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

A COMPARATIVE ANALYSIS: SOUTH AFRICAN TRANSFER PRICING REGIME IN RELATION TO OTHER DEVELOPING AFRICAN COUNTRIES

By

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APRIL 2020

DECLARATION

I declare that "**A Comparative analysis: South African transfer pricing regime in relation to other African developing countries"** is my own work and that all the sources that I have used or quoted have been indicated and acknowledged by means of complete references. This research report is submitted for the degree of Master of Commerce (specialising in Taxation) at the University of the Witwatersrand, Johannesburg. It has not been submitted for any other degree or examination at any other university.

_____

Signature

18 April 2020

Date

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ABSTRACT

The desire by African countries to grow their economies has led to majority of the developing African countries opening their trading boarders to the world with an objective to attract foreign investments. In recent years Africa has seen major investments by multinational corporations that resulted in growth in international transactions (i.e. the cross-border intercompany transactions) by the affected multinational corporations. These investments have also presented the continent with challenges relating to transfer pricing manipulations by the same multinational corporations.

The tax base erosion in developing countries has led to a rise in the number of regulations implemented by different countries which are aimed at dealing with transfer pricing as over the past years, transfer pricing has become increasingly important to those companies with cross-border intercompany transactions due to the complexities of transfer pricing regulations. The continuous changing transfer pricing environment also makes it challenging for multinational companies to comply with the requirements and manage their transfer pricing position. The laws and regulations on transfer prices need to be designed in such a way that they do not result in the continent losing on foreign direct investment which the countries need.

The aim of this dissertation is to provide the comparative analysis on the adequacy and the readiness of the South African transfer pricing regime in relation to other developing African countries with the focus on detail analysis of the current SA transfer pricing regime, the challenges currently being faced by the country in relation to other countries and lastly provide the recommendation that can be applied to address these challenges.

Key words: Arm's length, arm's length price, arm's length principle, Arm's Length Standards (ALS), Base Erosion and Profit Shifting (BEPS), controlled transactions, cross-border transactions, developing countries, Income Tax Act, Kenya, Multinational Corporations (MNCs), Organization for Economic Co-operation and Development (OECD), related parties, South Africa, South African Revenue Service (SARS), Tanzania, transfer pricing, uncontrolled transactions

LIST OF ABREVIATIONS AND ACRONYMS

The following abbreviations and acronyms are used in this research:

ALP- Arm's Length Principle
ALS – Arm's Length Standard
APA – Advanced Pricing Agreement
ATAF – African Tax Administration Forum
BEPS – Based-Erosion and Profit-Shifting
CbCRs – Country-by-Country Reporting
CUP - Comparable Uncontrolled Prices
IPR – Intellectual Property Rights
KRA – Kenya Revenue Authority
LDCs – Less Developed Countries
MDGs – Millennium Development Goals
MNCs – Multinational corporations
OECD – Organization for Economic Co-operation and Development
PE – Permanent establishment
PwC – PricewaterhouseCoopers
SARS – South African Revenue Service
TNMM - Transactional Net Margin Method
TRA – Tanzania Revenue Authority
TP -Transfer Pricing
UK – United Kingdom
UN – United Nations
USA – United States of America

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CHAPTER ONE

INTRODUCTION

1.1.Background

For many years the global innovation, growth, and government revenues have been the important sources by the multinational corporations. As the number of international trades between the companies within the same group of companies grows, the scope of these companies to exploit the national tax systems between countries and to reduce the tax bills also expands and as a result the tax bases and the tax system fairness in the countries being exploited are undermined. (Cooper, Fox, Leoprick & Mohindra 2016)

The transfer mispricing challenges due to profit shifting is one of the issues in economies that are still developing that requires attention as the corporate tax in developing countries accounts for the large share of the revenue generated by the receiver of revenue. (Cooper et al. 2016)

In recent years the developing African countries have attracted more foreign investments from the multinational corporations as they are rich in resources such as gas, oil and minerals like platinum, gold, diamond etc, however the increase in foreign investments do not seem to be translating into economic growth for the developing countries.

The investments by multinational corporations in the African sub-regions have been criticised globally that that they are not motivated by fair-trade that would see both the multinational corporations and African developing countries. The foreign investments in the African continent have been seen to be benefiting the MNCs than the African regions. (Sikkaa & Willmott 2010)

It cannot be argued that developing countries would like to protect their tax bases whilst ensuring that the foreign direct investments held in their countries are not negatively impacted. Due to the use of complex structures that MNCs to avoid paying tax in some jurisdictions using transfer pricing that has resulted in tax revenue losses as the developing countries are under-resourced countries which has resulted in majority of the developing African countries not being able to receive their rightful tax revenues. (Silberztein 2010)

In 2015 Hattingh reported that the efforts made that South Africa to develop legislation that extensively address transfer mispricing and behaviour on tax abuse did not bear any fruitful results due to the limited resources currently at the transfer pricing department at SARS. (Hattingh 2015)

1.2. Objectives and research questions

This research aims to address the impact of the tax revenue losses growth due to the international transfer pricing manipulations by the multinational corporations in South Africa when comparing it to other developing African countries.

The risks include the failure by the existing legislations to address the challenges that are caused by the application of the arms' length principle to arrive at the arm 's length price and the failure to address the challenges faced as are result of the growth in foreign investments by multinational corporations.

At the end of this research report the following problems would have been addressed:

1.2.1. What can South Africa and other African countries do differently to what has been done in the past to address the challenges that they are facing in relation to transfer pricing?

- In finding the solutions to what South Africa and other African countries can do differently to address the issues faced regarding transfer pricing. This research will outline an analysis of the transfer pricing regimes in South Africa, Kenya and Tanzania as these are the countries that are being compared in this study.
- The transfer pricing regulations are set out in the *Income Tax Act, 58 of 1962, Republic of South Africa; Income Tax Act, Chapter 332, The United Republic of Tanzania and Income Tax Act, Chapter 470, Republic of Kenya.*

1.2.2. These countries have been studied and focus on the arm's length principle, business principle and different methods to determine the arm's length price and how each of the three countries addresses the transfer pricing issues that they are currently faced in these countries.

1.2.3. What structures are used by the multinational corporations to shift the profits from the developing African countries to low or no tax jurisdictions?

The following topics will be studied in obtaining a broader understanding around the structures used by the MNCs to shift profits out of the African countries:

- reasons why multinational corporations engage in transfer pricing manipulation
- purpose of tax havens
- different transfer pricing manipulation schemes such as use of management fees, use of special conduit, thin capitalisation, under-or-over pricing of pricing and invoices and the use of intellectual property rights.

1.2.4. Is the South African Transfer Pricing regime adequate to address the transfer pricing?

After analysing the SA transfer pricing regime against the two East-Africa countries being Kenya and Tanzania this research will draw a conclusion as to whether the current SA transfer pricing regime is adequate to address the current and any future challenges that the country will experience.

1.3. Research methodology

The research methodology followed in this dissertation is the qualitative and interpretive based on the extensive literature review (including the historical review). An analysis is undertaken to determine the challenges that developing countries and the steps that are necessary to address the challenges impacting the developing countries.

1.4. Scope and limitations

The research report is focused specifically on transfer pricing in developing countries from an income tax point of view. The developing countries that will be considered in comparison to South Africa are Kenya and Tanzania due to the fact that the tax legislation in Kenya provides for the comprehensive transfer pricing rules and it is considered to be highly experienced in transfer pricing and the selection of Tanzania is mainly due to the fact that Tanzania is one of the African countries that continues to invest in its transfer pricing rules and in recent years it was seen as the country that has progressed on its transfer pricing regime over and above just the general arm's length anti-avoidance rules.

1.5. Chapter outline

The research report will consist of eight (8) chapters as outlined below:

Chapter one (1) - Introduction

Chapter one will provide the problem, the background to the problem and the research questions that will be addressed in the research.

Chapter two (2) - Historical review of transfer pricing

Chapter two will present the historical review of transfer pricing review by a few scholars who have looked at the issues that developing countries in Africa are facing with regards to transfer pricing in the previous years.

Chapter three (3) - Transfer pricing concepts and theories

Chapter three will provide an overview on the concepts and the theories of international transfer pricing ,this chapter will also presents the concept and theories around the existence of multinational corporations with details around the principles such as arm's length, residence

principle, business profits, methods to determine transfer pricing methods as well as the transfer pricing manipulation schemes used by the multinational corporations are provided.

Chapter four (4) – Overview of South African transfer pricing

Chapter four will explains South African transfer pricing where it outlines an overview from the South African Income Tax Act perspective, challenges or shortcoming with the current legislation, and the impact of such challenges.

Chapter five (5) – Transfer pricing in other developing African countries

Chapter five presents the overview of transfer pricing in developing African countries, the importance of transfer pricing in developing countries within the African continent, common challenges that are currently being faced as well as the current strategies in place aimed at dealing with the transfer pricing challenges that are being encountered.

Chapter six (6) – Kenya and Tanzania transfer pricing regime

Chapter six details the transfer pricing regimes in Kenya and Tanzania with consideration given to the current laws and regulations governing the setting of the transfer price by the multinational corporations engaging in cross-border transactions with these countries.

Chapter seven (7) –Comparative analysis of South Africa, Kenya and Tanzania

Chapter seven will provide a comparative analysis on the adequacy of the transfer pricing in South as discussed in chapter four (4) against Kenya and Tanzania details as set out in chapter six. This chapter will also present recommendations of what can still be done in the future to address the challenges that some developing countries within the African continent continues to face regarding transfer pricing with specific consideration given to South Africa.

Chapter eight (8) – Conclusion

Chapter 8 will outline the key findings from this research report and any recommendations that are proposed from this study.

CHAPTER TWO

HISTORICAL REVIEW OF TRANSFER PRICING

Both developed and developing countries continues to face the transfer pricing challenges that arises from the profit-shifting to no or low tax countries. As the transfer pricing issues are global concern scholars have tackled this subject matter with the aim to assess the adequacy of the existing laws aimed at dealing with transfer pricing manipulations by MNCs.

This chapter looks at some of the scholars that have written on the matter and the conclusions drawn from their analysis.

McLure pointed out that the existence of transfer pricing and availability of the tax havens has resulted in majority of the countries that are less developed to be able to raise revenue from their corporate taxes. In 2004 in his analysis he outlined the four reasons that has led to the suffering of the developing countries because of transfer pricing. The four reasons were namely: (McLure 2004)

- inadequate transfer pricing laws and regulations to deal with the problems surrounding transfer pricing;
- lack of administrative capacity to enable the countries to deal with the issues despite having the legal framework to monitor the existence of transfer pricing.;
- tax administrators in the countries that are less developed do not have the evidence that is relevant to prove the comparable uncontrolled transactions and profitability;
- developing countries have unresolved transfer pricing cases that takes long to be closed and settled which leads to these countries being uninterested in solving them.

Supporting what McClure detailed in his research, the report by PricewaterhouseCoopers in 2011 outlined that due to the lack of technical experience, lack of capacity and the resources necessary conduct the processing and evaluation of the relevant transfer pricing information and as result the developing countries will not be able to enforce the existing documentations that may be in place in their respective legislations. (PwC 2011

Borkowski argues that the consequences on the developed and developing economies are as a result of transfer pricing manipulation. Her argument was that the problem is mainly due to what the is deemed to be the acceptable method to determine the transfer price between MNCs. The abilities by the United Kingdom (UK) and United States of America (USA) to have their own view on what they deem to be the appropriate methods and the risks audits that are conducted in those countries have worked in their favour according to Borkowski.

