016:1). The amendments did not result in a change of the fundamental principle of intra-group services under the *OECD Guidelines*. The reason for the amendments was to provide clarity and certainty on the treatment of current intra-group services (OECD, 2015c:200). The amendments to Chapter VII of the *OECD Guidelines* will be discussed in Chapter 3 of the research report. The fundamental arm's length principle in relation to intra-group services is discussed as follows:

An intra-group service is a service provided by one member of a MNE group for the benefit of one or more group members (Przysuski, 2008:2) and encompasses a wide range of services such as management, co-ordination and control functions, administration, technical, financial and commercial services (OECD, 2010:205).

The allocation of cross-border intra-group service charges can be a complex problem for a MNE group. The OECD has developed guidance provided in Chapter VII of the *OECD Guidelines* to determining arm's length pricing for intra-group services. (Langlois et al, 2011:2.)

The *OECD Guidelines* outline two main aspects to be considered when determining transfer pricing for intra-group services within a MNE group. The first issue is to determine whether one member of the MNE group has rendered intra-group services to one or more members of the same MNE group. The second issue is how to determine an arm's length charge for such services. (OECD, 2010:206.)

2.2.1. Determining whether intra-group services have been rendered

The *OECD Guidelines* indicates that intra-group services have been rendered when an activity is performed by one group member for another group member. Such activity must provide the service recipient with economic benefit or commercial value that enhances the recipient's commercial position. To determine whether intra-group services have been rendered, it needs to be considered if an independent enterprise in the same circumstances would have been prepared to pay for the activity or would have performed the activity in-house. If the activity is not one for which the independent enterprise would be willing to pay for or perform the activity itself, then the activity cannot be considered as an intra-group service. (OECD, 2010:206.)

Some intra-group services are provided by one member of a MNE group in order to meet an identified need of another group member. Such services will generally satisfy the benefit test as the services are designed specifically for the service recipient's operations. (OECD, 2010:207.)

Furthermore, it is common for a MNE group to centralise certain business activities in the parent company or a group service centre and make it available to other group members for their benefit. The centralised service will be considered as a chargeable intra-group service because such service is what independent enterprises would have been willing to pay for, or to perform for themselves. The following are examples of centralised services:

- Administration services such as planning, coordination, budget control, financial advice, accounting, auditing, legal, factoring, information technology services.
- Financial services such as supervising cash flows and solvency, capital increases, loan agreements, refinancing, management's interest and exchange rate risks.
- Operational services such as assisting in the fields of production, purchase, distribution and marketing.
- Human resources services such as recruitment and training.
- Research and development or administration and protection of intangible property for the MNE group. (OECD, 2010:209.)

According to the ECOSOC (2015:4-5):

> 'There are numerous reasons for a MNE group to provide intra-group services on a centralised basis. Services may be provided by an associated enterprise for the rest of the group in order to minimise costs through economies of scale. This may allow the MNE group to increase its profits or improve its competitive position by being able to reduce prices charged to customers. Centralising services may allow for specialisation within a MNE group which may also involve the creation of centres of excellence. Some MNE groups may centralise services in a regional management company for associated enterprises in a particular geographic region in order to align functional and management responsibilities. In some cases, an associated enterprise may not have the skills or resources locally

in house for the service it requires and may rely on specialists that are responsible for providing the same type of services across a wider geographic or functional grouping of entities. Another potential benefit of having centralised services for a MNE group is the certainty that such services will be available when required and that the quality of the services is consistent within the MNE group.'

The *OECD Guidelines* also identifies certain services or activities as non-beneficial activities for the service recipient entity and those services or activities cannot be considered as chargeable intra-group services (Przysuski, 2008:4). The non-beneficial activities or services identified in the *OECD Guidelines* are as follows:

- Shareholder activities.
- Duplicated services.
- Incidental benefits.
- On-call services. (OECD, 2010:207-210.)

2.2.1.1. Shareholder activities

A shareholder activity is an activity that provides an economic benefit solely to the parent company or a regional holding company of a MNE group. Such shareholder activity cannot be considered to be a chargeable intra-group service to the associated enterprises. The costs associated with the shareholder activity must be borne exclusively by the parent company on an arm's length basis. Examples of the shareholder activities are as follows:

- Costs related to the juridical structure of the parent company such as shareholder meetings, issuing of shares in the parent company and supervisory board costs.
- Costs related to reporting requirements of the parent company including the consolidation of reports.
- Costs related to raising of funds to acquire share capital in subsidiary companies. (OECD, 2010:207-208.)

The shareholder activity is distinguishable from the broader term 'stewardship activity' used in the *Transfer Pricing and Multinational Enterprises* report issued in 1979 (OECD, 2010:207). This report provided the concept of central coordination and managerial activities, but did not provide a clear methodology on how to treat the costs of such activities (Mitra et al, 2014:2). Thereafter, the OECD issued a report which provided the allocation of central management and services costs under *Transfer Pricing and Multinational Enterprises, Three Taxation Issues* report in 1984. This report provided a broader definition of benefits and suggested two approaches on how to deal with costs relating to central coordination and managerial services in the case of a centralised MNE group (Mitra et al, 2014:2-3). However, this did not bring a consensus to the treatment of central coordination and managerial costs (Mitra et al, 2014:2-3). After number of deliberations, the *OECD Guidelines* published in 1995 shifted from an 'activity-centric approach' to a 'comparable circumstances' approach (Mitra et al, 2014:2). The comparable approach refers to whether under comparable facts and circumstances, the service is one that an independent enterprise would have been willing to pay for or to perform the service itself (OECD, 2010:208).

2.2.1.2. Duplicated services

A duplicated service generally occurs when a service is provided to an associated enterprise which is already performed either by itself or by an independent entity. Such duplicated activity cannot be considered as an intra-group service. The following services are not considered as duplicated services:

- The duplication of services is only of a temporary nature. For example, where a MNE group is reorganising to centralise its management functions.
- The duplication is undertaken to eliminate the risk of a wrong business decision. For example, obtaining a second legal opinion on a subject. (OECD, 2010:208.)

2.2.1.3. Incidental benefits

There are some cases where intra-group services are provided by a group member to some group members but may be incidental to other group members. For example, a re-organisation of the MNE group, the acquisition of new members or the termination of a division could result in incidental benefits to other group members. These activities could be constituted as intra-group services to the particular group members involved but may also provide economic benefits for other group members not involved in the decision making such as increasing efficiencies, economies of scale or other synergies. The incidental benefits are not a chargeable intra-group service for other group members because in the same circumstances an independent enterprise would not be willing to pay for these services. (OECD, 2010:208.)

Similarly, any benefit derived by an associated enterprise solely from its affiliation with the parent company or MNE group also constitutes an incidental benefit (OECD, 2010:209). For example, an associated enterprise receives a higher credit rating from the lender on the basis of its relationship in the MNE group, this is an incidental benefit. If an associated enterprise were to be assessed on a stand-alone basis, the associated enterprise would be expected a lower credit rating from the lender (ECOSOC, 2015:10). An intra-group service does exist if the higher credit rating is due to a guarantee provided by another group member (OECD, 2010:209). An intra-group services also exist if an associated enterprise has indirectly benefitted from the MNE group's good reputation due to global marketing and public relations campaigns and the indirect benefit would result in an increase of the associated enterprise's turnover (OECD, 2010:209). It is important to distinguish the passive association from active promotion carried out by the MNE group for the purposes of enhancement of the profit making potential of particular members of the group (OECD, 2010:209).

2.2.1.4. On-call services

An on-call service is where an associated enterprise agrees to provide a particular service immediately or within a short period of time (ECOSOC, 2015:5). For example, a parent company or a group service centre is on hand to provide the services such as financial, managerial, technical, legal or tax advice to members of the MNE group at any time (OECD, 2010:209-210).

Generally, in a similar circumstance, an independent enterprise will incur a stand-by charge to ensure the availability of the services when the need for them arises (OECD, 2010:210). For example, an independent enterprise will pay an annual retainer fee to a lawyer firm to ensure entitlement to legal advice and representation if litigation occurs (OECD, 2010:210).

An on-call service may vary in amount and importance from year to year. An independent enterprise would not incur stand-by charges where the potential need for the service was remote or could be obtained from other sources without an on-call arrangement. To determine whether the on-call services have been rendered, the benefit of the on-call arrangement offered to the group member needs to be considered over a period of several years rather than the year where a charge is to be made. (OECD, 2010:210.)

2.2.2. Determining an arm's length charge

Once it is determined that an intra-group service has been rendered, the next step is to determine whether the service charge is in accordance with the arm's length principle. Under the arm's length principle, the charges for intra-group services should reflect the charges that would have been paid by the independent enterprises in similar circumstances. (OECD, 2010:210.)

The concept of the arm's length principle is set out in Article 9(1) of the *OECD Model Tax Convention.* According to the OECD (2010:33), Article 9(1) provides:

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

2.2.2.1. Identifying actual arrangements for charging of intra-group services

The *OECD Guidelines* indicates that there are two types of methods determining the charges for intra-group services. These methods are the direct-charge method and the indirect-charge method. (OECD, 2010:211-212.)

The direct-charge method is used when intra-group services are rendered by one group member to meet the specific need of another group member, and the charges for such services can be clearly identified. In general, the direct-charge method is considered to be the most appropriate method by the tax authority to determine an arm's length charge for intra-group services because the services and the charges can be readily identified and quantified. The direct-charge method could also help in determining whether the charge is consistent with the arm's length principle. A MNE group often adopts this method where the services rendered to an associated enterprise are similar to the services rendered to the independent parties, since the MNE group has the ability to demonstrate a separate basis for the charge. This method will not be recommended if the comparable services provided to the independent parties are merely occasional or marginal. (OECD, 2010:211.)

In cases, where the direct-charging method is difficult to apply, the MNE group would identify other methods for charging for intra-group services provided by the parent companies or the group service centres. In such cases, the MNE group may use cost allocation and apportionment methods as basis for calculating an arm's length charge. Such methods are so-called indirect-charge methods. The indirect-charge method would generally not be applicable if specific services are provided not only to associated enterprises but also to independent enterprises. (OECD, 2010:2011.)

To apply the indirect-charge methods, the following need to be considered:

- The charges have to be supported by an identifiable and reasonable foreseeable benefit.
- An allocation key should be sensitive to the commercial features of the individual case.
- The indirect-charge method should contain safeguards against manipulation and follow sound accounting principles.
- The allocation costs are consistent with the actual or reasonable expected benefits to the service recipient of intra-group services. (OECD, 2010:2012.)

In some cases, the application of the indirect-charge method may be necessary. An example would be where it may be difficult to estimate the actual benefit of the centralised services within a MNE group. Another example of where the indirect-charge method should be used is when a separate recording and analysis of the relevant services provided for each service recipient provides a disproportionate administrative burden. In these cases, the MNE group could use an allocation key to allocate the costs that cannot be specifically assigned to the actual service recipients of the various services. Therefore, to satisfy the arm's length principle, an allocation key used in the indirect-charge method must be consistent with what the independent enterprises would be prepared to accept in similar circumstances. (OECD, 2010:212.)