She further emphasised that having rigorous and detailed regulations to deal with transfer pricing does not exempt the developed countries from the transfer pricing manipulation however the

developing countries were impacted the most as they are not determined enough to deal decisively with the transfer pricing with the fear that they may discourage foreign investments and their inability to assess and determine the extent of transfer pricing problems due to the inability to gather evidence to assist in the determining the appropriate profit or loss resulting from the cross-border transactions which makes it hard to ascertain the actual tax liability. (Borkowski 1997)

In 2012 Nyamori published the journal named '*An Analysis of Kenya's Transfer Pricing Regime, International Transfer Pricing'* which provided an analysis on the effectiveness of the transfer pricing regime in Kenya. Nyamori analysed the decision reached in the *Unilever Kenya Ltd v the Commissioner of Income Tax* case. In the Unilever case the judge has applied the OECD guidelines to deal with the matter at hand as Kenya did not have the guidelines to deal with this matter. Nyamori argued that due to Kenya not being the member of the OECD in 2012 they could not be part of the formulation and the drafting of the OECD guidelines. Nyamori was of the view that the court should have considered the substantive Kenyan laws and provisions that deals with transfer pricing that were in existence at the time of the case prior to them applying the foreign jurisprudence. (Nyamori 2012)

His argument also detailed that the transfer pricing rules in Kenya which were in place in 2012 to deal with transfer prices were not without problems as they failed to make the documentation requirement mandatory and due to the rules being a subsidiary legislation, they weren't able to override the existing Income Tax Act in Kenya.

He concluded that due to the scarcity of the experts to deal with transfer pricing complexities and lack of comparable data to determine the price that is considered to be at arm's length complexity of transfer pricing with scarcity of its experts and lack of comparable data for determining the arm 's length hinders the efforts to alleviate the manipulation of transfer pricing by MNCs. (Nyamori 2012)

A study by Weston in 2010 revealed that transfer pricing documentation in South Africa differed from company to company, and in most cases, was based on what the companies felt to be important. In addition, the study says that taxpayers in most instances do not understand the reasons for documentation, including the goals and objectives. (Weston 2010)

CHAPTER THREE

OVERVIEW OF TRANSFER PRICING CONCEPTS AND THEORIES

3.1. Introduction

For the associated MNCs that are operating in different countries, the transfer pricing is deemed to be the corner stone. Companies need to take into consideration various issues when determining the transfer price. This chapter is aimed at providing an overview of transfer pricing, transfer pricing principles in general are revisited with the key consideration being given to the overview around the multinational companies, the transfer pricing manipulation schemes that are applied by the MNCs to achieve transfer mispricing, arm's length principle, residence principle, business profits and lastly the transfer pricing methods that are generally applied.

3.2. Understanding transfer pricing

In his research in 2000 Hines defined transfer pricing as the price that is charged on the sale of goods and services between parties that are related who could be located domestically or internationally. Globally, the Cross-border transactions have given rise to transfer pricing manipulation, these manipulations see multinational corporations arranging their transactions in such a way that the revenues are moved illegally and taxed in favourable jurisdictions to reduce their tax burdens. (Hines 2000)

Transfer pricing can also be referred to as the mechanism by which the price on the cross-border intra-company transactions are set. MNCs have adopted the operation in which they determine which entities within the group of companies are profit or loss-making. There have been instances where the method used to determine the price of the transactions does not reflect the true value of the transactions and as a result the profits are shifted to no or low tax jurisdictions and the losses derived from some parts within the good are shifted to high tax jurisdictions. Such acts are unfair as they deprive the country of its tax revenue and the reduction of the amount of resources for development objectives funding. (OECD 2013)

The transfer pricing regulations on transfer pricing are aimed at ensuring that there is accuracy and fairness in the transfer pricing among the entities that are related. The regulations that are in place in different countries enforce the arm's length transaction rules that requires that the companies within the same group of companies set their transactional pricing based on similar transactions done between unrelated parties. Transfer pricing is regarded as one of the major issues in cross-border transactions as there is an estimate of about 60 percent of the international trade consisting of transfers between connected persons. (Mboweni 2019)

In a modern economy where several related MNCs is increasing with globalization transfer pricing is corner stone of all the cross-border transactions. Traditionally transfer pricing was defined as an act of setting the price of goods and services between associated multinational corporations but as the world

evolved different researchers went on to have different meanings assigned to tis terminology. Some scholars view transfer pricing as the means of manipulations by the MNEs to maximise profits while others view it as measures for the government to obtain revenue through the prices that are at arm's length. (Kiunsi 2017)

Multinational corporations and transfer prices cannot be separated. With different countries imposing different income tax rates results in MNCs seek to find strategies that will assist in the reduction of the group tax liabilities through the transfer prices manipulation. Most tax authorities view the transactions between multinational corporations with suspicion as such transactions have always been perceived as the abusive income-shifting between the related tax papers. (Azemar & Corcos 2009)

Developing African countries cannot address the transfer pricing challenges without an understanding of the nature of how the multinational corporations operates and the transfer mispricing or misquoting schemes that are currently being utilised by the MNCs to shift profits from developing countries to no or low tax jurisdictions.

The sections below outline further the nature of the corporations which are regarded as multinational corporations, reasons MNCs engage in transfer pricing and different manipulation schemes that are used to achieve the transfer mispricing and more information regarding arm's length principle.

3.3. Multinational corporations

The multinational corporations are defined as the business organizations where the activities and business operations are in more than two countries. MNC can also be referred as the organizational form that defines the foreign direct investment. Where the MNC exist the country of location where the holding/parent company is incorporated and of those subsidiaries in the foreign countries. As the multinational corporations vary in terms of the multinational activities, number of companies in the same group, number of countries in which the companies are operating, number of employees etc. (Lazarus 2001)

The emphases are given economically to the owners' ability to control the operations in the foreign countries. There confusion frequently equates the ability to control and the capital flow across the national borders. (Lazarus 2001)

Most companies within the same group of companies usually opt for the structures which often sees the ultimate parent companies controlling the operational companies' structure. The parent company sees the ultimate company controlling the functions, the multinational group structure and the capital decision making. (Kiunsi 2017)

As the functions concerning the multinational companies are generally carried at different locations which could range from procuring materials, productions, sale and the distribution of goods and services. Other functions that would be controlled at the group level would include services such as

services functions (i.e. Human resources, marketing, finance), research and development functions which are integrated and expanded to other various multiple locations forming part of the same group of companies.

Multinational companies play a very important role in international trade. The transactions between MNCs and unrelated buyers amounts to the substantial amount but on the same breath the transactions within the MNCs is also considerable. (Ngundi 2009)

The environment in which the multinational corporation needs to develop processes to allocate the costs and overheads in the estimation of the transfer prices for goods and services. The cash flows, the goals around marketing, economic scale and economic advantages in their divisions, Joint ventures (JV) and subsidiaries should be used to measure the accounting and taxable profits. The setting of the environment and the allocation the costs and determine the transfer pricing is the discretion of the ultimate holding company and due to this discretion, the corporations can ensure that the business strategies are designed in such a way that the profits are shifted to no or low tax and risk jurisdictions. (Ngundi 2009)

The conditions surrounding the commercial and financial relations are usually driven by the market forces when the unrelated enterprises are dealing with each other. When the related companies are dealing with each other are not driven by the external forces, and due to the MNCs not being keen on the adopting the independent market forces. Because the related enterprises do not determine the transfer pricing considering the market prices the revenue authorities pays attention to such transactions to ensure that the transfer pricing risks are addressed. (Feinschreiber & Kent 2008)

3.4. Reasons for multinational corporations to engage in transfer mispricing

Transfer pricing is not considered to be illegal and the only time the use of transfer pricing can be deemed to be illegal it is when it is being used to derive the tax benefits in way that is being deemed abusive and misleading. Transfer pricing can be used in some instances by multinational corporations as tax avoidance schemes to benefit without facing any criminal consequences if it is used within the confines of law.

There are many reasons why multinational corporation would engage in transfer pricing however for the purposes of dissertation the focus is drawn on the managerial and financial motivations that drive MNCs to conduct such transfer pricing acts.

Van der Zwan in his research in the field of business and financial management he suggests that multinationals have both managerial and financial motivations when determining transfer price between companies within the same group of companies. Some of the motivations by management to engage in

transfer pricing includes but not limited to minimizing of the tax liabilities and achieving goal congruence. (Harmse & van der Zwan 2016)

3.4.1. Internal motives – performance management and evaluation

The ultimate objective of any company big or small is to maximize profits and the same with the multinational companies they want to make profits as opposed to merely a good performed of each component within the group. Achieving group profits requires that the performance be managed from the bottom of the group (division level) up to the ultimate holding company and this should entail assessments and evaluations of the performance of divisions and division managers individually to ensure that alignment is achieved in the process. For the performance management and evaluation to be successfully achieved each component's profits should be assessed as an individual against the rest of the group and additionally the group need to ensure that the negotiations around the transfer price needs to be independently assessed to ensure that the prices that are considered to be arm's length within the group approximate the market-related value. (Harmse & van der Zwan 2016)

Feedback from the assessment that concluded on the certain price to be set as arm's length is not on itself enough to support that the price is indeed at arm's length. The company ultimate motivation to maximize profits has an impact on the company's objectivity when it comes to determining the transfer price and as such there may be instances where the performance management and evaluation is conducted in such a manner that will place the company in a position where the overall tax liabilities are lower than what it would have been had an independent assessment of the transfer price set done as the many MNCs conclude agreements that influence the profit , capital and cash flow allocation across all the component to achieve high profits while minimizing the tax liabilities. (Harmse & van der Zwan 2016)

3.4.2. Operational Objectives

(a) Entry to the market

As multinational companies consist of many companies/ legal entries established and operating in multiple locations in different countries, the research conducted by Harmse and van der Zwan in 2016 found that the objective by MNCs to establish subsidiaries is to enter into a new market to be able to charge low transfer prices within the group. This strategy is the form to reduce the current profits with the expectations to have profits increase in the future as the profits will be shifted within the group from high tax paying countries to no or low paying countries profits. (Harmse &van der Zwan 2016)

(b) Efficiency considerations

Multinational corporations usually promote this motive to achieve efficiencies within the group. This strategy is done in such a way that the new companies that are established and enter the market within the same group of companies the market leader gain an advantage to charge prices reductions to companies within the same group when the demands and market decline in the area where the members of the MNCs are declining. The decisions to reduce prices within the same group of companies are made at the head office where the operating strategies are made. (Harmse & van der Zwan 2016)

(c) Minimizing the exchange rate risk

As MNCs transact internationally they are exposed to the exchange rate fluctuations. Multinational corporations can set transfer pricing in such a way that it minimizes or eliminates any risks associated with the volatility of the exchange rate. Over the years transfer pricing has been used as an effective way to minimise the losses as a result of the foreign exchange currency fluctuations. (Mboweni 2019)

(d) Cash flow management

This motive entails the shifting of funds from one company to another within the same group of companies that are operating in different countries. Mboweni believes that MNCs shifts funds due to the operational risks that the domestic countries face, uncertainly around the politics such as the issue in South Africa relating to the expropriation of land without compensation and the nationalisation of banks and mines and as a result the companies are driven to move their funds to countries that they consider to the investment friendly and are politically stable (Mboweni 2019). Developing countries are also not sleeping on this issue as they have over the years introduced the regulations that restrict MNCs from shifting profits, management fees and royalties.

3.4.3. Different corporate income tax rates

Due to different countries charging different corporate or income tax rate there has been opportunities that have been presented to multinational corporations to explore various options to find themselves making high profits in one jurisdiction but having those high profits being taxed in a no or low tax country. In recent years, many companies operating as multinational have found themselves on the wrong side with the tax authorities as a result of them repatriating profits from one company within the same group of companies operating in a high tax rate country to a country which is a low tax rate country. The discovery by the tax authorities has proved that MNCs shifts profits mainly to achieve a tax benefit and had nothing to do with achieving a business objective.

3.4.4. Tax havens

As discussed in 3.4.3. most of the manipulation of transfer pricing by multinational corporations is committed through the shifting of revenue or profits to no or low tax jurisdictions also known as tax havens.

MNCs can avoid taxes on a global scale by transferring profits to tax havens with the help of highly qualified and experienced legal and financial experts from major economic centres in the world.

The Business Tech in 2019 released the results that indicated the countries which have the highest profits shifted into due to them being the biggest tax havens in the world.