An allocation key may be based on a single factor or several factors to allocate costs such as turnover, the use of employee headcount, number of users or on some other basis. To determine whether an allocation key is appropriately applied, it may be dependent on the nature and usage of the services. For example, an allocation key for payroll costs may be based on employee headcount in each associated enterprise whilst an allocation key for information technology costs may be based on the number of users in each associated enterprise. (OECD, 2010:212-213.)

When an indirect charge method is applied, it may be difficult to evaluate the benefit provided in relation to intra-group services because the relationship between the charge and the services rendered may be obscured. This means that the service recipient has been charged for a service which does not relate to the actual service received. In this case, there might be a potential risk of double taxation, because it may be difficult to determine a deduction for the costs incurred or to demonstrate that a service has been provided if the compensation cannot be identified. (OECD, 2010:213.)

In general, the direct-charge method is the preferred method to be used when identifying an arm's length price for intra-group services. The direct-charge method can be applied when the services provided by a group member to another group member are similar to the services rendered to independent parties, or where the services can be readily identified and quantified. In cases, where the direct-charging method is difficult to apply, the indirect-charge method could be used for intra-group services if the charges are in accordance with the arm's length principle. (ECOSOC, 2015:12.)

2.2.2.2. Calculating an arm's length consideration

This section describes different transfer pricing methods that can be used to determine an arm's length price for intra-group services, and the application of these methods. The transfer pricing methods are used to calculate or test the arm's length price from transactions between associated enterprises (ECOSOC, 2012b:1).

The *OECD Guidelines* recommend five transfer pricing methods that can be applied to determine an arm's length consideration. These methods are categorised as either traditional transaction methods or transactional profit methods (OECD,2010:59). The transfer pricing methods consist of:

- Traditional transaction methods.
    - Comparable uncontrolled price method.
    - Cost plus method.
    - Resale price method.
- Transactional profit method.

- Transactional net margin method.
- Transactional profit split method. (OECD,2010:59.)

According to the OECD (2010:59), the purpose of selection of a transfer pricing method is as follows:

> 'The selection of a transfer pricing method always aims at finding the most appropriate method for a particular case. For this purpose, the selection process should take account of the respective strengths and weaknesses of the OECD recognised methods; the appropriateness of the method considered in view of the nature of the controlled transaction, determined in particular through a functional analysis; the availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method and/or other methods; and the degree of comparability between the controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material differences between them. No one method is suitable in every possible situation, nor is it necessary to prove that a particular method is not suitable under the circumstances.'

To determine which transfer pricing method should be selected, it is necessary to understand the controlled transaction based on the functional analysis (ECOSOC, 2012b:1). The functional analysis seeks to identify and compare the economically significant activities and the responsibility undertaken, the type of assets used and possible risks by the independent enterprises and the associated enterprises (ECOSOC, 2012a:7). The functional analysis would assist with:

- Identifying and understanding the intra-group transactions.
- Identifying the characteristics that would make a particular function suitable for use as a comparable.
- Determining any necessary material adjustments to the comparable.
- Checking the relative reliability of the transfer pricing method selected.
- Determining if a modification of the transfer pricing method is appropriate as the functions, allocation of risks, or assets, have been modified. (ECOSOC, 2012b:1.)

The functional analysis analyses the nature of functions performed, the degree of risks undertaken, and the nature and value of assets used from both the perspective of the service provider and the service recipient (ECOSOC, 2012a:8 and OECD, 2010:213). The functional analysis is relevant in determining anticipated return since the high level functions performed, risks assumed and assets employed, the higher the anticipated return (ECOSOC, 2012a:8). The functional analysis consists of:

- The functions performed – The functional analysis describes the functions carried out by each of the parties to the intra-group transaction. The purpose of this is to identify critical functions performed by the associated enterprises.
- The assets used – The functional analysis needs to identify the significant assets such as tangible assets (for example, property, plant and equipment) and intangible assets (for example, trademark, patent, know-how, trade secrets) used by the associated enterprises.
- The risk undertaken – The risk analysis should be considered together with functions and assets. The risk analysis identifies the economically significant risks that are assumed by each of the parties to the intra-group transaction. For example, financial risk, market risk, foreign exchange risk, credit risk, country risk and business risk.
- Other factors – The functional analysis also includes the contractual terms of the transaction, the economic circumstance of the associated enterprises, and the business strategies they used. (ECOSOC, 2012b:1-2 and ECOSOC, 2012a:10-19.)

The transfer pricing methods could be selected once the functional analysis is performed. The *OECD Guidelines* indicate that the traditional transaction method is the preferred method, if a traditional transaction method and a transaction profit method are equally reliable. Furthermore, the comparable uncontrolled price method is the preferred method, if the comparable uncontrolled price method and any other transfer pricing method are equally reliable. (OECD, 2010:60.)

It is important to note that when applying the cost plus method, resale price method or transactional net margin method, it is necessary to select the party to the transaction for which a financial indicator (for example, mark-up on costs, gross profit margin or net profit margin indicator) is tested. The selection of the tested party must be consistent with the functional analysis of the controlled transaction. The tested party is generally the less complex party to the controlled transaction and must be the party where the most reliable data for comparability is available. This could support the selection and application of the transfer pricing method. (ECOSOC, 2012a:33.)

The transfer pricing method to be used to determine an arm's length price for intra-group services should be determined in accordance with the guidance provided in Chapter I – The Arm's Length Principle, Chapter II – Transfer Pricing Methods and Chapter III – Comparability Analysis of the *OECD Guidelines* (OECD, 2010:214). The most commonly used transfer pricing methods for intra-group services are the comparable uncontrolled price method, the cost plus method and the transactional net margin method (ECOSOC, 2015:12).

Comparable uncontrolled price method

The comparable uncontrolled price method compares the price charged for a service in a controlled transaction with the price charged for identical or similar services in a comparable uncontrolled transaction (OECD, 2010:63). The difference between the two prices may indicate that the conditions of the controlled transaction are not consistent with the arm's length principle (OECD, 2010:63). The price comparison can be made between the internal uncontrolled transactions or the external uncontrolled transactions, this will depend on the existence of such transactions and the availability of related information (Cooper et al, 2016:155).

The internal uncontrolled transaction refers to where a member of the MNE group has entered into sufficiently comparable transactions with an independent enterprise. The external uncontrolled transaction refers to where two independent parties have entered into sufficiently comparable transactions under similar market conditions. (OECD, 2010:115.)

The price is the condition being examined when applying the comparable uncontrolled price method. It is important to consider that minor price differences may have a material effect on the condition being examined (Cooper et al, 2016:155). In general, the required standard of comparability for applying the comparable uncontrolled price method is considered to be high in comparison to the other transfer pricing methods (Cooper et al, 2016:155). The *OECD Guidelines* outline five factors to be considered when assessing comparability of a transaction

- The specific characteristics of the services provided, taking into account the nature and extent of the service, whether or not the service involves specific experience, technical know-how or the use of intangibles.
- The actual functions undertaken, the assets used and the risk assumed by each enterprise with respect to the transactions.
- The contractual terms of the transactions that define the allocation of responsibilities, risk and benefits between the enterprises.

- The economic circumstance in which the transaction take place such as geographic location, the size of markets, the extent of competition in the markets and the relative competitive positions, the availability of substitute services, the nature and extent of government regulation of the market and other factors.
- The business strategies pursued by the parties to the transactions such as strategies relating to market penetration, diversification, innovation, risk aversion, political changes, duration of arrangement and other factors. (OECD, 2010:44-50 and Cooper et al, 2016:85.)

In applying the comparable uncontrolled price method, an uncontrolled transaction is considered comparable to a controlled transaction if:

- There should be no differences in the transactions being compared that could materially affect the market related price; or
- Reasonably accurate adjustments could be made to account for any differences between the controlled and uncontrolled transactions. (OECD, 2010:63 and ECOSOC, 2012b:5.)

When differences exist and the accurate adjustments cannot be made, the comparable uncontrolled price method will be considered inappropriate to use as the comparable will be unreliable and an alternative method should be adopted (ECOSOC, 2015:12).

The comparable uncontrolled price method is regarded as the most direct and reliable way of determining an arm's length price (OECD, 2010:59-60). The comparable uncontrolled price method requires detailed transaction analysis and the price in the transaction is also subject to analysis (Cooper et al, 2016:155). There is no requirement to select a test party as it is not a one-sided analysis (Cooper et al, 2016:155). However, the comparable uncontrolled price method can be difficult to apply because the detailed information in respect of the transactions is often not available, or where detailed data on the internal uncontrolled transaction exist but the transactions are often not comparable (Cooper et al, 2016:155).

The comparable uncontrolled price method is considered to be the most appropriate method where there is a comparable service provided between the independent enterprises in the service recipient's market (external uncontrolled transaction), or the associated enterprise renders the services to an independent enterprise in similar circumstances (internal uncontrolled transaction). (OECD, 2010: 214.)

Cost plus method

The cost plus method starts with the cost incurred by the supplier of property or services in a controlled transaction for the property transferred or the services rendered to an associated enterprise. An appropriate cost plus mark-up is added to the costs incurred, to make an appropriate profit in relation to the function performed, the assets used, the risks assumed and the market conditions. (OECD,2010:70-71.)

The cost plus method is used to analyse transfer pricing transactions in relation to the supplier of property or services. It is commonly applied to contract manufacturing or assembly activities and services activities. The cost plus method is a one-sided analysis, which requires the selection of the tested party. The cost plus method focuses on the related manufacturer or the service provider as the tested party. This method evaluates the arm's length nature of an intra-group charge by reference to the mark-up on cost incurred by the supplier of property or services. It compares the

margin earned by the tested party to the margin earned by independent enterprises. (ECOSOC, 2012b:17 and Cooper et al, 2016:160-162.)

The financial ratio used under the cost plus method is the gross profit margin, which is defined as gross profit (gross profit equals net sales minus cost of goods sold). The costs and expenses of an enterprise generally fall into three categories: (1) the direct costs of producing a product or service such as salary, cost of raw material; (2) the indirect costs of production such as cost of repair and maintenance of equipment; (3) the operating expenses such as administration expenses. The gross profit margin used in the cost plus method is a profit margin subtracting the direct and indirect costs of production from the sale price. In contrast, a net profit margin would consider the direct and indirect cost of production as well as the operating expenses. The application of different accounting treatments to the controlled and uncontrolled transactions could result in inconsistent calculation of the gross profit. To ensure that the gross profit margins are calculated uniformly for the tested party and the independent enterprises, an appropriate adjustment of the accounting treatment may be necessary. In a situation in which it is necessary to consider certain operating expenses in order to obtain consistency and comparability, then a net margin method will be more reliable to use than the cost plus method. (ECOSOC, 2012b:17-19.)

To apply the cost plus method, an uncontrolled transaction is considered comparable to a controlled transaction if:

- There should be no differences between the transactions being compared that could materially affect the gross profit margin; or
- Reasonably accurate adjustments could be made to reduce the material effects of such differences. (ECOSOC, 2012b:20 and OECD, 2010:71.)

When assessing comparability for the application of the cost plus method, it is critical to consider that minor differences in the characteristics of the product may not materially impact the gross profit margins (Cooper et al, 2016:160-162). The functional comparability is more important, since the main basis underlying the cost plus method is that parties with comparable functional profiles will be compensated similarly (Cooper et al, 2016:160-162).

The application of the cost plus method can sometimes be problematic in practice because the reliable gross profit margin data may not be comparable due to differences in the accounting treatment. Furthermore, it is a one-sided analysis therefore the arm's length gross profit margin for one party may result in an extreme result for the other party to the controlled transaction, for example, a loss or extreme profitability. (Cooper et al, 2016:160-162.)

The cost plus method is applied in transactions involving the intercompany sale of tangible property where the related manufacturer performs limited manufacturing activities such as a contract manufacturer, a toll manufacturer or a low risk assembler, or intra-group services. This method assumes the incurrence of low risks, because the level of costs will reflect the value being added and hence the market price. The cost plus method should not be applied in a fully-fledged manufacturing transaction as a fully-fledged manufacturer owns valuable intangible property or incurs substantial risks. (ECOSOC, 2012b:21-22.)

The cost plus method would be considered as the most appropriate method in the absence of the comparable uncontrolled price method, where the nature of the activities involved, the type of assets used and the risks assumed are comparable to those undertaken by independent enterprises in similar circumstances (OECD, 2010:214).

Resale price method

The resale price method starts with the price at which the product that has been purchased from an associated enterprise is then resold to an independent enterprise. The resale price is reduced by an appropriate gross profit margin/resale price margin to determine an arm's length price. The appropriate gross profit margin may be determined by reference to the gross profit margins earned by the same reseller on items purchased and sold in internal uncontrolled comparable transactions. The gross profit margin earned in external uncontrolled comparable transactions by the independent enterprises may also serve as a guide. (OECD, 2010:65-66 and Cooper et al, 2016:158.)

The financial ratio used under the resale price method is the gross profit margin, which is defined as gross profit (gross profit equals net sales minus cost of goods sold) (ECOSOC, 2012b:11). The gross profit margin represents the margin that a reseller would seek to cover its sales, general and administration expenses, taking into account the functional analysis (Cooper et al, 2016:158-159). The accounting consistency is important when applying the resale price method, as the gross profit margins will not be comparable if the accounting treatment differs between the controlled and uncontrolled transactions (ECOSOC, 2012b:11). The resale price method is a one-sided analysis, which requires selection of the tested party. The resale price method focuses on the related sales company which conducts marketing and sales activities, as the tested party (ECOSOC, 2012b:9).

To apply the resale price method, an uncontrolled transaction is considered comparable to a controlled transaction if:

- There should be no differences between the transactions being compared that could materially affect the gross profit margin; or
- Reasonably accurate adjustments could be made to account for any differences between the controlled and uncontrolled transactions. (ECOSOC, 2012b:12 and OECD, 2010:67.)

The approach to assessing comparability of the resale price method is similar to the cost plus method. When assessing comparability for the application of the resale price method, it is critical to consider that minor differences in the characteristics of the product may not materially impact the gross profit margin (Cooper et al, 2016:160). The functional comparability is more important, since the main basis underlying the resale price method is that the parties with comparable functional profiles will be compensated similarly (Cooper et al, 2016:160).

The resale price method is often used in cases where it is applied to purchase and resale of tangible goods in which the reseller does not add significant value to the tangible goods, for example, making physical modifications, contribution of valuable intangible property or undertaking significant marketing activities. In addition, the resale price method could be used in transactions involving commissionaire or sale agents, and a fully-fledged manufacturer who owns valuable patents or other intangible properties. (Cooper et al, 2016:160 and ECOSOC, 2012b:14.)

The resale price method is typically used to determine the arm's length price to be earned by a related purchaser in an intercompany transaction when the purchaser, in turn, resells to unrelated parties (OECD, 2010:65). Therefore, the resale price method could not be considered as an appropriate transfer pricing method in determining an arm's length price for intra-group services.

Transactional net margin method

The transactional net margin method examines the net profit margin relative to an appropriate base (for example, costs, sales, assets) that the tested party realises in a controlled transaction (OECD, 2010:77-78). The transactional net margin method compares the net profit margin (relative to an appropriate base) that the tested party earned in the controlled transaction to the same net profit margin earned in comparable uncontrolled transactions or by independent enterprises (ECOSOC, 2012b:24).

The transactional net margin method operates in similar manner to the resale price method and the cost plus method, but the transactional net margin method examines the net profit margin instead of the gross profit margin, and the transactional net margin method requires less product comparability than the resale price method and the cost plus method. In some cases, it may be more reliable to use the transactional net margin method as the transactional net margin method has a greater tolerance to product differences and the cost accounting differences compared to the traditional transaction methods. (ECOSOC, 2012b:25.)

The transactional net margin method is used to analyse intra-group transactions in relation to tangible property, intangible property or services. The transactional net margin method is a one-sided analysis, which therefore requires the selection of a tested party (Cooper et al, 2016:164). The party that has the less complex functional analysis would generally be selected as the tested party, and the tested party should not own valuable intangible property (OECD, 2010:113 and ECOSOC, 2012b:24). The benefit of applying this method is that there is more comparable data available and less adjustments are required to account for differences in the functions and the risks between the controlled and uncontrolled transactions (ECOSOC, 2012b:24).

There are number of profit level indicators that are allowed under the transactional net margin method (ECOSOC, 2012b:35). A profit level indicator is a measurement of a company's profitability that is used to compare comparables with the tested party (ECOSOC, 2012b:35). A profit level indicator may consider profitability in relation to sales, costs or assets. To use the right profit level indicator, it should take into account the strengths and weaknesses of the various indicators; the nature of the controlled transaction; the availability of reliable uncontrolled comparables; and the degree of comparability between controlled and uncontrolled transactions (OECD, 2010:83). An overview of different profit level indicators are as follows (ECOSOC, 2012b:35 and Cooper et al, 2016:164):

Type of profit level indicator	**Formula**	**Tested party**	**Example of use**
Return on assets	Operating profit divided by operating assets such as tangible assets.	Party holding and employing assets.	Asset intensive activities such as manufacturing activities.
Return on capital employed	Operating profit divided by capital employed.	Party with capital employed.	Asset or capital intensive activities such as manufacturing activities.
Operating margin	Operating profit divided by sales.	Party earning sales income.	Marketing, sales and distribution activities.
Return on total costs	Operating profit divided by total costs.	Party incurring costs.	Manufacturing and service activities.

Berry ratio	Gross profit divided by operating expenses.	Party incurring operating expenses.	Distribution activities.

Product comparability is important when applying the comparable uncontrolled price method, as the differences will result in different prices. The cost plus method and the resale price method are less dependent on product comparability and are more focus on functional comparability, as the differences in functions are reflected in the operating expenses which could influence the gross profit margin. However, the transactional net margin method is less dependent on the product and functional comparability because the net profit margin is less influenced by these differences. (ECOSOC, 2012b:35.)

The comparability analysis for the transactional net margin method requires a high degree of similarity in several factors between the tested party and independent enterprises. The net profit margins may be influenced by the factors that have no or less effect on the gross profit margins, due to the differences in the operating expenses between the enterprises. The factors that may influence the net margin include the industry or market differences, competitive position, business strategies, management efficiencies, the threat of substitute products, degrees of business experience (for example, start-up business or mature business), and the difference in cost structure. Any differences between the transactions being compared could materially affect the net profit margin: reasonably accurate adjustments could be made to adjust for such differences. (ECOSOC, 2012b:35.)

The transactional net margin method is one of the most commonly applied methods in practice due to flexibility and the relative availability of information (Cooper et al, 2016:166). The transactional net margin method is generally used in transactions in relation to routine manufacturing, distribution, services or other activities that do not contribute valuable intangible property (Cooper et al, 2016:166 and ECOSOC, 2012b:38).

The transactional net margin method is another method that can be used to determine arm's length pricing for intra-group services. The transactional net margin method may be used where there is difficulty in applying the comparable uncontrolled price method or the cost plus method (ECOSOC, 2015:18 and OECD, 2010:214).

Transactional profit split method

The transactional profit split method applies when both sides of the controlled transaction contribute significant intangible property (ECOSOC, 2012b:39). The purpose of this method is to split profits between the associated enterprises on a basis that independent enterprises would use in similar transactions (ECOSOC, 2015:19).

The transactional profit split method begins by identifying the profits to be allocated between the associated enterprises from the controlled transactions. These profits are allocated between the associated enterprises based on each associated enterprise's relative contribution. The relative contributions could be determined by the functions performed, risks assumed and assets used by each associated enterprise. (ECOSOC, 2012b:40.)

The transactional profit split method is generally used in cases where the associated enterprises engage in number of interrelated transactions, which cannot be analysed on a separate basis using a traditional transaction method. In other words, it is impossible to identify comparable transactions (ECOSOC, 2012b:42).

The profit split method is appropriate where more than one party makes valuable and unique contributions or where transactions are highly interrelated and cannot be evaluated separately (OECD, 2010:66). Therefore, the transactional profit split method could not be considered as an appropriate transfer pricing method in determining the arm's length price for intra-group services.

2.2.2.3. Considerations on including a profit element

A question may arise whether a profit element should be included in the charge for intra-group services by the service provider. In an arm's length transaction, an independent enterprise would normally include a profit element in the charge for the services rendered rather than providing the services merely at a cost. However, there are circumstances where the independent enterprises would not make a profit from the performance of the services alone (OECD, 2010:214-215). For example, a taxpayer adopts a market penetration business strategy by temporarily charging a price for its product that is lower than the price charged for the similar products in the same market (OECD, 2010:50). Another example, a taxpayer intending to enter a new market segment or expand its market share by temporarily incurring higher costs such as start-up cost or increased marketing costs, and achieves lower profit levels than other taxpayers operating in the same market (OECD, 2010:50). Based on the above examples, it is not always the case that an arm's length price will result in a profit for associated enterprise who performs intra-group services (OECD, 2010:215).

2.3. Conclusion

The South African transfer pricing legislation is set out in s 31 of the Income Tax Act. *Practice Note 7 of 1999* indicates that the *OECD Guidelines* would be followed in the absence of specific guidance in the South African transfer pricing legislation in relation to the intra-group services (SARS, 1999:34).

To determine the arm's length nature of intra-group services charge, two tests need to be satisfied. The two tests are (i) the benefit test and (ii) the arm's length test (OECD, 2010:206). The benefit test is to determine whether intra-group services provide the service recipient with economic benefit or commercial value that enhances the service recipient's commercial position (OECD, 2010:206). The benefit test can be determined if an independent enterprise in the similar circumstances would have been prepared to pay for the services or performed the same services in-house (OECD, 2010:206). The arm's length test is to determine whether the charges for intra-group services reflect the charges that would have been paid by the independent enterprises in similar circumstances (OECD, 2010:210).