The table below ranks the jurisdictions that provides facilities that help multinational corporations escape tax (i.e. pay low or no tax). (Business Tech 2019)

Rank	**Country**	**CTHI Value***
1	British Virgin Island	2769
2	Bermuda	2653
3	Caymans Island	2534
4	Netherlands	2391
5	Switzerland	1875
6	Luxembourg	1795
7	Jersey	1541
8	Singapore	1489
9	Bahamas	1378
10	Hong Kong	1372
11	Ireland	1363
12	United Arab Emirates	1245
13	United Kingdom	1068
14	Mauritius	950
15	Guernsey	891
16	Belgium	822
17	Isle of Man	804
18	Cyprus	698
19	China	659
20	Hungary	561
21	Curacao	552
22	France	525
23	Malta	519
24	Germany	461

25	USA	408

*CTHI value represents the corporate tax haven index that ranks the tax havens in the world for multinational corporations. The countries are ranked in accordance to how aggressively and extensively each country contributes in helping the multinational enterprises escape paying tax and shifting of the tax revenues of other countries around the world.

Based on the above none of the African countries are regarded as low or no tax jurisdictions and as they are rich in minerals they attract more foreign investments by MNCs and gets impacted the most by the profit-shifting as majority of the European countries invests in the African continent with the intention to get the profits out of the continent and as a result they stand to lose the most from international tax avoidance given their main reliance on corporate income tax.

The main purposes of MNCs is to maximize profit and minimize tax. For that reason, most of them have been investing in low tax countries commonly known as tax havens. Tax haven was defined by in the PHD thesis written by Kiunsi in 2017 as a country which has a lower rate of taxation than in other countries and can also be referred to as the country which can finance its public services with no or nominal income taxes that actively makes itself prone to tax avoidance by non-residents that would have paid under a high tax rate. (Kuinsi 2017)

Kiunsi further outlined four elements in identifying the tax haven jurisdiction: (Kuinsi 2017)

- the income attracts no or low taxes;
- there is no effective exchange information about how the tax payer will benefit from low tax jurisdiction;
- no transparency in the operation of the legislation, legal or administrative provisions; and
- the requirements to substantiate qualifying activity is not available.

There are four reasons that makes the multinational corporations continue to advance their investments from the developing countries into the tax havens: (Kiunsi 2017)

- the tax havens countries have measures put in place to ensure that companies use to evade and avoid tax laws and regulations in other countries;
- no or low tax rates gives MNCs an advantage to minimize tax liability whilst making profits;
- banks and finance businesses in tax havens countries face less regulations on the supervision; and
- use of tax haven countries by tax planners to generate more profits for MNCs.

In addition to the above stated reasons the findings by Christian Aid reveal that in tax haven countries, there are no substantial economic activities that are carried on such that the associated corporations in tax haven jurisdiction are there for purposes of avoiding and evading tax (Christian Aid 2013) and in line with these findings, OECD points out that profit shifting issues arise when MNCs use existing loopholes, gaps, frictions or mismatch in interaction of the domestic laws of the country (OECD 2013).

Such situation is happening in tax haven countries because the laws are always made to contrast other country's tax laws. Thus, tax haven countries play significant role in transfer pricing by allowing profits to be made in such countries.

3.5. Transfer pricing manipulation schemes

In this section different transfer manipulation schemes that multinational corporations use is explored and discussed in detail.

As most of the multinational companies have funding their tax planning to avoid is done by qualified tax planners. The tax planners are mainly given a mandate to structure transactions in such a way that the gaps that exist in the country of interest where the entity would like to invest in are used to the advantage of MNCs to ensure that despite MNCs making revenues or profits in those countries the schemes in place achieve tax minimisation while banking a lot of profits from operations. According to Kiunsi most of the schemes that tax planners explore aim to reduce, defer or eliminate the overall tax without companies found to be breaking the tax laws. (Kiunsi 2017)

In most cases it has been found that strategies and structures that are put in place are complex and would be designed in such a way that the sole objective is to avoid tax rather than achieving business objective. The use of qualified and experienced lawyers and accountant has been found to be critical in MNCs achieving no or minimal tax in the domestic countries where they operate, and profits are generated.

Although lawyers and accountants play a major role in the tax planning, not all tax planning are transfer pricing manipulation. To ensure that no or minimal tax is paid by the MNCs there are different tax avoidance schemes that can be set up to manipulate transfer prices however the nature of the transactions involves guides how the scheme is set up as for example the management of management fees and invoicing for sale of goods and services cannot be treated the same way.

A critical area of reform facing many developing countries is to put measures in place that will curb aggressive tax planning and tax evasion. Tax planning, or tax avoidance refers to the use of legal methods to minimize income tax owed by multinational enterprises (MNEs). Where illegal ways such as the illegal mispresenting of the transactions are employed by MNEs to avoid or reduce their taxable

income knowingly and illegally misrepresenting their transactions, such act would be referred to as tax evasion. (Readhead 2016)

Transfer pricing manipulation is referred to as the process of setting prices that are not at arm's length for transactions that take place between companies within the same group of companies. Between companies that are associated this can be achieved through misrepresentations on the invoice (e.g. charging more expenses to reduce the profits, overcharging for goods or services that would not have necessarily been sold or performed. (Kiunsi 2017)

In some instances it is easy for multinational corporations to manipulate prices to avoid having maximum tax liabilities circumstances and this has been made possible by the tax planners as they get involved in the setting of the long complicated procedures to set-up prices that are not market related and when the tax planning and the calculations for the transfer pricing using the acceptable OECD methods are used the it is not easy for the tax authorities to identify the manipulation in the calculation and it is sometimes very hard to prove whether the price used by the MNC is at arm's length or not (Kiunsi 2017). It is even hard in South Africa since the documentation requirement differs from one taxpayer to the other.

Section 3.5 in this research looks at the under or over pricing of prices and invoices, use of special conduit entities, use of intellectual property rights, use of management fees and the thin capitalisation as the transfer pricing manipulation schemes that are mostly used by the multinational companies.

3.5.1. Under or over pricing of prices and invoices by MNCs

This scheme involves over or under pricing of goods transferred between companies within the same group with aim of misrepresenting and shifting profits. Over or under invoicing entails that invoices for goods and services transferred between related parties do not reflect the exact actual amount of transferred goods or services. For example, in under-pricing companies within the group can sell a product with the market price of R1 200 at R600 and in over-pricing the product with the market price of R600 is sold at R1 200. In most cases the taxes lost through this scheme are substantial.

3.5.2. Use of special conduit entities

The use of special conduit entities sees the multinational corporations establishing or investing into a company (i.e. subsidiary) which operates in the country with no or low tax jurisdiction (i.e. tax havens) for example the Mauritius corporate tax rate is 15% while the South African tax rate is 28% and it is submitted that it is this reason that lead some multinational corporations such as Multichoice, Nestle, Accenture etc to have operations in both South Africa and Mauritius.

Companies such as those mentioned above may be at an advantage to know about different tax rates in the countries they operate in and may develop schemes that can lead to them reducing the tax liability. Developing of the special conduit entities are designed properly when all the information relevant in the development is available and the transactions concluded are likely to attract no or minimal tax.

Some of the special conduit entities would be to set up a trust by the multinational corporate in the jurisdiction where any income received by the trust are exempt and channel any revenues from other entities to the trust with the view of knowing that those revenue would not be subject to tax.

In this type of the scheme the intra-group transactions constitutes majority of the revenue for the group, as majority of the MNCs trades with each other in the same group there is fear that the intra-group transactions may result in double taxation. The rise in the intercompany transactions are due to MNCs entering the emerging markets to procure materials and labour at a reasonably cheaper price between each other than at prices that would generally be charged if they acquired in an open-market. (Ngundi 2009)

Transfer pricing has been an area of concern globally not only for the multinational corporations but for the tax authorities in the countries impacted. The main concerns on the transfer pricing has been due to globalization and the increase in the transactions that are cross-border. The challenge for tax authorities has been to manage the MNCs that are operating in their countries but located outside its own tax jurisdictions while the multinational corporations are continuously under pressure to structure to their affairs to reduce the double taxation threats. (Ngundi 2009)

Multinational corporations encounter challenges when the economic challenges are not favourable. As the companies within the same group report their financial results separately the loss reported by one entity in the group would not necessarily results in the loss-making position for the whole group of companies. (Ngundi 2009)

3.5.3. The use of management fee

This scheme entails the use of management fee and other costs for tax avoidance. In this case, MNCs may register management company in a country where management fee is low compared to the management fee charged where operations of the company are taking place.

When considering the income tax deduction relating to the management fees these are the key questions that needs to be considered:

- Are companies using more than one company or corporation for business purposes?

- Are the companies using the management fees to bill for the central expenses between them? or
- Are they billing management fees to companies outside the group of companies for the management services rendered?

Management fees can be allowed as a deduction from the taxable income where the amount of the fees charged is reasonable and in addition the management fees must have been incurred in the production of income or for the purposes of earning an income and the company must have the legal obligation to pay the management fees. (BDO 2017)

Most MNCs have been and are still using management fees to reduce and eliminate tax by moving income from a profit-making component to the entity that is making losses and many tax authorities are aware of this issue however due to capacity issues they have been unable to successfully track and curb this.

To respond to the use of management fees to manipulate transfer pricing the tax authorities have been reviewing extensively the deductibility of the management fees. The multinational corporations get sent a questionnaire which need be completed and the completed questionnaire will be tested against the deductibility requirements as set out in the laws and regulation of the country. Double taxation can arise where the management fees can be disallowed in one entity by the tax authorities and still be taxed as income in the company that received the fees as an income. (BDO 2017)

Where the MNCs believes that they have been double taxed they are allowed to request in writing to the tax authorities to relook at the implication, the authorities will then investigate the matter by paying special focus on the transactions between related and unrelated companies to the complainant and where it is found that an error was made from the authorities side the adjustments for the refund will be made to the MNC. However, it is important to note that the onus to prove that the management fees are deductible by way of providing supporting evidence lies with the MNC and not the tax authority. (BDO 2017)

3.4.5. Use of Intellectual property rights

The increased global competition, rapid changes, investments in the research and developments, human resource skills, innovation risks and production and marketing has let multinational corporation understanding the use of the Intellectual property rights (IP) in international trade environment. (Kumar 2018)

The use of intellectual property rights scheme involves the right to use intellectual property such as trade mark, technological expertise and intangible. Most of the multinational corporations that have a footprint in Africa have rights to their intellectual properties and receive royalty fees from those that are

using their IP. For example, The South African Breweries Miller (SAB Miller) is a subsidiary of ABInBev Plc, one of the largest breweries company in the world, which uses intellectual rights of parent company SABMiller Plc. The trademark owned by the parent company for African breweries brands is registered in Holland which is also known as the Netherlands where there is no or low tax on royalty fees. The subsidiaries that are using the trademark in Africa can treat the fees that they are paying to use the patent as expenses so that they can qualify for the domestic tax relief.

Multinational companies continue to invest in the research and development of their intellectual properties to ensure that with the increased globalisation and emerging markets the trademarks, patents and other IP rights are not infringed which could result in them losing more on the returns to them as the creators. Like any other creators, the MNCs would like to ensure that the costs of investments in the research and development as well as introducing the products and the technologies to the market are recovered and profits are made. (Kumar 2018)

SARS allows for the deduction of the costs that are incurred by the taxpayers to research and develop intellectual properties or the costs incurred for the use of the IP provided such costs are incurred in the production of income. The provisions that stipulates the tax deduction of the costs of using the IP is contained in terms of the specific sections in the income tax act or the general deduction formula contained in *s11(a) read with 23(g) of the income tax Act 58 of 1962.*

Other sections are available in the Act that provides guidance around the timing and the extend of the deduction allowed in a given year of assessment. The research conducted in 2012 by Oosthuizen investigated different income tax deductions which are available to the taxpayers. He noted that the importance of case laws in the application of the general deduction formula contained in *s11(a) read with s23(g) of the income tax Act 58 of 1962* to the payments made in relation of the intellectual properties.

The South African Income tax Act no 58 of 1962 provides for the deductions to any expenses and costs in section 11 to 19 which is read with section 23 which provides for the deduction prohibitions. Some sections contained between 11 and 19 are applied to specific items however where no specific section in the Act can be applied to test the deductibility of the claims or costs the taxpayers can seek a deduction In terms of the *'general deduction formula'* contained in *section 11(a) read with section 23(g) of the Income Tax Ac*t. (Oosthuizen 2013)

In South Africa, it is advisable that the taxpayers consider s11 to s19 read with s23 to assess if the expenditure incurred for the intellectual property can be deducted. To apply the above sections to the IP expenditure the taxpayers needs to assess if the expenditure was incurred to develop or acquire or merely for the use of the intellectual property as that drives the timing and the amount to be deducted

bearing in mind that the burden of proof is on the tax paper to prove that the deduction must be allowed.

3.5.6. Thin capitalisation

When the multinational corporation makes cross-border investments, whether by setting up an entire operation or by acquiring the whole or part of an existing operation, one of the key questions that arises is whether the investment was by way of debt or equity. (Govender 2011)

The tax treatment of debt instrument is different to the equity one as the return on equity instruments is dividends. Carrying interest-bearing debt usually yields tax advantages in the country in which the investment is located. This has resulted in the tax authorities of a growing number of countries, concerned about the loss of tax revenue through the repatriation of profits from their countries to other countries by way of interest rather than dividends, paying close attention to methods of financing, that is, to the question of thin capitalisation. (Govender 2011)

The problems relating to thin capitalisation arise because under most tax systems debt and equity are treated differently. Interest on debt is treated differently from dividends on equity capital, the differences in treatment give rise to the possibility that characterising equity as debt (or vice versa), deliberately or otherwise, may result in tax advantages (or disadvantages) to companies in corporate groupings. In some countries, this may be of considerable relevance in purely domestic situation. (Govender 2011)

In most countries, when a company receives capital from a foreign parent company or other foreign associate by way of a debt bearing a commercial rate of interest, the interest on the debt would often be allowed as a deduction for corporate normal tax in the borrowing company's hands. Although the payment of interest to a foreign parent company or associated company may potentially be subjected to withholding taxes, these taxes are often eliminated or substantially reduced if the terms of a double tax treaty/agreement between the two countries allows. However, shares are provided as a form of capital rather than debt, the dividend distributions will be made as a form of the return is capital would normally be in the form of dividend distributions. In South Africa the company distributing the dividends will be subjected to the dividends tax and the dividends income will be exempt in terms of s10.

The payment of dividends to a foreign parent company or associated company may be subjected to dividends withholding taxes and to avoid double taxation the eliminations will be made in terms of the double tax agreement or treaties if it signed between the two countries concerned.

Dividend distributions to a foreign parent company or associated company are also often subject to a withholding tax at a higher rate than that applicable to interest payments. Therefore, if the group decides to provide funds from a parent company in one country to a subsidiary in another country

almost entirely by way of a debt bearing a commercial rate of interest, the subsidiary company's tax liability may be substantially reduced and in the absence of special provisions to the contrary compared with the situation had similar funds been provided as share capital. There may even be greater tax advantage for the subsidiary if interest paid to the parent company (or associate) is not subject to any withholding tax on payment or if a double tax treaty eliminates any potential withholding tax on interest payments to a foreign parent company. (Govender 2011)

in practice these taxes are often eliminated or reduced substantially by the terms of a double tax treaty between the two countries concerned.

The provisions of using capital as debt or as equity also have an important tax consideration on the parent company. It is normally more advantageous for the parent company to provide capital by way of equity rather than debt, the reverse is true for the subsidiary. If capital is provided in the form of shares the return would be dividends and the dividends are often exempt from tax but if the capital is in the form of debt, then the tax implications would be different as the interest treatment would need to be considered for tax. (Govender 2011)

The thin capitalisation scheme entails use of interest rate obtained from intra-financing between associated MNCs to manipulate transfer pricing. Interest on debt if debt is deductible for tax purposes but the dividend on the shares is not but rather for example in SA companies are subject to dividends tax. This scheme sees a lot of MNCs using debt financing within the group of companies rather than equity as debt attracts more tax benefits that what they would generally be afforded if equity was used for funding. Generally, interest on debt is deductible by the debtor for tax purposes but dividend on shares is not. (Govender 2011)

The transfer pricing manipulation using thin capitalisation can be done by using three ways: (Govender 2011)

- financing by the company in a tax haven to another company within the group that is based in a high tax country and as the interest from the high tax country would be higher it will attract no or low tax in a tax haven;
- overpricing of interest due to the exchange rate risks as a result strong currency in one country than the other; and
- the objective by the company to maintain a high debt to equity ratio

As one cannot arrive at the most appropriate and acceptable transfer pricing without considering the Arm’s length principle section 3.6 of this research below provides details on what multinational corporations need to consider when intending to set the price that is at arm’s length.

3.6. Arm's length principle

OECD have issued common guidelines that are applied by different countries in the world to achieve the arm's length principles (ALP) which deliberates that arm's length principle aimed at achieving the following:

- creating a common ground between taxpayers that are part of the multinationals and those that are independent;
- aims at ensuring that the price determined using the ALP is aligned to the market rates;
- attempt to reduce the risk associated with double taxation and non-taxation;
- providing alignment between domestic legislations and tax treaties reflected in domestic; and
- provides a tool to curb base erosion and profit shifting. (OECD 2013)

The arm's length principle (ALP) is defined as the financial characteristics of transactions between independent enterprises under conditions where each party strives to acquire the utmost possible value from such as transaction (SARS 1999).

SARS practice note 7 details the ALP in paragraph 7 where it outlines that the main key in achieving the application of the ALP is ensuring that the transactions between '*connected persons'* are treated at arm's length, this means that the transactions are to be treated as if they were between independent parties. (SARS 1999)

The aim of practice note 7 when it was first brought into effect was to resolve the issue around determination of the price that is at arm's length when multinational companies are trading amongst each other. To achieve this the note proposed that the price for a similar uncontrolled transaction between parties that are independent should be used as a benchmark when the multinational corporations determine the price for the controlled transactions within the group. This was to allow that any difference that is identified between the two transactions (i.e. controlled vs uncontrolled) is adjusted for. (SARS 1999)

When companies within the same group of companies are trading and the transfer pricing is set to be at arm's length the reasoning behind is that the principle should be based on the premise that transactions in an economy are generally governed by the market conditions therefore it becomes important that the transactions between companies that are related or companies belonging to the same group are treated the same way as those companies that are independent.

The process of determining the arm's length price is not straight-forward and requires judgement and scepticism from both the taxpayer and the tax authorities. For example, in South Africa the transfer pricing cases are to be looked at case by case as each case is different from the other so a blanket approach cannot be applied. (SARS 1999)

The difficulties in setting the market-related price is usually due to but not limited to the fact that many goods and services may seem to be similar in nature, but are actually different in many other instances and it is for this reason that when determining the arm's length price, one should refrain from adopting a blanket approach and apply distinctive business and related realities applicable to the set of facts that are present. An arm's length price could be a series of prices and not necessarily be made up of a single price and the facts and circumstances of each case should be able to establish where within the series of prices the specific arm's length price requires lies. (SARS 1999)

Both companies and tax authorised have an administrative burden to comply with the arm's length price. There is also the financial burden that comes with setting the arm's length price as sourcing arm's length prices and the administrative side of things can be very costly however despite this burden there is no other significant option that exists for an alternative solution as the abandonment of the principle would not only lead to a threat to international harmonisation but also an increased in the possible threat of double taxations. (Cheng & Lagerkvist 2009)

According to the OECD more than 100 developed, emerging and developing countries have adopted their arm's length principle as their transfer pricing standard.

3.7. Methods to determine transfer pricing

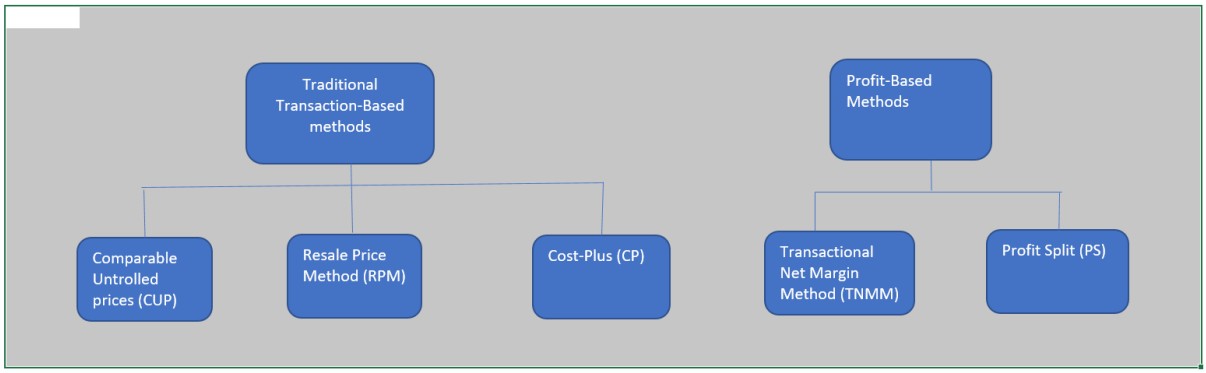
The OECD guidelines to which South Africa subscribed for have recommended the methods to be used to determine the arm's length price, the methods are categorised in two namely:

- traditional transactional-based methods, and
- transactional profit method.

It is important to note that interpretation the difference between the two main categories of transfer pricing methods is that the traditional transaction-based methods are based on the information and prices at which uncontrolled and comparable transactions between unconnected parties will take place while the transactional profit method determines the division of profits that independent parties would expect to realise from a specific transaction.

The different methods for both the traditional transactional methods and the profit-based methods are discussed below.

Figure A: Transfer pricing family tree (Tyrrall & Atkinson 1999)



3.7.1. Traditional transactional-based methods

(a) Comparable Uncontrolled Prices (CUP)

This method dictates that prices charged for goods and services in a controlled transactions environment or between related companies in the same multinational entities group, should be compared to prices of transactions charged in an uncontrolled environment or between unrelated companies. Controlled transactions are defined as those transactions that occur between companies in the same group (i.e. related parties' transactions) while uncontrolled transactions are defined as those that take place between independent, unrelated parties where there is both a willing buyer and a willing seller. (Tyrrall & Atkinson 1999)

The transactions can only be comparable if there are no differences between the two transactions that would result in a material effect on the price and if there are no differences then the transactions can be compared and any differences in the price can be eliminated. (SARS 1999)

Having the same product or services that is being transferred in two transactions by two companies does not necessary qualify the transactions to be comparable. For the comparison to be accurate the considerations should also be given to business functions and the economic circumstances. (SARS 1999)

Examples of situations where the adjustments may be required when the products or services that are comparable are transferred between parties that are independent: (SARS 1999)

- difference in transaction terms (e.g. the credit terms)
- difference in the volume transferred (e.g. sell kilograms to an independent party vs. 2000 kilograms to a connected person;
- sale of good on Free on Board (FOB) to a related and at cost, Insurance and Freight (CIF) price to an unrelated party; and

- difference in quantity of products, market levels, geographic markets or the type of intangible assets.

The CUP method is generally considered to be the best method to determine the correct arm's length price in comparison to other methods. In most cases it is difficult to establish a similar comparable uncontrollable price due to differences in products and services.

It is very difficult to find a transaction between unrelated parties which looks exactly like the controlled transaction as there are various considerations that need to be given to be able to determine the adjustments that need to be made or eliminated from the price to achieve the arm's length price that would be acceptable to the tax authorities.(SARS 1999)

With the growth in the economy that is intangible there comes major challenges concerning the application of the arm's length principle (United Nations 2012).