There are three transfer pricing methods that can be applied to calculate or test an arm's length consideration for intra-group services, and these transfer pricing methods are the comparable uncontrolled price method, the cost plus method and the transactional net margin method (OECD, 2010:214). To determine which transfer pricing method should be selected, it is important to analyse the nature of functions performed, the degree of risks undertaken and the nature and

value of assets used from the service provider and the service recipient perspective (ECOSOC, 2012a:8 and OECD, 2010:213).

The comparable uncontrolled price method is considered to be the most appropriate method to determine an arm's length pricing for intra-group services (OECD, 2010: 214). The comparable uncontrolled price method can only be applied if there are similar services provided between independent enterprises in the recipient's market or an associated enterprise providing similar services to an independent enterprise (OECD, 2010: 214). In practice, it is difficult to find a transaction between independent enterprises which is similar to a controlled transaction, and it is also difficult to determine reasonable adjustments to account for any differences between the controlled and uncontrolled transactions (SARS, 1999, 15).

The cost plus method could be considered as the most appropriate method to determine an arm's length pricing for intra-group services in the absence of the comparable uncontrolled price method (OECD, 2010:214). In practice, the application of cost plus method can be problematic because the gross profit margin data may not be comparable due to the accounting inconsistencies and other factors (ECOSOC, 2012b:21).

The transactional net margin method that can be used to determine an arm's length pricing for intra-group services, where there is difficulty in applying the comparable uncontrolled price method or the cost plus method (ECOSOC, 2015:18 and OECD, 2010:214). In practice, the transactional net margin method is one of the most commonly applied method to determine an arm's length pricing for intra-group services, because the net profit margin used under the transactional net margin method is less influenced by the product and functional differences (ECOSOC, 2012b:35) and it is easy to find comparable information (Cooper et al, 2016:166).

3. Chapter 3 – Action 10 of the *BEPS Action Plan*

The international tax system has changed significantly in recent years (OECD, 2017:7). The OECD identified that the existing *OECD Guidelines* in relation to the transfer pricing rules could be misapplied which result in the allocation of profits not being aligned with the economic activity carried out by the members of a MNE group, therefore the OECD has introduced the *BEPS Action Plan* (OECD, 2015a:27). The *BEPS Action Plan* involves input from 34 countries (members of the OECD), G20 members and more than 40 developing countries (non-members of the OECD) including South Africa (Cliffe Dekker Hofmeyer, 2016:1). The aim of the *BEPS Action Plan* is to realign taxation with economic substance and value creation, while preventing double taxation (OECD, 2015d:5).

On 3 November 2014, the OECD issued a *Discussion Draft of the Proposed Modifications to Chapter VII of the Transfer Pricing Guidelines Relating to Low Value-Adding Intra-Group Services ('Discussion Draft'*). This proposed modification does not represent the consensus views of Committee on Fiscal Affairs and its subsidiary bodies but is rather intended to provide stakeholders with substantive proposals relating to the modification of Chapter VII of the *OECD Guidelines* and the introduction to low value-adding intra-group services. (OECD, 2014a:3-4.) The key features of the *Discussion Draft* include:

- A standard definition of low value-adding intra-group services.
- Clarifications of the meaning of shareholder activities, duplicated services, specifically in the context of low value-adding intra-group services.
- Determination of appropriate mark-up for low value-adding intra-group services.
- Determination of appropriate cost allocation methodologies in respect of low value-adding intra-group services.
- Guidance on the satisfaction of a simplified benefit test in respect of low value-adding services.
- Guidance on documentation should the MNE apply the simplified approach. (OECD, 2014a:3.)

On 23 May 2016, the OECD Council approved the *Discussion Draft* and the amendments relating to intra-group services under Chapter VII of the *OECD Guidelines* are set out in Action 10 of the *BEPS Action Plan* (OECD, 2016:1).

On 5 October 2015, the OECD released a final report relating to Action 10 of the *BEPS Action Plan* that introduces a simplified transfer pricing approach for low value-adding intra-group services as well as some modifications and clarifications to existing paragraphs of Chapter VII of the *OECD Guidelines* (OECD, 2015b:141). The goal of the Action 10 of the *BEPS Action Plan* is to reduce base erosion payments through excessive management fees and head office expenses to achieve a balance between appropriate charges for low value-adding services and head office expenses, and provide protection to the payor countries' tax base (OECD, 2015b:141). The main reason of modifying Chapter VII of the *OECD Guidelines* under Action 10 of the *BEPS Action Plan* is to enhance certainty and clarity relating to the treatments of intra-group services, for both taxpayers and tax administrations (OECD, 2015c:200).

According to OECD (2015d:5), the *BEPS Action Plan* is:

> '…soft law legal [instrument. It is] not legally binding but there is an expectation that they will be implemented accordingly by the countries that are part of the consensus. The past track record in the tax area is rather positive. Minimum standards were agreed in particular to tackle issues in cases

where no action by some countries would have created negative spill overs (including adverse impacts of competitiveness) on other countries. Recognising the need to level the playing field, all OECD and G20 countries have committed to consistent implementation in the areas of preventing treaty shopping, Country-by-Country Reporting, fighting harmful tax practices and improving dispute resolution. In addition, existing standards have been updated and will be implemented, noting however that not all BEPS participants have endorsed the underlying standards on tax treaties or transfer pricing. In other areas, such as recommendations on hybrid mismatch arrangements and best practices on interest deductibility, countries have agreed a general tax policy direction. In these areas, they are expected to converge over time through the implementation of the agreed common approaches, thus enabling further consideration of whether such measures should become minimum standards in the future. Guidance based on best practices will also support countries intending to act in the areas of mandatory disclosure initiatives or CFC legislation.'

This chapter summarises and analyses the approved changes and clarification to existing paragraphs of Chapter VII of the *OECD Guidelines* on intra-group services. These changes have been developed under Action 10 of the *BEPS Action Plan*. Furthermore, this chapter analyses the simplified approach proposed under Action 10 of the *BEPS Action Plan* for low value-adding intra-group services.

3.1. Amendment to Chapter VII of the *OECD Guidelines*

The Action 10 of the *BEPS Action Plan* does not change the fundamental principle of intra-group services under the *OECD Guidelines*. The Action 10 of the *BEPS Action Plan* includes additional sentences, examples and headings to the existing paragraphs of Chapter VII of the *OECD Guidelines* in order to provide certainty and clarity to the treatments of intra-group services (OECD, 2015c:200). The table below quotes the additional sentences included under Action 10 of the *BEPS Action Plan* in relating to the existing transfer pricing rules for intra-group services under *OECD Guidelines*:

Paragraph reference per the *OECD Guidelines*	**Additional sentences added under Action 10 of the *BEPS Action Plan***
Paragraph 7.2 (providing a brief introduction to intra-group services and examples of different type of intra-group services)	According to the OECD (2015b:143), the following additional sentences have been added under the introduction: 'It is not in the interests of [a] MNE group to incur costs unnecessarily, and it is in the interest of an MNE group to provide intra-group services efficiently. Application of the guidance in this chapter should ensure that services are appropriately identified and associated costs appropriately allocated within the MNE group in accordance with the arm's length principle.'
Paragraph 7.8 (discussing intra-group services that are provided by one member of a MNE group in order to meet an identified need of another group member)	According to the OECD (2015b:144), the following additional sentences have been added under the benefit test: 'It is essential, however, that reliable documentation is provided to the tax administrations to verify that the costs have been incurred by the service provider.'
Paragraph 7.10 (dealing with examples of costs associated	According to the OECD (2015b:145), the following additional examples and sentences have been added for the shareholder activities:

with shareholder activities)	'(b)… costs relating to the parent company's audit of the subsidiary's accounts carried out exclusively in the interest of the parent company, and costs relating to the preparation of consolidated financial statements of the MNE (however, in practice costs incurred locally by the subsidiaries may not need to be passed on to the parent or holding company where it is disproportionately onerous to identify and isolate those costs); (c)… costs relating to the parent company's investor relations such as communication strategy with shareholders of the parent company, financial analysts, funds and other stakeholders in the parent company; (d) Costs relating to compliance of the parent company with the relevant tax laws; (e) Costs which are ancillary to the corporate governance of the MNE as a whole. … Where activities such as those described above are performed by a group company other than solely because of an ownership interest in other group members, then that group company is not performing shareholder activities but should be regarded as providing a service to the parent or holding company to which the guidance in this chapter applies.'
Paragraph 7.11 (providing a brief introduction of duplicated services and examples of services that are not considered as duplicated services)	According to the OECD (2015b:145-146), the following additional sentences have been added for the duplicated services: 'Any consideration of possible duplication of services needs to identify the nature of the services in detail, and the reason why the company appears to be duplicating costs contrary to efficient practices. The fact that a company performs, for example, marketing services in-house and also is charged for marketing services from a group company does not of itself determine duplication, since marketing is a broad term covering many levels of activity. Examination of information provided by the taxpayer may determine that the intra-group services are different, additional, or complementary to the activities performed in-house. The benefits test would then apply to those non-duplicate elements of the intra-group services. Such regulated sectors require control functions to be performed locally as well as on a consolidated basis by the parent; such requirements should not lead to disallowance on grounds of duplication.'
Paragraph 7.15 (dealing with an arm's length consideration for the provision of services that would be made between independent enterprises)	According to the OECD (2015b:147), the following additional sentences have been added under the form of the remuneration: 'Similarly, in some buying or procurement services a commission element may be incorporated in the price of the product or services procured, and a separate service fee may not be appropriate.'

The Action 10 of the *BEPS Action Plan* attempts to provide certainty to the introduction of intra-group services. This includes providing guidelines to the required documentation and the form of remuneration. Lastly, Action 10 of the *BEPS Action Plan* provides a distinction between duplicated services and intra-group services as well as between shareholder activities and intra-group services, respectively.

3.2. Low value-adding intra-group services

3.2.1. Introduction

The Action 10 of the *BEPS Action Plan* introduces a guidance relating to low value-adding intra-group services (OECD, 2015b:153). The guidance contains the definition of low value-adding intra-group services, the simplified approach for determination of the arm's length charges and the benefit tests, the documentation and reporting requirements, and the levying of withholding tax on low value-adding intra-group services charges (OECD, 2015b:153). The simplified transfer pricing approach for low value-adding intra-group services is an example of the safe harbour provisions, that are discussed in more detail in Chapter 4 of the research report.

3.2.2. Definition of low value-adding intra-group services

The Action 10 of the *BEPS Action Plan* defines low value-adding intra-group services for the purposes of the simplified approach as the services performed by one or more members of a MNE group which:

- Are supportive in nature.
- Are not part of the core business of the MNE group that create profit-earning activities or contribute to economically significant activities.
- Do not require the use or creation of unique and valuable intangibles.
- Do not involve the assumption or control of substantial or significant risk and do not give rise to the creation of significant risk. (OECD, 2015b:153.)

The Action 10 of the *BEPS Action Plan* further provides a list of services that would likely meet the definition of low value-adding intra-group services for the application of simplified approach:

- Accounting and auditing services. For example, maintaining accounting records and preparing operational and financial results.
- Processing and managing of account receivable and account payable. For example, compiling customer billing information and credit control checking.
- Human resources activities. For example, staffing and recruitment, training and employee development.
- Monitoring and compilation of data relating to health, safety, environmental and other standards regulating the business.
- Information technology services. For example, installing, maintaining and updating information technology systems.
- Internal and external communications and public relations support (excluding advertising or marketing activities as well as development of underlying strategies).
- General legal services. For example, drafting and reviewing agreements and providing legal consultation and opinions.
- Tax obligation activities. For example, information gathering and preparing tax returns.
- General administrative services or clerical nature services. (OECD, 2015b:154-155.)

In addition, the Action 10 of the *BEPS Action Plan* provides a list of activities that would not qualify for the simplified approach:

- Services that form part of the core business of the MNE group.
- Research and development services such as software development.
- Manufacturing and production services.
- Purchasing activities.

- Sales, marketing and distribution activities.
- Financial transactions.
- Extraction, exploration or processing of natural resources.
- Insurance and reinsurance.
- Services of corporate senior management. (OECD, 2015b:153-154.)

3.2.3. Simplified determination of the arm's length charges for low value-adding intra-group services

The proposition of the simplified method is to allocate all low value-adding services costs incurred in supporting the business of the MNE group to member recipients (OECD, 2015b:156). According to the OECD (2015b:156), the basic benefits of applying the simplified approach are:

> '… (1) reducing the compliance effect of meeting the benefits test and in demonstrating arm's length charges; (2) providing greater certainty for MNE groups that the price charged for the qualifying activities will be accepted by the tax administrations that have adopted the simplified approach when the conditions of the simplified approach mentioned in paragraph 7.45 have been met; and (3) providing tax administrations with targeted documentation enabling efficient review of compliance risks … .'

A MNE group may elect to adopt the simplified approach for low value-adding intra-group services and the simplified approach should apply on a consistent basis either group-wide or on a regional or divisional subgroup basis (OECD, 2015b:156).

3.2.3.1. Application of the benefits test

Under the arm's length principle to determine the transfer pricing for intra-group services within a MNE group, the benefit test need to be satisfied. Intra-group services rendered must provide the serviced recipient with economic benefit or commercial value that enhance the service recipient's commercial position. The benefit test can also be determined if an independent enterprise in similar circumstances would have been prepared to pay for the activity or would have performed the activity in-house. (OECD, 2015b:156-157.)

The Action 10 of the *BEPS Action Plan* indicates that if a MNE group complies with the documentation and reporting requirements under the simplified approach, this compliance would provide sufficient evidence that the benefit test is met in relation to the low value-adding intra-group services. To evaluate the benefit test, the Action 10 of the *BEPS Action Plan* further indicates that the tax administrations should consider benefits only by the categories of the services and not on a specific charge basis. A single annual invoice describing a category of the services should suffice to support the charge for low value-adding intra-group service and other correspondence of individual acts should not be required by the tax administrations. (OECD, 2015b:157.)

3.2.3.2. Determination of cost pools

The initial step in applying the simplified approach is on an annual basis to calculate a pool of costs for each category of low value-adding services incurred by the members of the MNE group that conduct those services (OECD, 2015b:157). The cost pool should include direct and indirect costs of the rendered services, and any operating expenses, for example, supervisory, general

and administrative (OECD, 2015b:157). The pass-through costs in the cost pool should be separately identified as no mark-up will be applied for these pass-through costs (OECD, 2015b:157). The pass-through costs are costs which are potentially excluded from the denominator of the taxpayer's net profit indicator (OECD, 2010:88). The cost pool should exclude costs attributable to an in-house activity that is solely benefitting the company conducting the activities such as shareholder activities (OECD, 2015b:157).

The second step is to identify and remove from the cost pool these costs relating to the services rendered by one group member solely on behalf of another group member. At this stage in the calculation, a pool of costs relating to the categories of low value-adding services provided to members of the MNE group should already be identified. (OECD, 2015b:157.)

3.2.3.3. Allocation of low value-adding services costs

The third step in this simplified approach is to allocate low value-adding service costs among the benefitting members of the MNE group using an allocation key. The taxpayers may select one or more allocation keys for allocation of costs relating to the services. The same allocation key or keys should apply consistently across the same category of the services and should provide a reasonable reflection of the respective benefits likely to be derived by each service recipient. As a general rule, the allocation key or keys should reflect the underlying need for the particular services provided. For example, an allocation key for the services related to people may be based on number of headcount, an allocation key for the information technology services may be based on the number of users in each associated enterprise, an allocation key for the fleet management services may be based on the number of vehicles. (OECD, 2015b.158.)

The allocation keys used are based on the facts and circumstances and the balance should be obtained between theoretical accuracy and practicality. There may be no need to use multiple allocation keys if the taxpayer can substantiate that the single key can reasonably reflect the benefits received. The same allocation key or keys should be applied consistently in determining the allocation to the service recipients within the group of the same type of low value-adding intra-group services and the same reasonable key should be used from year to year unless there is a justified reason for change. The reasons for substantiating that the allocation key produces outcomes which reasonably reflect the benefit expected to be received by each service recipient should be described in the documentation. (OECD, 2015b:158.)

3.2.3.4. Profit mark-up

In order to determine an arm's length charge for low value-adding intra-group services, the service provider should apply a profit mark-up equal to 5% of all costs in the pool (excluding any pass-through costs). The mark-up under the simplified approach does not need to be substantiated with a benchmarking study. The same mark-up may be applied to all low value-adding intra-group services irrespective of the categories of the services. The Action 10 of the *BEPS Action Plan* further notes that the low value-adding intra-group services mark-up should not be used as a benchmark for determining an arm's length price for services which do not meet the definition of low value-adding intra-group services, or the services rendered are not within the simplified scheme. (OECD, 2015b:158.)

3.2.3.5. Charging for low value-adding services

The charge for low value-adding services shall be the sum of:

(i) the cost incurred by a group member providing the services specifically to another group member under step two, plus the mark-up of 5%, and

(ii) the share of pooled costs allocated to the member under the third step using selected allocation key plus the mark-up of 5%.

The charge for low value-adding services is payable to the group member that incurred costs in the pool. The proportion basis would be applied to each member's share of the pooled costs where there is more than one group member. (OECD, 2015b:159.)

3.2.3.6. Threshold for the application of the simplified approach

The tax administrations may include a threshold when adopting the simplified approach to low value-adding intra-group services. The threshold might be based on fixed financial ratios of the service recipient or based on total service costs to turnover of the MNE group or other measurement. Where such a threshold is applied, the tax administration would not accept the simplified approach if the level of low value-adding intra-group service fee exceeds the threshold and the tax administration may require a full functional analysis and a comparability analysis (including the application of benefit test) to support low value-adding intra-group service charge. (OECD, 2015b:159.)

3.2.4. Documentation and reporting

Action 10 of the *BEPS Action Plan* indicates that a MNE group electing for application of the simplified methodology is required to prepare the following information and documentation and make it available upon request to the tax administrations:

- A description of the categories of low value-adding intra-group services provided, the beneficiaries involved, the reasons substantiating that such services constitute low value-adding services, the rationale for the supply of services within the context of the MNE business, a description of the benefits or expected benefits of each category of services, a description of the selected allocation keys and the reasons substantiating that such allocation keys result in outcomes that reasonably reflect the benefits received, and confirmation of the mark-up applied.
- Written contracts or agreements for the supply of services and any modifications to those contracts and agreements. Such written contracts or agreements should include the entities involved, the nature of the services, and the terms and conditions.
- Documentation and calculations presenting the determination of the cost pool and the mark-up applied. This should include a detailed listing of all categories and amounts of relevant costs including costs for the services provided solely to another group member.
- Calculations indicating the application of the specified allocation keys. (OECD, 2015b:159.)

3.2.5. Levying of withholding tax on charges for low value-adding intra-group services

The levying of withholding tax on charges for low value-adding intra-group services may prevent the service provider recovering all the costs incurred for rendering the services. The Action 10 of

the *BEPS Action Plan* encourages the tax administrations to levy withholding tax only to the amount of the profit element or mark-up of the low value-adding intra-group charge. (OECD, 2015b:160.)

3.3. Conclusion

The fundamental principle of intra-group services remains the same with the modification of Chapter VII of the *OECD Guidelines* under the Action 10 of the *BEPS Action Plan* providing certainty and clarity for both taxpayers and tax administrations (OECD, 2015c:200).

The Action 10 of the *BEPS Action Plan* also introduces an elective and simplified approach for low value-adding intra-group services. The objective of introducing the simplified approach for low value-adding intra-group services is to achieve a necessary balance between appropriate charges for low value-adding intra-group services and head office expenses, and to protect the tax bases of developing countries from excessive service charges (OECD, 2015b:141-142 and OECD, 2015d:17). The simplified approach reduces the compliance burden and provides greater certainty regarding to the price charged for the taxpayers (OECD, 2015b:156). The simplified approach also provides the tax administrations with targeted documentation enabling efficient review of compliance risk (OECD, 2015b:156).

Currently, South Africa follows *OECD Guidelines* when implementing the transfer pricing rules for intra-group services (National Treasury, 2010:76). On 22 February 2017, the South Africa's Minister of Finance indicates that SARS is updating the transfer pricing *Practice Note* to include new guidance on the arm's length principle stated under the Action 8-10 of the BEPS Action Plan (National Treasury, 2017:137). However, there is no indication when SARS will issue a revised version of the existing *Practice Note 7 of 1999* and there is uncertainty whether SARS will adopt the simplified approach for low value-adding intra-group services (Hart & Honiball, 2014:3).

4. Chapter 4 – Comparison between South African transfer pricing legislation and Action 10 of the *BEPS Action Plan*

This chapter summarises and compares the approaches adopted by the South African transfer pricing legislation and the Action 10 of the *BEPS Action Plan* for intra-group services. The analyses of the approaches adopted by the South African transfer pricing legislation and the Action 10 of the *BEPS Action Plan* are discussed in detail under Chapter 2 and Chapter 3 of the research report. This chapter further identifies any improvements that can be made based on the comparison between the South African transfer pricing legislation and the Action 10 of the *BEPS Action Plan* for intra-group services.

4.1. Comparison overview

South African transfer pricing legislation

The South African transfer pricing legislation was introduced in 1995 and was changed significantly in 2012. The current South African transfer pricing legislation in s 31 of the Income Tax Act stipulates that the cross-border transactions, that would include intra-group service arrangements, between connected residents and non-residents should be entered into on the terms and conditions that would have applied had the transaction between independent parties dealing at arm's length (Stiglingh et al, 2015:629). The current literal wording of s 31 of the Income Tax Act has been motivated by the *OECD Guidelines* published in 2010 (Edward Nathan Sonnenbergs, 2010:3). *Practice Note 7 of 1999* issued by SARS in 1999 indicates that South Africa will follow the *OECD Guidelines* published in 1995 when determining an arm's length price for intra-group services, even though South Africa is not a member of the OECD (SARS, 1999:5-34). Currently, *Practice Note 7 of 1999* is outdated and it does not refer to the current s 31 of the Income Tax Act or the revised *OECD Guidelines* published in 2010. In 2010, the National Treasury indicated that South Africa will continue to follow the *OECD Guidelines* in the application of the transfer pricing rules (National Treasury, 2010:76).