Some of the challenges that comes with determining transfer pricing for intangible are driven by the following questions such as :(Mc Nair, Dotley and Cobham 2010)

- how to can the market value for intangible be determined?
- how can the comparable product be identified against an intangible that is unique in nature from others?
- how should the determined intangible future value and risk be reflected be transferred between jurisdictions?

(b) Resale price method

The resale price works in situations where there is an independent distributor or seller of the company's goods, services or products. The arm's length price is determined by deducting from the selling price charged by the distributor any resale price margins. (United Nations 2013)

The resale price method is mainly used in the group of companies where one company is responsible for marketing and sales and the activities this that company will be considered in the transfer pricing analysis. When the resale price transfer pricing analysis is conducted the company looks at the price that the company would charge for the product if the sale was with an unrelated party which is also referred to as the resale price, this analysis assist with the determination of the arm's length gross margin where sales company would still retain the cover for the sales, general and administrative expenses and still be able to make the profit. (United Nations 2013)

To determine the profit for the resale company consideration should also be given to the functions and the risks encountered. This method is based on the gross profits rather than determining the arm's length prices such as the CUP method. (United Nations 2013)

Figure B: Resale price equation (Tyrrall &Atkinson 1999)

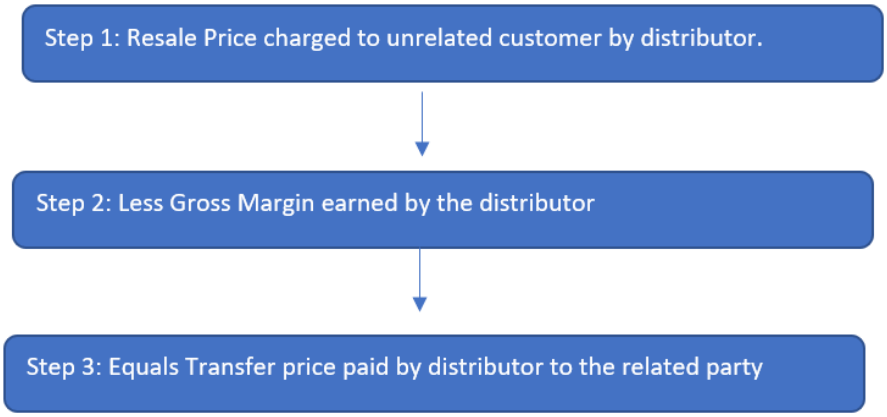


Figure B illustrates the price that is at arm's length as indicated in step 3 is the net gross margins charged by the distribution company.

When the resale method is applied in the transaction it is very important to compare the essential functions performed by the independent entity to those functions that are performed by the company that is part of the MNCs to the unrelated party to ensure that any differences are identified and adjusted for. (SARS 1999)

The resale method usually requires less adjustments when compared to the CUP and that is mainly since the transfer price that is set when applying resale price is mainly based on the functions that are performed by the sale and the distribution company. It has also been found that the comparing prices for functions results in the minor differences. (SARS 1999)

Taxpayers that are using the resale price method to determine the arm's length price focus only on the sale price between them and the unrelated company and the gross margin that is required to recovered for the functions that were performed by the resale company. There are instances where there are differences between the cost structure of the MNC and the unrelated company and where such differences exist the prices determined will have differences. (SARS 1999)

The resale price method is more appropriate in the determination of the arm's length price in situation where the distributor focuses more on the sales of the product rather than the production. (United Nations 2013).

According to the SARS interpretation note 7 the following are challenges when the resale method is being used:

- difficulties in the finding the transaction between unrelated companies that would be comparable to the transaction between multinationals which would not result in material effect on the margin;
- different in accounting policies applied by companies to determine the gross margin;
- lack of access to the segregated data information that will assist in the determination of the transfer price that would be comparable between controlled and uncontrolled entities.

(c) Cost plus method

Cost plus method is ideally and commonly used when one related party is a manufacturer, while the other related party is the seller of the product.

When using the cost-plus method to calculate the arm's length price, the taxpayer should take the costs that have been incurred by the supplier of the good or services-controlled transaction between the companies that are related. The cost-plus mark-up that would be determined when unrelated parties trade would then be added to the cost while considering the functions that have been performed, the risks assumed, assets used in the production and the market conditions impacted the affected companies. (United Nations 2013)

This method is usually used to analyse transfer pricing issues which involves tangible items or services and it is applied mostly in manufacturing or assembling activities. (United Nations 2013)

The tested party in the cost-plus method is the manufacturer or service provider method of the parties that are related party. The transfer pricing analysis evaluates the gross mark- up on the costs that were incurred by the manufacturer or service provider in the intercompany transactions that involves the transfer of tangible goods or services. (United Nations 2013)

The mark-up that is applied to controlled transactions is determined with reference to the mark-up that would have been earned if the same supplier in the uncontrolled transactions would be used and if this cannot be done then the mark-up should be determined using the mark-up that would have been in a comparable transactions by the parties that are unrelated taking into account all the factors such as the functions, risks and employing similar assets of those tax papers. s. (SARS 1999)

The transaction between related parties and unrelated parties are comparable for the purposes of cost-plus method is the following conditions are met: (SARS 1999)

- there transactions between related parties and unrelated parties do not have differences that can material affect the cost-plus mark-up in an open market; or
- the differences between the transactions compared can be reasonably adjusted to eliminate any differences.

According to the SARS interpretation note 7 the following are challenges when the cost-plus method is being used:

- difficulties in determining the costs that are to be applied in the cost-plus method;
- there is no related link between level of costs and market price;
- different accounting policies to determine the arm's length price using the cost-plus method; and
- lack of access to the segregated data information that will assist in the determination of the transfer price that would be comparable between controlled and uncontrolled entities.

3.7.2. Profit-based methods

The profit-based methods generally begin with examining the profits resulting from certain controlled transactions to establish if a transfer price is at arms' length.

Figure A illustrates two main categories of profit-based methods: The traditional net margin method and the profit- split method which are discussed in detail below.

(a) Transactional Net Margin Method (TNMM)

TNMM focuses on the net margin/profit generated by a related party in determination the arm's length transfer price. TNMM is mostly used in where the related party employs intangible asset/s whose results are not easily determined. In such circumstances, the arm's length return of the related company is computed by establishing the margin realised by companies that are involved in similar functions with unconnected parties. The balance is thereafter left to the connected enterprise that controls the intangible asset. (United Nations 2013)

For the purposes of TNMM the net margins are compared on a different base for example costs, assets or sales. The base is also commonly referred to as profit level indicators. In practice there are four ratios commonly used as bases or profit level indicators.

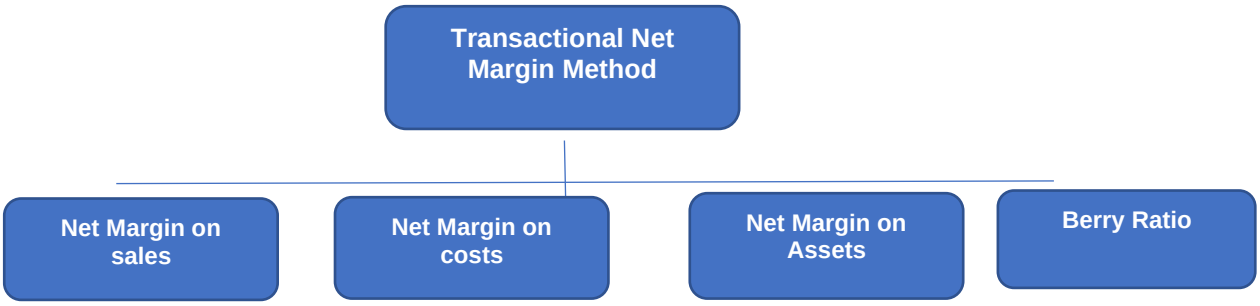
Even though the transactional net margin method is classified as a transactional profit method, the method has been found to be more like the Cost Plus (CP) and Resale Price (RP) methods as opposed to the profit-split method. This method focuses on the net profit rather than the gross profit of the

company. As with the cost-plus and resale price methods this method focuses on the duties performed by the company. (SARS 1999)

The transactional net margin method is one of the less reliable methods of calculating transfer price as the calculations using the TNMM involves the calculation of the net margin considering the operating expenses in the calculation to determine the net profit. (SARS 1999)

Where the operating expenses structures for related parties and unrelated parties are structured differently it becomes difficult to compare the controlled transactions to uncontrolled transactions when determining the transfer pricing using the TNMM and as a result the results derived from this process would be less reliable as there would not have been enough details to conduct the comparison. TNMM is not the method that one should go for as their first choice to the complexities that comes with the method and internationally are being considered as a last resort. (SARS 1999)

Figure C: Ratios commonly used in the applying TNMM (Cheng & Lagerqvist 2009)



Net margin on sales

The net margin on sales ideally is the operating profit before interest and tax, rather than the profit before tax. This approach eliminates the funding differences between the businesses. (Tyrrall & Atkinson 1999)

Net margin on costs

The net margin on costs measures the profitability relative to direct expenditure and overheard expenditure. This approach eliminates the profit related to classification of expenditure between cost of sales and operating expenditure. (Tyrrall & Atkinson 1999)

Net margin on assets

This approach is based on the returns on total operating assets rather than the returns on equity in order to eliminate differences in financing by equity holders. Operating assets will exclude investments in long-term assets. Adjustments may also need to be made for different methods of asset valuation,

e.g. revaluation method against the cost model, differing accounting policies and age of the assets among other factors. (Cheng & Lagerqvist 2009)

Berry ratio

The berry ratio measures the returns based on operating expenses and is calculated by dividing gross profit by operating expenses. The berry ratio assumes that there is a direct correlation between the operating expenditure and the gross profit earned. (United Nations 2013)

Practical problems noted for the TNMM are: (SARS 1999)

- influence of factors that do not have an impact on the price of goods or services, gross margins and this results in price calculated would be deemed unreliable;
- unavailability of the information that is required to calculate the arm's length price using the TNMM;
- comparable data may not be available;
- method is considered one-sided; and
- difficulties in determining the transfer pricing once the margin has been calculated.

(b) Profit-split method

The Profit-split method is aimed at removing the impact on profits of special circumstances made in an environment that is controlled or between related parties. This is done by establishing the share of profits that not dependent and unrelated companies would expect to realise from entering in transactions that are similar. (United Nations 2013)

In his research Moyo explained that the profit-split method begins by determining which profits divided from the transactions that are controlled between related companies. The profits are divided between the related companies according to the contribution based on the functions/duties performed, risks affected the entity and lastly the assets used by each company. External data on profit split between external unrelated companies is then used to perform a valuation related to the contribution of the company. This is done so that the splitting of the consolidated profits between related companies is benchmarked or comparable with that of unrelated companies conducting functions that are like those of related companies. (Moyo 2015)

The OECD guidelines highlight two approaches to the profit-split method and under the two alternative methods the first step is to determine the approach to allocate the combined profits. The combined profit is then allocated as follows: (SARS 1999)

- the residual profit-split approach allocates the profits based on the functions performed by the parties involved in the transaction and then the residual profits will then be allocated to the parities based on the economic contribution for the amount that has to be allocated;
- the combined operating profit is then divided between the companies in accordance to the contribution that each company would have made.