To satisfy the arm's length principle per the *OECD Guidelines* published in 2010, intra-group services that have been rendered should provide the service recipient with economic benefit or commercial value that enhance the service recipient's commercial position (OECD, 2010:206). Furthermore, intra-group service charge should reflect what would have been paid by the independent enterprises under similar arrangements (OECD, 2010:33). The *OECD Guidelines* provide two approaches that may be used for allocating the costs of intra-group services such as direct-charge and indirect-charge (OECD, 2010:2011-2012). In addition, the preferable transfer pricing methods to be used for intra-group services are (i) comparable uncontrolled price method, (ii) cost plus method and (iii) transactional net margin method (ECOSOC, 2015:18).

Action 10 of the BEPS Action Plan

During 2013, the OECD identified that the *OECD Guidelines* published in 2010 may create uncertainty for intra-group services treatments and there is risk of base erosion payments through excessive management fees and head office expenses, therefore the Action 10 of *BEPS Action Plan* was introduced (OECD, 2015b:141). On 23 May 2016, the OECD Council approved the amendments to Chapter VII of the *OECD Guidelines* and the amendments will be set out in Action 10 of *BEPS Action Plan* (OECD, 2016:1). The fundamental principle for intra-group services

treatments under Action 10 of *BEPS Action Plan* remains the same with Chapter VII of the *OECD Guidelines*. The difference between the Chapter VII of the *OECD Guidelines* and the Action 10 of the *BEPS Action Plan* is the introduction of a simplified transfer pricing approach in relation to low value-adding intra-group services. The simplified transfer pricing approach for low value-adding intra-group services is an example of the safe harbour provisions.

The Action 10 of the *BEPS Action Plan* includes an elective and simplified transfer pricing approach for determining the amount of low value-adding intra-group services to be charged and paid for by the members of the MNE group (Jie-A-Jeon & Zivkovic, 2015:1). Low value-adding intra-group services are defined as services that (i) are of a supportive nature, (ii) are not part of the core business of the MNE group, (iii) do not require the use and creation of unique and valuable intangibles, and (iv) do not involve the assumption or control of substantial or significant risk and do not give rise to the creation of significant risk (OECD 2015b:153). The simplified approach involves a clear identification of the costs to be transferred, the use of common allocation key for all service recipients, and the transfer of total costs associate to low value-adding intra-group services, plus a mark-up of 5% (Aldrin Rojas M, 2016:1). The mark-up does not need to be substantiated with a benchmarking study (OECD, 2015b:158). The simplified approach also simplified the benefit test, the Action 10 of the *BEPS Action Plan* indicates that compliance with the documentation and reporting requirements would provide sufficient evidence that the benefit test is met (OECD, 2015b:157).

Comparison

The current South African transfer pricing legislation is aligned with the arm's length principle per the *OECD Guidelines* published in 2010, but there is lack of guidance in South Africa regarding the practical application of the current s 31 of the Income Tax Act. The current *Practice Note 7 of 1999* is outdated as it refers to the *OECD Guidelines* published in 1995, when determining an arm's length price for intra-group services.

Chapter VII of the *OECD Guidelines* was updated in 2010 with a further amendment in 2016 as set out in Action 10 of the *BEPS Action Plan*. The Action 10 of the *BEPS Action Plan* provides clarity and legal certainty to intra-group services treatments and introduces an elective and simplified approach as a safe harbour provisions for low value-adding services.

In the 2017 *Budget Review*, South Africa's Minister of Finance indicated that SARS is working on updating the transfer pricing *Practice Note* and the revised version will include new guidance on the arm's length principle stated under the Action 8-10 of the *BEPS Action Plan* (National Treasury, 2017:137). However, there is no clear indication whether SARS will implement the modifications of Chapter VII of the *OECD Guidelines* in relation to intra-group services or adopt the safe harbour provisions in relation to low value-adding intra-group services set out in Action 10 of the *BEPS Action Plan* under the revised transfer pricing *Practice Note.*

South Africa should update its *Practice Note* by incorporating the changes made to the intra-group services treatments under the Action 10 of the *BEPS Action Plan*, as the changes provide certainty and clarity to both taxpayers and tax authority.

The question raised after comparing the South African transfer pricing legislation and the Action 10 of *BEPS Action Plan* is whether South Africa should improve its *Practice Note* by adopting the safe harbour provisions in relation to low value-adding intra-group services. To identify whether

or not the South African transfer pricing *Practice Note* should adopt the safe harbour provisions, the following need to be considered:

- The benefits and concerns regarding safe harbour provisions.
- The situations in which safe harbour provisions may be applied in a transfer pricing system based on the arm's length principle. (OECD, 2013:4.)

4.2. Transfer pricing safe harbour provisions

4.2.1. Introduction

To apply the arm's length principle can be a fact-intensive process as it may impose heavy compliance and administrative burden for both taxpayers and tax administrations. This has led to some OECD member countries to consider safe harbour rules as an effective way of dealing with transfer pricing issues. (OECD, 2013:2 and Deloitte, 2009:4.)

The concept underlying the safe harbour mechanism is set out in Chapter IV of the *OECD Guidelines* published in 1995 where this *OECD Guidelines* had negative view regarding transfer pricing safe harbour provisions and it was suggested that the safe harbour rules could raise perverse effects on pricing decisions of entities engaged in controlled transactions. It could also have a negative impact on the tax revenues of the country implementing the safe harbour provisions as well as the tax revenues of countries whose associated enterprises engage in controlled transaction with taxpayers electing the safe harbour provisions. The *OECD Guidelines* published in 1995 further indicated that the safe harbour provisions are incompatible with the arm's length principle and therefore the use of safe harbour provisions was not recommended. There are number of countries adopted the transfer pricing safe harbour provisions irrespective of the negative view concluded by the *OECD Guidelines.* (OECD, 2013:3.)

On 16 May 2013, the OECD released a revised Section E on safe harbour provisions in Chapter IV of the *OECD Guidelines* as the negative view does not accurately reflect the practice of OECD member countries. The new version on safe harbour provisions provide opportunities for countries to reduce the compliance burdens and to provide taxpayer with greater certainty for smaller taxpayers and/or less complex transactions. The new version also encourages to use bilateral or multilateral safe harbour provisions under the right circumstances in order to avoid international tax conflicts. Adopting the safe harbour provisions may provide significant compliance relief and administrative simplicity and certainty to taxpayers and tax administrations. (OECD, 2013:3 and KPMG, 2013:2.)

According to the OECD (OECD, 2013:4), the definition and the concept of the safe harbour provisions are:

> 'A safe harbour in a transfer pricing regime is a provision that applies to a defined category of taxpayers or transactions and that relieves eligible taxpayers from certain obligations otherwise imposed by a country's general transfer pricing rules. A safe harbour substitutes simpler obligations for those under the general transfer pricing regime. Such a provision could, for example, allow taxpayers to establish transfer prices in a specific way, e.g. by applying a simplified transfer pricing approach provided by the tax administration. Alternatively, a safe harbour could exempt a defined category of taxpayers or transactions from the application of all or part of the general transfer pricing rules… .'

The purpose of the revised Section E on safe harbour provisions is to avoid a definition that conflates safe harbour provisions with administrative simplification measures which are not directly involved in the determination of the arm's length prices (PwC, 2013:1 and OECD, 2013:4).

The simplified transfer pricing approach for low value-adding intra-group services discussed in Chapter 3 is an example of the safe harbour provisions.

4.2.2. Benefits of the safe harbour provisions

The basic objectives of the safe harbour provisions are as follows:

- Safe harbour provisions may simplify compliance and reduce compliance cost for eligible taxpayers in determining arm's length conditions for controlled transaction.
- Safe harbour provisions may provide assurance to eligible taxpayers that the price charged or received on controlled transaction will be accepted by the tax administration with a limited audit or without an audit.
- Safe harbour provisions may allow tax administrations to allocate their administrative resources efficiently. (OECD, 2013:5.)

4.2.2.1. Compliance relief

To apply the arm's length principle requires data collection and analysis that may be difficult or costly to obtain and/or evaluate for both taxpayers and tax administrations. In certain cases, such compliance burdens may be disproportionate to the transfer pricing risk of the transaction. (PwC, 2013:1 and OECD, 2013:5.)

The safe harbour provisions may significantly reduce compliance burdens for the taxpayer such as eliminating data collection and minimising detailed documentation requirements. Under the safe harbour provisions, the taxpayers will know in advance the transfer prices which will not be challenged by the tax administrations and the taxpayers are not obligated to search for comparable transactions or expend resources to support the arm's length prices to the tax administrations. (OECD, 2013:5.)

The simplified approach such as a safe harbour provision for low value-adding intra-group services could reduce the compliance effect of meeting the benefit test and in demonstrating arm's length charges (OECD, 2015b:156). If the taxpayers comply with the simplified documentation and reporting requirements under the Action 10 of the *BEPS Action Plan* this would provide sufficient evidence that the benefit test is met (OECD, 2015b:157). A mark-up of 5% should apply to the total costs associated to the low value-adding intra-group services and this mark-up does not need to be substantiated with a benchmarking study (OECD, 2015b:158).

4.2.2.2. Certainty

The safe harbour provisions should provide certainty that the taxpayer's transfer prices will be accepted by the tax administration so that the taxpayer will not be subjected to an audit or reassessment in connection with the transfer prices. The tax administration shall accept the transfer prices without any scrutiny should the transfer prices fall within the safe harbour parameters. The taxpayer should be provided with relevant safe harbour parameters which would provide acceptable transfer price by the tax administration. (OECD, 2013:5 and Deloitte, 2009:9.)

By applying the simplified approach such as a safe harbour provision for low value-adding intra-group services, it could provide certainty to the taxpayers that the price charged will be accepted by the tax administrations (OECD, 2015b:156).

4.2.2.3. Administrative simplicity

The safe harbour provisions should result in an administrative simplicity for the tax administrations. When the eligibility for the safe harbour provisions has been established, the qualifying taxpayers involved in low transfer pricing risk should be subjected to minimal examination with respect to the transfer prices of controlled transactions. The tax administrations can secure its tax revenues in low risk situations and allocate more administrative resources on the examination of more complex or higher risk transactions and taxpayers. (OECD, 2013:5.)

The simplified approach such as a safe harbour provision for low value-adding intra-group services could allow the tax administrations to allocate their administrative resources efficiently and provide the tax administrations with targeted documentation enabling efficient review of compliance risk (OECD, 2015b:156 and OECD, 2013:5).

4.2.3. Concerns over safe harbour provisions

The four main concerns regarding the safe harbour provisions are as follows:

- Safe harbour provisions may lead to taxable income being reported that is not consistent with the arm's length principle.
- Safe harbour provisions may increase the risk of double taxation or double non-taxation when unilaterally adopted.
- Safe harbour provisions may introduce tax planning opportunities for taxpayers.
- Safe harbour provisions may introduce issues of equity and uniformity. (OECD, 2013:6 and PwC, 2013:2.)