The gross profit under the profit-split method is allocated based on the risks and activities in the location. (SARS 1999)

(c) Residual profit split analysis

When applying the residual profit-split approach, the basic return is first allocated to the related parties in accordance to the method that unrelated parties with similar circumstances (i.e. functions and risks) would have applied to perform the allocation. Then the remaining profits will then be allocated to the parties based on the facts and circumstances that would be present at the time of the allocation. Some of the facts and circumstances that are considered to drive the allocation includes but not limited to the economic contributions made that would have been by the parties that are affected. (SARS 1999)

Even though the facts and circumstances that drive the allocation basis for the residual profit-split analysis there is some level of judgement that would be required to reach a conclusion on the accuracy of the allocation. In some instances, you find that product development and advertisement are identified to be the relevant contributors to the profit and when each is assessed it is found that they contribute 50 percent to the remaining profit and as such there would be a 50:50 residual profit split between the manufacturing division and the advertising division. (SARS 1999)

There has been no clear definitive guidance that cleared prescribes how the contribution made by the parties can be measured. In most cases the transactions entered into by related parties would be different from the transactions between independent parties and as a result it becomes difficult to use the unrelated parties transaction as a basis on how the multinational residual split should be performed as each transactions would present itself with distinguishing features that may not be found in the other transaction and a result the results become less reliable. (SARS 1999)

(d) Contribution analysis

Multinational corporations are incorporated differently from the comparable local or domestic companies. Multinationals can be designed in such a way that the operations within the group leads to efficiency and saves costs for the group and because in the group there are different

contributors which is not available to companies that operate independently. For example, the multinational corporation can set up the different companies and assign functions to the entities (i.e. have one company doing marketing, administration, accounting etc) and due to this integration multinational benefits the most from cost saving while independent parties do not have such benefits.

Practical problems as per the SARS Practice note 7 are:

- difficulties in accessing the world-wide group data that is required to perform transfer pricing using the profit-split method;
- subjectivity in the allocation of the profits calculated; and
- profit-split method is considered a less reliable measure of the transfer price that is at arm's length when compared to other methods such as the cost-plus method.

Whilst there are various methods that can be used to the arm's length price for transactions between corporations that are operating within the same group of companies, it remains the company's responsibility to determine the transfer pricing strategy that has to take into consideration all the factors such as the goods or services offered, the functions that the parties involved performed, the risks that affects the companies and the assets that are employed in the business to ensure that the calculated transfer price is at arm's length. Each taxpayer has the responsibility to perform comparison of the price that they consider to be at arm's length to other prices that are charged for similar transactions with similar features in an open market to ensure that any differences that are identified are adjusted for or eliminated to ensure that the transfer price set is accurate and market related.

CHAPTER FOUR

SOUTH AFRICAN TRANSFER PRICING

4.1. Introduction

With increasing globalisation which drives business activities around the country, South Africa has found itself in the fore front of attracting foreign investments. Since president Cyril Ramaphosa became the president of this South Africa, our country has held different business seminars with the objective to attract foreign investments in the country. South Africa has one of the developing countries in the African continent with leading economy and has been trading internationally with other countries such as China, USA, India etc for years and its re-emergence in the internal market position has seen expansions in the business activities and the country is on route to accelerate on their foreign investments. Increased foreign investments brings about transfer pricing risks as the increased foreign investments does not necessarily translate into economic growth due to the misalignment of the country's objectives in relation to those of the multinational companies investing in the country and as such the tax base of the South Africa always needs to be protected to avoid exploitation.

Prior to 1995 South Africa did not have transfer pricing laws and regulations, except for the exchange control regulations which were aimed at dealing with the manipulation of the systems around the currency. According to Manyaka in his research in 2010 the lack of transfer pricing rules was mainly due to South Africa being isolated and could not freely trade internationally due to the political pressures. (Manyaka 2010)

The exchange controls rules have in the past provided South Africa with protection against manipulation of transfer pricing. In the past South Africa found itself in a position where majority of the revenues/profits have been shifted out of the country illegally through manipulation to lower tax jurisdictions and the exchange controls were in place to deal with the transfer pricing challenges. When the exchange controls were relaxed section 31 was introduced in the Act in 1995 and has been into effect since that date. (SARS 1999)

In this chapter the South African transfer pricing is outlined, and the focus is given to the South African transfer pricing background, the transfer pricing regulations, approach to the arm's length pricing and the challenges faced by South Africa within the transfer pricing context.

4.2. South African transfer pricing background

When the then minister of Finance, Mr Derek Keys appointed the Katz Commission in 1994, they noted the vulnerability of the South African tax system against the excessive price manipulation between the related parties. The Katz Commission was also tasked with the bench marking with different countries and providing the recommendation of the suitable approach to combat transfer pricing manipulation for the South African environment. (Moyo 2015)

The legislation on the transfer pricing was introduced in South Africa for the first time with effect from 19 July 1995 and in respect of goods or services supplied on or after that date. When the legislation was introduced at the time it was aimed at dealing with the international transactions that involved the acquisition and the supply of goods or services between parties that are related where the price was not arm's length. Where these requirements were met, the legislation gave the Commissioner the discretion to direct the determination of the taxable income to calculate the transfer price at arm's length and propose any adjustments in instances where the price is not at arm's length. In addition, the legislation at the time also contained specific thin capitalisation rules.

The Katz commission identified the following four approaches from which the South African government could choose to implement to address transfer pricing manipulation (Moyo 2015):

- the first was the most rigorous approach and had a legislative backing. It was going to be substantiated by binding regulations which would describe what constituted acceptable transfer pricing. The initial approach introduced was on the system that is used in the United States of America (USA).
- the second approach had legislative backing like the first one above and had comprehensive guidelines, but it did not have formal regulations. This approach was based on the system used in Germany.
- the third approach was based on the OECD guidelines. This approach depended on the ALP applied to determine most acceptable transfer pricing activities. The approach was based on the system that is used in the United Kingdom and the other countries that have fully adopted the OECD guidelines.
- the fourth and the final approach was not based on any transfer pricing regulations, instead it followed general anti-avoidance rules and common law and tax law to deter transfer pricing. This approach was based on the similar system used in the Netherlands.

The Katz Commission recommended the third approach (i.e. OECD guidelines) as the most suitable for South Africa. Section 31 (transfer pricing regulations) of the Act was subsequently amended in July 1995, and again in August 1999. Interpretation note 7 was introduced by the National Treasury which reflected the adoptive approach of the Katz Commission as described.

4.3. Tax treaties

The tax treaty refers to the credit in the form of a rebate. In South Africa the tax is allowed for taxes paid on income earned from foreign countries. The cumulated credits allowed during any year of assessment may not exceed the tax payable amount.

Tax treaties provide for the agreement between two countries to avoid or mitigate double taxation, they tend to reduce the taxes of one country for residents of the other country to reduce double taxation of the same income.

The South African double tax treaties generally provide the following provisions:

- definitions of the taxes that will be covered in the agreement;
- reduction of interest, dividends, royalties withholding tax paid by the resident of one country to the resident of other countries;
- tax limitations on business income from the permanent establishment;
- definitions of incomes earned by individuals in residents such as salary, self-employment, pension and other income.
- exemptions provided for certain types of income received by individuals or corporations; and
- procedural framework showing the law and regulations enforcement and dispute resolutions.

4.4. Arm's length principle

Transfer pricing rules are anti-avoidance rules which are primarily aimed at preventing multinational groups from shifting profits to low tax jurisdictions. The arm's length principle is the backbone of transfer pricing, in terms of which taxpayers are required to show that they have transacted with foreign related parties on the same terms as would have applied if the parties had been unrelated.

Where the related parties engage in the transactions for transfer goods and services the parties involved needs to determine the arm's length price. The transfer price determined between the related parties should be calculate taking into consideration the terms and conditions existing on transactions with similar characteristics between independent parties. (SARS 1999)

Applying transfer pricing rules based on the arm's length principle is not easy, even with the help of the OECD's guidelines. It is not always possible and certainly takes valuable time to find comparable market transactions to set an acceptable transfer price

4.5. Documentation

This section of this report will look at the types and the extent of the documentation that taxpayers should consider keeping safe to be able to demonstrate the application of the methods to determine transfer price.

In terms of section 29 of the Tax Administration Act of 2011 issued a Draft Notice on 15 December 2015. The Draft Notice requires that the taxpayers with the consolidated turnover of R1 billion and above on the affected cross border related party transactions to keep the additional records. When the Notice comes into effect it will become mandatory for multinationals with the consolidated with a turnover of R1 billion or more to prepare and safe keep the documentation for transfer pricing documentation. (Deloitte 2018)

The amendments contained in the Tax Administration Laws Amendment Act, 2016 which were promulgated earlier that year also included the definition of the "international tax standard" which includes the 'country-by-country' reporting (CbCR) standard for multinational enterprises. When the amendments were announced it was not clarified how South Africa will implement the country-by-country reporting.

South Africa attempted to align the requirement for the CbCR to the Organisation for Economic Co-operation and Development (OECD) documentation requirements. Based on OECD guidelines the CbCR must be completed for companies with turnover/revenue in excess of 750 million Euros which is approximately R12,1 billion at the current exchange rate of approximately R19,94 (Oanda 2020). The recommendations provided by the Davis Tax Committee the threshold of R1 billion or more is applied to the South Africa to transfer pricing documentation in terms of the Draft Notice. However, the South African transfer pricing do not currently have clear guidance on the threshold for CbCR and as a result the South African taxpayers are disadvantaged when compared to taxpayers in other countries. (Deloitte 2018)

For the purposes of promoting transparency for multinational by taxpayers, South Africa with other 30 countries signed a new tax cooperation agreement in 2016 which set out the information to be provided by the multinational corporations to the tax authorities.

In line with the above agreement the South African Revenue Service has implemented BEPS Action Point 13 which means that the South African taxpayers (i.e. multinational corporations) must comply with the following responsibilities:

4.5.1. Country-by-Country Reporting ('CbCR')

- global operations where the MNCs conduct business need to be disclosed for the purposes of reporting. OECD and SARS provide on the guidance of how the CbCR should be completed by the tax papers who are required to make this submission to SARS, SARS requires that South African multinational corporation with a group turnover of R10 billion or more complete this form for submission;
- where the ultimate holding company that is a non-SA resident, the SA company that is part of the multinational corporation and the threshold is €750 million the CbCR should be prepared and completed for the periods on or after 1 January 2016. SARS has engaged with tax authorities in other 54 countries to discuss the sharing platforms for the CbCR; and
- the first of these CbCRs needed to be completed on the South African Revenue Services e-filing portal during the year of assessment ended 28 February 2018 for South African MNEs with financial year ended on and after 31 December 2016 (Deloitte 2018)

4.5.2. Masterfile

South African taxpayers that are the ultimate parent companies of an MNC are requires to complete the Master File. The global operations of the multinational companies including the business overview and the transfer pricing policies should be completed in the Masterfile by the taxpayer.

Any other South African companies are required to complete the Masterfile where the aggregate cross border related party transactions are in excess of R100m for the year of assessments commencing on and after 1 October 2016. All other taxpayers are not required to file but would be expected to keep and maintain any documentation and be able to produce upon request by SARS. The information required when one submits the Masterfile includes the following: (Deloitte 2018)

- ownership structure showing the shareholding details of persons involved such as shareholding percentages, residency of the shareholders;
- the details of the principal office such as the name, address, legal form and tax residence of each of the connected persons; and

- the business operation summary, showing
    - business description such as the type of business involved, the specific business, external market circumstances description of the business (including the type of business, details of the specific business, external market conditions and trading operational plans;
    - company organogram showing details such as the title and the location of different level of management from junior to senior members; and
    - details on the economic and legal issues affecting the profitability of the business in the industry

4.5.3. Local file

- local file is the document required by SARS to be submitted by the taxpayers for disclose all the intercompany transactions that they have entered with companies in the same group that are in foreign countries. This file is treated as the transfer pricing document that will be required for each legal entity affected;
- in addition to the local file, SARS requires that South African taxpayers with cross border intercompany transactions in excess of R100m during any year of assessments to keep any records that they deem to be relevant in the determination of the transfer price;
- the local file can also be required to be completed in the SARS e-filling portal in addition to the CbCR in instances where the South African MNC had met the requirements of the CbCR. The completion and the submission apply to taxpayers who met the requirements for the financial year-end ending on or after 31 December 2016; and
- Other South African companies who for the periods commencing on or after 1 October 2016 have generated accumulated cross-border transactions with related parties in excess of R100m are also required to complete. (Deloitte 2018)

4.6. Interest and penalties

In 2018, the Government Gazette published by the South African Revenue Service ("SARS") contained penalty imposed on the non-compliance incidents by a person in terms of *Section 210(2) of the Tax Administration Act, 2011 (Act no. 28 of 2011).* Additionally, a fixed amount of a penalty in accordance with sections 210(1) and 211 of the Act was noted that it would be imposed where there is non-compliance with the transfer pricing documentation regulations. (PKF 2018)

Where taxpayers are required to submit the CbCR, Masterfile and the Local file to SARS and fails to honour the request for 12 months from the last day of the year of assessment under review, SARS would be left with no choice but to impose a penalty that would be determined based on the assessed loss or taxable income amount and such penalty would range between R250 to R16 000 per month. (PKF 2018)

With most South African taxpayers now into ecommerce and the new-ways of doing things for efficiency purposes SARS now has introduced online platforms for the submission of the required transfer pricing documentation from the comfort of their homes. The online platform which is available at the SARS website allows for the submission of the Country-by-Country Reporting (CbCR), Master File (MF)and Local File (LF) should be submitted via the country-by-country functionality on filling. The CbCR is referred to as the CBC01 form, the MF and LF on the other hand are uploaded as supporting documents.