4.2.3.1. Divergence from the arm's length principle

When the safe harbour provisions impose a simplified transfer pricing approach, it might be required to follow a certain method where another method may otherwise be the most appropriate method applicable to the facts and circumstances of the taxpayer under the general transfer pricing rules. Such an occurrence could be inconsistent with the arm's length principle (OECD, 2013:6 and PwC, 2013:2.).

The safe harbour provisions involve a trade-off between strict adherence to the arm's length principle and administrative simplicity. The safe harbour provisions are not designed to fit exactly to the facts and circumstances of the transactions. The prices under the safe harbour provisions could be improved by collecting, collating and continuously updating a pool of information in relation to the prices and pricing development in order to be in line with the prices determined in accordance with arm's length principle. However, the extensive research to set the safe harbour parameters closely in line with the arm's length principle can erode the administrative simplicity of the safe harbour provisions. (OECD, 2013:6; PwC, 2013:2 and Deloitte, 2009:9-10.)

Any disadvantage to the taxpayers from the safe harbour diverging from an arm's length result may be avoided when the taxpayers have the option to elect either the safe harbour provisions or the general arm's length rules. The tax administrations should consider the potential loss in the tax revenue from such an elective system as the taxpayers may elect either the safe harbour amount or the arm's length amount that is more favourable to their circumstances in a particular year. In order to limit such potential revenue losses, the tax administrations should require the taxpayers to notify them in advance of using the safe harbour provisions or to commit to use the safe harbour provisions for certain number of years. (OECD, 2013:6 and PwC, 2013:2.)

The simplified approach such as a safe harbour provision for low value-adding intra-group services could lead to taxable income being reported that is not consistent, due to the safe harbour provisions for low value-adding intra-group services being an elective system. The taxpayers could elect using either the safe harbour provisions or the general transfer pricing rules for low value-adding intra-group services, which is more favourable to their circumstances. This could result in a potential loss in the tax revenue for the tax administrations. (OECD, 2013:6 and OECD, 2015b:141.)

4.2.3.2. Risk of double taxation, double non-taxation and mutual agreement concerns

A major concern raised by the safe harbour provisions are the international impact as the safe harbour provisions could influence the pricing strategy of the taxpayers. The safe harbour parameters may provide an incentive to the taxpayers to modify the prices that they would otherwise have charged to controlled parties in order to increase reported profits in their country and to avoid transfer pricing scrutiny in the safe harbour country. There may be a concern of overstating the taxable income in the country that provides the safe harbour provisions as that country may impose significant penalties for understatement of tax or failure to meet the documentation requirements, with the result that there may be added incentive to ensure that the transfer pricing rules are accepted without further review. (OECD, 2013:6 and Deloitte, 2009:10.)

The safe harbour provisions may cause the taxpayers to report income that is above the arm's length levels. This would benefit the tax administration providing safe harbour provisions as more taxable income would be reported by such domestic taxpayers. On the other hand, this may lead to less taxable income being reported in the other tax jurisdiction. The other tax administrations may challenge the prices determined from the application of the safe harbour provisions in order to protect it tax base and the taxpayer may potentially face double taxation issues. The country providing the safe harbour provisions shifts its administration burden to the other jurisdictions. (OECD, 2013:7.)

In cases that involve smaller taxpayers or less complex transactions, the benefits of the safe harbour provisions might outweigh the problems that those transactions created. The safe harbour provisions are elective where the taxpayers may incur a moderate level of taxation and viewing it as an acceptable price to be paid in order to obtain relief from the compliance of the complex transfer pricing rules. (OECD, 2013:7.)

The countries that adopt the unilateral safe harbour provisions should be prepared to consider modifications of the safe harbour outcomes under the mutual agreement procedures in order to limit the potential risk of double taxation. The country that offers the safe harbour provisions should make it explicit in advance to the taxpayer whether the country would attempt to alleviate

any eventual double taxation resulting from the application of the safe harbour provisions. If the safe harbour provisions are not elective and the country in question refuses to consider double tax relief, the risk of double taxation in relation to the safe harbour provisions should be unacceptable and this will be inconsistent with the double tax relief provisions that treaties provide. (OECD, 2013:7.)

In other instances, if unilateral safe harbour provisions permit the taxpayers to report income below arm's length levels, then the taxpayers could have an incentive to elect the safe harbour provisions. In such situations, there will be no assurance whether the income reported by the taxpayers in other countries is consistent or above the arm's length levels based on the safe harbour provisions. The burden of under-taxation would fall exclusively upon the country providing the safe harbour provisions and should not negatively affect the other countries' ability to tax an arm's length income amount. In such a case, the double non-taxation would be unavoidable and this could result in distortions of investment and trade. (OECD, 2013:7.)

If the safe harbour provisions are adopted on a bilateral or multilateral basis by means of the competent authority agreements between the countries, then the problem of the non-arm's length results and potential double taxation and non-taxation raised under the safe harbour provisions can be eliminated or prevented. Under this procedure, two or more countries may agree to the category of transactions and/or taxpayers which the safe harbour provisions will apply and establish acceptable pricing parameters in the agreements. Such agreements should be published in advance so that the taxpayers could consistently apply the acceptable pricing parameters in each of the affected countries. (OECD, 2013:7.)

The *OECD Guidelines* indicate that having two or more countries with potentially divergent interests agree on the safe harbour provisions could limit some of the arbitrariness in relation to the unilateral safe harbour provisions and could also eliminate double taxation and double non-taxation created from the safe harbour provisions. The creation of the bilateral or multilateral safe harbour provisions by the competent authority agreement for smaller taxpayers or less complex transactions could be a worthwhile approach to transfer pricing simplification and it could avoid some of the potential pitfalls of the unilateral safe harbour regimes. (OECD, 2013:7-8.)

The simplified approach such as a safe harbour provision for low value-adding intra-group services could increase the risk of double taxation or double non-taxation when unilaterally adopted (OECD, 2013:6). The Action 10 of the *BEPS Action Plan* is soft law legal instrument and it is not legally binding, but there is an expectation that the countries will implement accordingly (OECD, 2015d:5). However, there is uncertainty when and which countries will adopt the safe harbour provisions for low value-adding intra-group services.

4.2.3.3. Possibility of opening avenues for tax planning

The safe harbour provisions may create tax planning opportunities for the taxpayers. The taxpayers may be incentivised to amend their transfer pricing in order to shift the taxable income to other countries. In addition, if the safe harbour provisions apply to 'simple' or 'small' transactions, the taxpayer may be incentivised to break the transactions up to fit within the scope of the safe harbour provisions. (OECD, 2013:8 and PwC, 2013:2.)

The tax planning opportunities may exist for taxpayers having better than average profitability, when the safe harbour provisions are based on an industry average. For example, a company

sells at an arm's length price and could earn a mark-up of 15% on controlled sales, if that company adopts the safe harbour provisions of 10% mark-up, then the company may have an incentive to comply with the safe harbour provisions and the remaining 5% will be shifted to a low tax jurisdiction. This will result in significant revenue loss for the country offering the safe harbour provisions. (OECD, 2013:8.)

The income-shifting concerns could be avoided by means of adopting the safe harbour provisions on a bilateral or multilateral basis. This could limit the application of the safe harbour provisions to transactions involving countries with the transfer pricing concern regarding to income-shifting. The tax administrations must be aware that the establishment of an extensive network of the bilateral or multilateral safe harbour provisions could potentially encourage 'safe harbour shopping'. The taxpayers could direct certain transactions to countries identified as having favourable safe harbour provisions. (OECD, 2013:8 and PwC, 2013:2.)

It is the country's decision if it is prepared to suffer some erosion of its own tax base when implementing the safe harbour provisions. The basic trade-off in order to make such decision is the certainty and the administrative simplicity of the safe harbour provisions for the taxpayers and the tax administrations, and the possibility of tax revenue erosion. (OECD, 2013:8.)

The simplified approach such as a safe harbour provision for low value-adding intra-group services could create tax planning opportunities for taxpayers, as the taxpayer could be incentivised to break the transactions up to fit within the scope of the safe harbour provisions (OECD, 2013:6-8). This could result in potential loss in the tax revenue for the tax administrations offering the safe harbour provisions for low value-adding intra-group services.

4.2.3.4. Equity and uniformity issues

The safe harbour provisions process may raise equity and uniformity issues. By implementing the safe harbour provisions, a tax administration may create two distinct sets of transfer pricing rules. The tax administration should clearly and carefully design the applicable criteria to differentiate those taxpayers that are eligible for the safe harbour provisions and those taxpayers not eligible for the safe harbour provisions. The tax administration should undertake certain process to minimise the similar taxpayers or possibly competing taxpayers finding themselves on opposite sides of the safe harbour threshold. The insufficiently precise criteria may cause similar taxpayers to receive different tax treatment, for example:

- One taxpayer is permitted to meet the safe harbour rules and the tax administration relieves the taxpayer from general transfer pricing compliance provisions.
- The tax administration obligates the other taxpayer to price its transaction in conformity with the general transfer pricing compliance provisions instead of using the safe harbour rules. (OECD, 2013:8-9.)

The revised Section E on safe harbour provisions in Chapter IV of the *OECD Guidelines* concluded that the preferential tax treatment under the safe harbour rules for a specific category of the taxpayers could potentially lead to discrimination and competitive distortions. By adopting the bilateral or multilateral safe harbour provisions could increase the potential of a divergence in tax treatment. (OECD, 2013:9.)

The taxpayers can only apply the simplified approach such as a safe harbour provision for low value-adding intra-group services, if the services comply with the definition set out in Action 10 of the *BEPS Action Plan*. The Action 10 of the *BEPS Action Plan* further provides a list of services that would likely meet the definition of low value-adding intra-group services for the application of simplified approach (OECD, 2015b:154). Therefore, the simplified approach such as a safe harbour provision for low value-adding intra-group services would not raise equity and uniformity issues.

4.2.4. Bilateral safe harbour provisions

The revised Section E on safe harbour provisions in Chapter IV of the *OECD Guidelines* contains three samples of memorandum of understanding that the country competent authorities may use to negotiate the bilateral or multilateral safe harbour provisions involving low risk functions (OECD, 2013:7).

The countries' competent authorities could adopt the safe harbour provisions under Article 25(3) of the *OECD Model Tax Convention* on a bilateral or multilateral basis if the conditions and circumstances so allow (OECD, 2013:11). According to OECD (2014b:39), Article 25(3) provides:

> 'The competent authorities of the Contracting States shall endeavour to resolve by the mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.'

The basic benefit of adopting a bilateral approach to the development of the safe harbour provisions are as follows:

- The memorandum of understanding is a bilateral approach executed through competent authorities. This could increase the possibility that safe harbour provisions do not result in double taxation or double non-taxation.
- The bilateral safe harbour provisions could be tailored to the economics of a particular market and circumstances and the bilateral safe harbour provisions are compatible with the arm's length principle.
- The countries could enter into the bilateral safe harbour provisions on a selective basis with similar tax rates. This could minimise the opportunities for transfer pricing manipulation and limiting the application of the safe harbour provisions to situations where transfer pricing risk is quite low.
- The bilateral safe harbour provisions could initially be limited to small taxpayers and small transactions so the countries could reduce it transfer pricing litigation exposure.
- The safe harbour provisions adopted by the competent authorities through the memorandum of understanding could be reviewed and modified from time to time. This arrangement can assure that the safe harbour provisions stay up to date to reflect developments in the broader economy.
- The developing countries might experience serious resource constraints. The bilateral memorandum of understanding entered into with the treaty partners could protect these developing countries' tax base. (OECD, 2013:11-12.)

The Action 10 of the *BEPS Action Plan* in relation to low value-adding intra-group services is soft law legal instrument and it is not legally binding, but there is an expectation that the countries, members and non-members of the OECD, will implement accordingly (OECD, 2015d:5). Currently, there is uncertainty when and which countries will adopt the safe harbour provisions

for low value-adding intra-group services. Therefore, by adopting the bilateral or multilateral safe harbour provisions for low value-adding intra-group services could mitigate the risk of double taxation or double non-taxation (OECD, 2013:9).

4.2.5. Recommendations on use of the safe harbour provisions

The transfer pricing compliance and administration could be complex, time consuming and a costly exercise. The safe harbour provisions could provide benefits of compliance relief, administrative simplicity and greater certainty to the taxpayers. (OECD, 2013:9.)

The *OECD Guidelines* state that the application of the safe harbour provisions may raise number of tax issues such as:

- The safe harbour provisions could potentially create perverse effects on the pricing decision of enterprises engaged in controlled transactions.
- The safe harbour provisions could have negative impact on the tax revenues of the country implementing the safe harbour provisions, as well as the tax revenues in the other countries, where the associated enterprises engage in controlled transactions with taxpayers electing the safe harbour provisions.
- The unilateral safe harbour provisions could lead to the potential risk of double taxation or double non-taxation. (OECD, 2013:9.)

However, in cases that involve smaller taxpayers or less complex transactions, the benefits of having the safe harbour provisions may outweigh the problems of double taxation or double non-taxation. Making safe harbour provisions elective to taxpayers could further diverge from an arm's length pricing. The countries adopting the safe harbour provisions should be willing to modify the safe harbour outcomes in the mutual agreement proceedings in order to limit the potential risk of double taxation. (OECD, 2013:9.)

The countries could negotiate safe harbour provisions on a bilateral or multilateral basis. The bilateral or multilateral safe harbour provisions could provide significant relief from both compliance burdens and administrative complexity, and would also eliminate the problems of double taxation or double non-taxation. The *OECD Guidelines* encourage to use the bilateral or multilateral safe harbour provisions under the right circumstances. (OECD, 2013:9.)

The *OECD Guidelines* clearly indicate that whether adopting the unilateral or bilateral safe harbour provisions, it is not a binding provision for countries which have not themselves adopted the safe harbour provisions. The *OECD Guidelines* further indicate that the safe harbour provisions cannot be used to determine the arm's length pricing for more complex and high risk transfer pricing matters. (OECD, 2013:9.)

The *OECD Guidelines* conclude that the country tax administrations should carefully weigh the benefits of application of the safe harbour provisions and its concerns regarding the safe harbour provisions. The country tax administrations should make use of the safe harbour provisions when they deem it to be appropriate. (OECD, 2013:9.)

The simplified approach such as a safe harbour provision for low value-adding intra-group services could provide benefits of reducing compliance burdens, providing greater certainty for taxpayers and administrative simplicity for the tax administrations (OECD, 2015b:156). The safe

harbour provisions for low value-adding intra-group services could potentially create perverse effects, but by adopting the bilateral or multilateral safe harbour provisions for low value-adding intra-group services could outweigh the problems.

4.2.3. Application of the safe harbour provisions in other countries

There are number of countries that have successfully adopted the safe harbour provisions in relation to certain intra-group services such as Australia, New Zealand, Singapore, Hungary and US (Cooper et al, 2016:208). Such safe harbour provisions represent a compromise between the potential risk to revenue and the compliance burden imposed on the taxpayers and the tax administrations would be required to determine and support the acceptable mark-ups (Cooper et al, 2016:208). South Africa could also consider applying the safe harbour provisions for low value-adding intra-group services. The table shows the applicable safe harbour rules:

Country	**Safe harbour rules**
Australia	7.5% mark-up (or a markdown of 5%) on the non-core services and in *de minimis* cases, provided that certain conditions are met. Increased to 10% mark-up with additional documentation (Cooper et al, 2016:208 and Deloitte, 2009:18).
New Zealand	7.5% mark-up (or a markdown of 5%) on the non-core services, provided that certain conditions are met. Increased to 10% mark-up with additional documentation (Cooper et al, 2016:208 and Deloitte, 2009:18).
Singapore	5% mark-up on routine services provided by the parent or a group service company for the reasons of business convenience and efficiency (Cooper et al, 2016:208 and Deloitte, 2009:18).
Hungary	3% to 7% mark-up for transactions that do not exceed Hungarian Forint 150 million, 5% mark-up of the service provider's net income, 10% mark-up of the recipient's operational costs and expenditures in the relevant year. Provided that certain conditions are met for low value-adding services (Cooper et al, 2016:208 and Deloitte, 2009:18).
US	Under services cost method, certain low margin services may be compensated on the basis of cost without a mark-up, provided a range of conditions is met (Cooper et al, 2016:208 and Deloitte, 2009:18).

4.3. Conclusion

The Action 10 of the *BEPS Action Plan* introduces an elective and simplified approach as a safe harbour provision for low value-adding intra-group services (OECD, 2015b:141). South Africa follows Chapter VII of the *OECD Guidelines* when determining the arm's length price for intra-group services (SARS, 1999:34). The current South African transfer pricing guidance under *Practice Note 7 of 1999* is outdated, the Commissioner is working to include new guidance on the arm's length principle stated under the Action 8-10 of the *BEPS Action Plan* (National Treasury, 2017:137). However, the Commissioner does not indicate whether the new transfer pricing *Practice Notice* will apply the simplified approach for low value-adding intra-group services under the Action 10 of *BEPS Action Plan*. The purpose of the comparison between the South African transfer pricing legislation and the Action 10 of the *BEPS Action Plan* is to identify any

improvements that can be made to the South African transfer pricing legislation for intra-group services.

South Africa should improve its transfer pricing *Practice Note* by adopting the safe harbour provisions for low value-adding intra-group services. The safe harbour provisions offer essentially benefits of compliance relief, certainty and administrative simplicity to both taxpayers and tax administrations (OECD, 2013:9). Even though the application of the safe harbour provisions could raise number of concerns, for example, divergence from the arm's length principle, the risk of double taxation or double non-taxation, the possibility of opening avenues for tax planning and the equity and uniformity issues (OECD, 2013:6), but by adopting the bilateral or multilateral safe harbour provisions could mitigate the risk of double taxation or double non-taxation (OECD, 2013:9).

5. Chapter 5 – Conclusion

This chapter concludes on the findings of this research report and proposes areas requiring further research.

The literal wording of the South African transfer pricing legislation in s 31 of the Income Tax Act has changed significantly in 2012. *Practice Note 7 of 1999* issued by SARS in 1999 indicates that South Africa follows Chapter VII of the *OECD Guidelines* when determining the arm's length price for intra-group services. In 2017 *Budget Review*, the South Africa's Minister of Finance indicates that SARS is updating *Practice Note 7 of 1999* to include new guidance on the arm's length principle set out in Action 8-10 of the BEPS Action Plan (National Treasury, 2017:137). Currently, there is lack of guidance from SARS regarding to the practical implications of the amendments in s 31 of the Income Tax Act. In addition, there is lack of indication from SARS when the revised version of *Practice Note 7 of 1999* will be issued, whether South Africa will follow the modification of Chapter VII of the *OECD Guidelines* set out in Action 10 of the *BEPS Action Plan,* and whether South Africa will adopt the simplified approach such as a safe harbour provision in relation to low value-adding intra-group services under Action 10 of the *BEPS Action Plan.*

The South African transfer pricing guidance should be improved by incorporating the modification of Chapter VII of the *OECD Guidelines* under Action 10 of the *BEPS Action Plan* for intra-group services in the revised version of *Practice Note 7 of 1999*, as the amendments of existing Chapter VII of the *OECD Guidelines* could provide certainty and clarity in relation to the treatments of intra-group services for both taxpayers and SARS (OECD, 2015c:200).

The question raised is whether South Africa should improve its transfer pricing guidance by adopting the simplified approach such as a safe harbour provision in relation to low value-adding intra-group services. As a result of increase in globalisation, the international trade has grown exponentially in South Africa therefore the protection of the South African tax base and the protection against common types of base eroding payments through excessive management fees and head office expenses are important to South Africa's wealth and development (SARS, 1999:5-6 and OECD, 2015b:141). Therefore, South Africa could improve its transfer pricing guidance by adopting the simplified approach as a safe harbour provision for low value-adding intra-group services, as the goal of the Action 10 of the BEPS Action Plan is to achieve a balance between appropriate charge for low value-adding services and head office expenses as well as provide protection of the tax base of the payor countries (OECD, 2015b:141).

In current practices, there are number of countries that have successfully applied simplification measures for low value-adding intra-group services such as Australia, New Zealand, Singapore, Hungary and US (Cooper et al, 2016:208). Therefore, South Africa could consider to adopt the safe harbour provisions for low value-adding intra-group services.

The benefits of adopting the safe harbour provisions for low value-adding intra-group services are as follows:

- The safe harbour provisions reduce the compliance burden and the compliance costs for eligible taxpayers as the general transfer pricing compliance could be complex, time consuming and costly (OECD, 2013: 5-9).
- The safe harbour provisions provide assurance to eligible taxpayers that the price charged or received on low value-adding intra-group services will be accepted by the tax authority without any scrutiny (OECD, 2013:5).

- [SARS] could secure it tax revenue in low risk transactions and allocate more administrative resources to examine more complex or higher risk taxpayers and transactions (OECD, 2013:5).

The application of the safe harbour provisions for low value-adding intra-group services could also raise various concerns, for example, the divergence from the arm's length principle, the risk of double taxation or double non-taxation, the possibility of opening avenues for tax planning and the equity and uniformity issues (OECD, 2013:6). South Africa could also improve its transfer pricing guidance by adopting the bilateral or multilateral safe harbour provisions as this could eliminate the risk of double taxation or double non-taxation (OECD, 2013:9). However, the benefits of adopting the bilateral or multilateral safe harbour provisions for low value-adding intra-group services may outweigh the problems of the safe harbour provisions.

This research report does not contain a detailed discussion with regard to other South African tax implications, for example withholding taxes, income tax and value-added tax, as well as the South African exchange control regulations. These are possible areas for further research in relation to low value-adding intra-group services.

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