4.7. Burden of proof

The OECD recommends that a taxpayer should provide enough information on the related party transaction that enables the tax authority to do the following three things:

- proving that the taxpayer considered transfer pricing requirements;
- enough information provided to the tax administrators to enable them to conduct a thorough analysis on the transfer pricing; and
- useful information provided to the provide tax authorities to enable them to perform detailed audits and investigations.

4.8. Challenges faced by South Africa regarding transfer pricing

Despite South Africa having the transfer pricing strategies that are currently in place to address the manipulation of transfer pricing the country continues to face different challenges surrounding the current transfer pricing regime which includes the following:

- Many multinational entities doing business in South Africa continue to be exposed to uncertainties on how tax authorities handle transfer pricing due to the shortage of formal transfer pricing rules and regulations in the legislation other than the reference that is made to the OECD guidelines which are mostly used selectively in the cases of disputes between taxpayer and SARS. (Moyo 2015)

- The transfer pricing documentation in South Africa varied from company to company and in most cases, it is based on what companies felt to be important and in most cases the tax payers do not understand the reasons for documentation which includes the goals and objectives. The other issue is that the lack thereof transfers pricing documentation policy in the Income Tax Act nor is it mentioned in the SARS information on the Tax guidelines. (Moyo 2015)
- Sourcing and gathering of transfer pricing data, calculations of the transfer pricing and the preparation of the documentation showing the factors, assumptions and other considerations used in the calculation of the transfer price that is at arm's length is time-consuming and expensive.
- When s31 amendments to the Act were made, the burden to prove the arm's length prices on transfer pricing will initially was with the tax payer which has effectively converted transfer pricing into a self-assessment provision of which his research in 2015 Moyo raised that the reliance on the self-assessment by tax payers poses additional risks such as:
  - What documentation is enough to SARS to prove appropriate transfer price?
  - The cost and administration burden of getting and keeping the transfer pricing arm's length documentation may get out of control;
  - Such documentation may contain confidential information like trade secrets and scientific secrets.
  - The length of the period that this documentation should be retained is unknown.
- With multinational corporations continuing to submit poorly prepared or no documentation at all on transfer pricing flags and draws SARS's attention to the taxpayer and triggers an investigation.
- Lack of comparability data to support the appropriate transfer price as a result of lack of the absence of technological and necessary skills required.

4.9. Current status of South African transfer pricing

With the attempts to address the transfer pricing issues that South Africa continued to face decades after implementing various solutions to address the issues, in recent times we have seen the country broadens the extent of the transfer pricing rules and regulations. The latest amendments were proposed in the Draft Taxation Laws Amendment Bill ("Draft Bill"), 2019, which was released on the 21st of July 2019. The "Draft Bill" included the proposal to amend the "affected transaction' definition in *s31* to broadens the scope of the transfer pricing regulations to include transactions between persons who are "connected persons" and "associated enterprises" to align the SA transfer rules with the those contained in the OECD and UN' use of the concept of "associated enterprises" when

for allocation of profits from transactions between "associated enterprises" or related parties. These latest amendments have not yet been incorporated in the Act.

This latest proposal by South Africa did not come as a surprise as the countries which have seen improvements in how they manage the transfer pricing issues in Africa such as Kenya and Tanzania have already incorporated the “associated enterprises’ in the scope of transfer pricing when applying the arm’s length principle. In principle it makes sense to have a uniform approach when dealing with transfer pricing to avoid possible double taxation which might impact the economy negatively. In instances where one country may apply the concept of "associated enterprises" broadly, resulting in a transfer pricing adjustment, while another counter-party jurisdiction to the same transaction, may apply a narrower concept and as a result there will be no similar transfer pricing correction which would see adjustments or eliminations to arrive to the arm’s length price. Currently there is no clear definition of the term "associated enterprise" in the current South African Income Tax Act amending the transfer pricing rules to include "associated enterprises" may achieve the objective of a common approach.

There is no doubt that despite the challenges that South Africa continues to face regarding transfer pricing the country has continued to strengthen the regulation surrounding the transfer pricing, in February 2019 it was reported that South Africa as a country has strengthened the transfer pricing and disclosure requirements through implementation of the international standards and this was considered to be a critical step to counter any undesired tax base erosion through profit-shifting.

South African signed the15 BEPS Action reports in October 2015 and the amendments of the OECD regulations to reflect the significant changes in 2017, as one of the countries that went ahead and adopt the new requirements in accordance with the local regulations’ improvements have been evident. Contained in the new regulation is the transfer pricing documentation requirements that will see the taxpayers not only preparing detailed documentation proving the set transfer pricing but also to be expected to file the information electronically in the SARS website. These regulations will further place SARS authorities in a position to identify and issue communication to South African who may be found to be in a risk of transfer pricing manipulation. While the process may have been found to be time consuming and tedious in the past the new system that has been introduced makes it easier for SARS to obtain the information required to identify risks and share transfer pricing documentation on a much broader basis.

Although as a country progress has been made, access to detailed and meaningful data and technological access remains the challenge for SARS when dealing with complex transfer pricing

investigations. The audits and investigations conducted by SARS have not improved in recent years due to capacity issues in their transfer pricing unit where there is a lack of highly qualified and skilled specialists in the field and these constrained have placed the South African receiver of revenue in a position where training and upskilling of the existing staff in the transfer pricing unit has is not conducted if not poorly conducted.

South Africa has over the years developed and adopted a framework to deal with the challenges such as the profit-shifting due to transfer mispricing. Transfer pricing rules in the country have changed as the world evolves but this has led to many South African taxpayers who are part of multinational corporations to invest the time and resources in the understanding of the new SA transfer pricing laws and regulations contained either in the Act or articles. As the country aims to raise more revenues through an increase in the tax collections to grow the economy, provide service delivery such as access to health, safely, education, water and sanitation it is unlikely that the tax rates will fall and any proposals to have the rates decreased should not even be entertained as they are not expected in the 2020 budget to be delivered by Tito Mboweni. What the country needs is the simplified transfer pricing rules that can easily be understood by taxpayers as it would make compliance easier.

Many international standards and best practices have already been adopted by South Africa. Transfer pricing is one tax area that is considered to be complex in nature as the treatment of certain transactions are subjective and the need to use highly qualified and skilled specialists to assist the taxpayers when dealing with transfer pricing related matters (i.e. sourcing and gathering of information, calculation of transfer pricing, completion of the required transfer pricing documentation, responding to the audit or investigation queries etc) to ensure that there is compliance with the transfer pricing regulations.

In his 2019 State of the Nation Address (SONA) President Cyril Ramaphosa announced that SARS has improved and additional steps will be taken for it to become a world-class institution and additionally as the country continues to face challenges regarding attracting foreign investment to improve the economy, it would be advisable for the country to offer APAs as a mechanism to attract foreign inbound into South Africa and to facilitate investment through South Africa to other African countries by offering bilateral APAs with other African countries.

It is common knowledge that tax collections need to increase in South Africa as a country. Despite concerns regarding the profit-shifting from the country to other low-tax jurisdictions due to transfer mispricing, mechanisms such as the APAs can be explored as it would drive for certainty,

consistency and equity where corporate tax that needs to be paid in relation to the cross-border transactions between related parties.

CHAPTER FIVE

TRANSFER PRICING IN OTHER DEVELOPING AFRICAN COUNTRIES

5.1. Introduction

Africa is home for a huge proportion of natural resources, it is where you find renewables and non-renewables. The continent pride itself with natural resources such as land that is arable, water, minerals, natural gas and wildlife. (United Nations 2019)

The African continent contributes 3 percent of its mineral resources to the world, the natural gas in Africa makes up 8 percent, oil reserves is 12 percent and both gold and platinum contributes 40 and 90 percent respectively. It is in Africa where you find 65 percent of the world' arable land and renewal fresh water makes up 10 percent of the world' total. And lastly, reserves such as diamonds, platinum and uranium are found largely in the African continent. (United Nations 2019)

Majority of the world's poorest countries are in Africa despite the continent being rich is natural resources, in 2019 when the United Nations did an analysis it was found that the capital accounts for natural resources in Africa makes up between 30 and 50 percent. More than 70 percent of Africa's population depends on natural resources such as woodlands and forests. Research shows that crime and corruptions are the enemy that is costing Africa of its rightful riches as majority of the deals in Africa are concluded illegally which results in cash flowing illegally and as a result it was estimated in 2019 that over $195 billion in Africa were lost annually to illegal trading (i.e. mining, finishing, logging etc) (United Nations 2019)

United Nations advised that what Africa needs to be able to see their natural resources translating into sustainability, economic growth and poverty eradication is unity, tightening of the laws and regulations governing illegal trading, exploitation and having leadership with integrity. (United Nations 2019)

Based on the recent reports in the Africa Economic Outlook for 2019, the recent global recessions, Africa achieved an average annual GDP of an estimated 3.5 percent in 2018 despite the global recessions, about the same as in 2017 and up from 2.1 percent in 2016. Africa's GDP growth is projected to accelerate to 4.0 percent in 2019 and 4.1 percent in 2020. As a result of the growth that is being seen and anticipated in the coming years it is believed that that multinational corporations would be looking to expand on their footprint in the continent by increasing their current investments and as such the transfer pricing will continue to receive more focus. (Economic Outlook 2019)

Transfer pricing remains an international developmental financing issue as without adequate collection of tax revenues, ability to secure and grow economy from natural resources and stringent laws around transfer pricing most developing countries will continue losing out from profit shifting committed by multinationals. (Curtis & Todorova 2012)

5.2. The importance of transfer pricing in developing countries

The following reasons are some of the highlights on the importance of having the transfer pricing regime in the developing African countries:

- Countries that are innovative, developing infrastructures, creating jobs, educating residents, have plans in place to eradicate poverty etc are at the forefront of having their economies grow. Investments by multinational corporations also plays a role in the economy growth, however MNCs can also be the enemy to the country's economic growth plans when they manipulate the transfer prices, shift tax revenues from countries that need it the most to grow the economy to countries where they will avoid or pay less tax (Mc Nair, Dotley & Cobham 2010). It is therefore for this reason that developing countries need to invest and develop more effective regulation and legislation on transfer pricing to overcome the challenges they are facing.
- Due to increased globalisation of the economy, many developing countries have opened their boarders to attract international trading and investments. MNCs contributes the most to international trade with over 67% of their transactions and investments are made constituting cross-border transactions with related parties within the same group. Due to the importance of these transactions and investments to economic growth developing countries need to find a way in their transfer pricing regulations to limit the illegal shifting of profits from their countries to tax havens without discouraging and distorting trade and investments. (OECD 2017b)
- Multinational corporations continue to play a pivotal role in developing countries; economy due to globalisation. With over two-thirds of their trade made up of related parties transactions Africa would not be immune from this and as a result the UN has developed the millennium development goals (MDGs) which are aimed at dealing with poverty eradication and fair share on the benefits generated in developing countries by MNCs. (Curtis & Todorova 2012)
- For developing countries to meet the Millennium Development Goals (MDGs) they would need to strengthen their tax systems and increase tax revenue collection and as a result it is therefore very important for the developing countries to get their priorities in order, their main

priority needs to be the protection of the tax revenues to be able to grow the economy. (Curtis & Todorova 2012)

- The administrative challenges that developing countries continues to face to gather, collect and analyse the relevant information that is required to deal with transfer pricing manipulation schemes that seek to promote tax avoidance remains one of the big challenges for developing countries as with no information they would not be able to determine which information is relevant. (Lohse, Riedel and Spengel 2012)
- Developing countries struggles to strike balance between maintaining competitive advantage and protecting their tax revenues from being shifted out of their countries by multinational corporations.
- Sometimes multinational enterprises uses transfer pricing legitimately in their commercial operations and functions to arrange transactions in such a way that profits get shifted from one country to another with the sole objective of paying no or less tax and as a result developing countries need to be in a better position to be able to identify and understand different schemes that are being used to shift the profits out of their countries as that will hinder their economic growth. (OECD 2017b)
- The current transfer pricing legislations in most developing African countries lack the technical, administrative and auditing capacity to ensure that the laws are enforced and to also conduct thorough effective and efficient audits where transfer pricing cases are concerned. Tax and Development Programme (TDP) provides solutions to some of these problems faced by such countries. (OECD 2017b)
- Due to more reliance on facts and circumstances when dealing with transfer pricing it makes it a subjective matter. Determining an arm's length price requires one to consider the substance over form when selecting the arm's length from a wide range of prices. Due to the subjectivity of transfer pricing there is more requirements for transfer pricing to be regulated to force compliance from taxpayers. Determining transfer price require technical skills expertise that will require training and resources to be able to arrive at the price that has is at arm's length. The regulations for transfer pricing will assist in the strengthening the treatment of revenue. (Stern 2013)
- Lack of transfer pricing framework in developing countries which creates more gaps in the tax regime which opens the developing countries to more tax revenue exploitation by the multinational corporations. Tax authorities across the globe agree that lack of framework leads to loopholes in the tax systems and most of them struggle with the treatment of transfer pricing due to lack of guidance provided to them and as a result majority of the profits are lost unnoticed. (Stern 2013)

- Due to having between 30 percent and 60 percent of the transactions between multinational corporations being with their own related associates, MNCs continue to be steps ahead of developing countries because they can have multiple companies, trade with each other, and be able to shift profit without these countries noticing as the policies they have for transfer pricing have gaps. For developing countries to be able to curb the this spread they would need to adopt strict transfer pricing policies that would be able to prevent further losses. (Stern 2013)
- Minimal treaty network that exists in developing countries also places these countries at a risk of not being able to administer the risks around double taxation. Treaties neds to be put in place to ensure that investors and countries are protected where double taxation is concerned. Double taxations risks lead to multinational corporations to be less attracted to investments in developing countries with the fear of being taxed in their domestic country and the developing country where their investments are held. Having double taxation treaties which will supplement the transfer pricing framework is important to ensure clarity is provided on how certain revenue streams such as interest income, dividends income, royalties fees, management fees and whole other incomes will be treated for tax purposes to avoid situations where MNCs find themselves in a position where they are taxed twice for the same stream of revenue. (Stern 2013)
- Having stringent transfer pricing regulations which will enforce and make it mandatory for MNCs to disclose all their information pertaining to their business structures and operations will assist developing countries to have access to such information for the determination of transfer price. (Stern 2013)
- Developing countries lose billions of Rands in the hands of multinational corporations and continue to spend large sum of money in compliance and legal costs when they seek to lodge investigations on MNCs that have structures set up with the sole purpose of shifting profits from developing countries to tax havens. For these countries to minimize the costs that are incurred in the process they need to implement transfer pricing regulations that will enforce compliance from MNCs. (Stern 2013)
- Having an adequate framework would not automatically make the MNCs' application of the legislation correct and effective (Stein 2013) however the legislation can assist with dealing with some of the challenges that the transfer pricing risks are currently deep rooted and as such it is important for developing countries to start somewhere in their development of the rules (OECD 2012).
- The importance of developing countries in the identification of the risks that they face due to transfer pricing cannot be stressed enough. Countries need to make positive use of their

limited resources in dealing with transfer pricing issues imposed on them by MNCs (OECD 2012) and continuing to justify their inadequate resources or not enforcing transfer pricing regulations will not help them with the collection of the tax revenues that are mainly generated from transactions between related parties (Stern 2013).

- With Africa being rich in natural resources and reserves, introducing of strict regulations and ensuring that they are enforced will pear positive outcomes for them in retaining the tax revenue collected and eventually results in economic growth which is in line with the resources they have. (Stern 2013).

5.3. Transfer pricing challenges faced by developing African countries

5.3.1. Lack of comparable data

It is recommended that transactions between related parties be assessed using the arm's length principle. Majority of the countries in the world, both developed and developing, OECD and non-OECD countries are using the arm's length principle when seeking to determine the transfer price. Sourcing of comparable data which is important in the calculation of the price that is deemed to eb at arm's length proves to continue to be a change for developing African countries due to limited resources, capacity and infrastructure and as a result they continue to lose the battle against transfer pricing. Some developing countries have found themselves in positions where they ended up sourcing data from data base in Europe and to determine the appropriate transfer price and this has been proven to be problematic due to differences between market and geographical conditions in these countries. (Mc Nair et al, 2010)

Performing a comparability analysis is key in the implementation of the arm's length principle (ALP) as it requires that comparison of conditions in controlled transactions between related parties and uncontrolled transaction between unrelated parties be conducted to ensure that the price set is at arm's length.

An emphasis needs to be made that the comparability analysis should not always focus primarily on the actual price of the goods or services in the transaction. In most cases the rules around transfer pricing operate with considerations given to whether the transaction has actually taken place, reviewing of the transaction contracts, locations where the transaction took place, economic conditions which were existing at the time of the transactions and whole other facts and circumstances that are deemed to be relevant in arriving at an appropriate transfer price. This

exercise is not merely checking the price calculated against the prices that are available in the market for transactions that are similar. (United Nations 2017)

Developing countries continues to be hit the most when it comes to enforcing their transfer pricing regulations due to lack of comparable data to be used to support their findings.

The following reasons are the main contributors to the difficulty faced by developing countries when it comes to obtaining comparable information:

- Developing African countries have less organized companies in sectors such as financial services, telecommunications, mining etc when compared to developed countries;
- The databases that exist on transfer pricing analysis currently focus on data from developed countries than that from developing countries and as a result transfer prices in Africa are not comparable due to lack of developing countries' data to conduct benchmarking exercises for transfer prices;
- The economies in developing countries have recently opened and some are still opening themselves to foreign investors and as a result the information available may not be enough to perform comparatives (Curtis & Todorova 2012);
- Lack of resources in developing countries to enable them to perform transfer pricing analysis property which leads to incomplete comparable information. (OECD 2013)

The availability of the local comparable data would simplify the transfer pricing analysis. In 2012 Curtis and Todorova proposed that the use of the non-local comparable data which is practical can also be implemented in the developing countries to perform the analysis required in determining the appropriate transfer price. (Curtis & Todorova 2012)

Few African countries, Kenya being one of them have started to address the issue around lack or less comparable data to conduct their analysis. This process has seen these countries exploring the use of other external databases as well as considering the idea of building their own software that will contain data that can also be adjusted for in the future as a long-term investment. (Curtis & Todorova 2012)

The allocation of profits on cross-border transactions between related parties and countries remains one of the biggest transfer pricing challenges. (Mc Nair et al, 2010)

The African Tax Administration Forum (ATAF) is the entity that has undertaken various efforts to address the issue of lack of local comparable data. The forum has proposed that developing countries subscribe to external databases as a short-term solution while looking to develop their own software in the long run. There have been discussions around the need for a database for Africa and discussions have been had regarding the need to create data centre “cloud” for the African region. (Curtis & Todorova 2012)

5.3.2. Lack of knowledge and resources

One of the key challenges that continue to affect the developing countries to curb or address the transfer mispricing by the multinational corporations is the lack of the adequate knowledge resources in such countries.

In the report written by PricewaterhouseCoopers in 2012 it was noted that it is not in dispute that one of the main challenges facing developing countries in the implementation of strategies such as Arm’s Length Standard (ALS) to address the transfer pricing risks is the lack of adequate knowledge and resources. Many tax authorities in the African countries do not have qualified, skilled and experienced auditors, economists, lawyers and accountants in their transfer pricing departments or units, lack of databases containing financial information to be used in the transfer pricing analysis and lastly the inadequate number of employees to deal with the processing of disputes and non-compliance. (PwC 2012)

Developing countries need to set up audit teams and committees that will be dedicated to the transfer pricing cases. Having dedicated teams will enable tax authorities to develop skilled teams that would be specialising in transfer pricing since due to subjectivity of transfer pricing there is a need for specific expertise in the area which is totally difference from a general corporate tax skill. (Curtis & Todorova 2012)

Another way that can be used to address non-compliance and complex issues surrounding transfer pricing may be to simplify transfer pricing regulations such as fixed margins for the transfer price or creation of the environment that would allow the tax authorities to develop technical capacity that would lead to the tax position that will be respected by all MNCs that need to comply with it. This platform could also be used by companies to prove that the transfer prices that they calculated are reasonable using the fixed default margin which could lead to less arguments around the arm’s length principle. (Curtis & Todorova 2012)

PWC US suggested that another way that African countries can opt for to ease the complexities and implementation costs that comes with the adoption of the arm's length standard would be to consider an approach that would be relevant and appropriate for the developing economies while considering making it industry-wide to cater for businesses operating in the same sector. (PwC 2012)

Should the developing African countries find themselves in the position where they adopt an approach that would cater for the African countries' consideration need to be taken around the issue of simplicity as the investors in the African regions are not only limited to Africans but other countries outside this continent also have investments in Africa. The approach should also adopt the ALS to ensure that multinational companies remain comfortable doing business in Africa and would ensure that the foreign direct investment remains undistributed. (Rosenbloom 2009)

5.3.3. Intellectual property

Intellectual property is governed under intellectual property law which refers to the legislation that concerning rights on patents, designs, trademarks and copyright protection. The intellectual property is aimed at protecting the intellectual properties that has been built or acquired by companies (i.e. legal entities) to ensure that the value that is carried by these companies on the intellectual properties is not vulnerable for exploitation by outside parties. (Smit & Wyk 2019)

Values attached to intellectual property (IP) can result in developed countries receiving more taxable income while developing countries swim in expenses. Due to developing countries not being prepared to deal with special cases like IP they often feel that the tax implications arising from transactions affecting the IP results in unfavourable results for them. (Curtis & Todorova 2012)

Generally, developing countries do not own any intellectual property of value and as such they do not financially benefit much from their own IPs that may be used by other countries. Majority of the multinational corporations have sustainable profits as a result of the rights they have on intellectual properties that may have attracted investments and sales for them. African countries have been reluctant in the adoption of the arm's length standards on intellectual properties due to them not having IPs. (Curtis & Todorova 2012)

The main concern for the African countries has mainly been mainly around the appropriate sharing of revenue between the multinational corporations and the African countries due to the significant value attributable to intellectual properties mainly in sectors such as mining, oil and gas. (Curtis & Todorova 2012)

5.3.4. Location savings

Location savings refers to the savings that companies operating in low-cost locations receives from the functions or activities that may have been outsourced to those low-cost locations. Majority of the multinational corporations tend to set up companies in both high cost and low-cost locations and then outsource most of the functions or activities take place in the low-cost locations which would then results in them saving on the costs of doing business. African countries, China and India have been some of the countries in the world that are able to offer labour services at a relatively cheaper rate compared to other countries and this has often seen a lot of MNCs outsourcing most of their routine activities to those countries and as result end up reporting on bigger margins than what would have been generated had the activities not being outsourced. The guidelines provided by the OECD motivates the African countries to develop more skilled and experienced employees to perform the transfer pricing audits. (Curtis & Todorova 2012)

5.3.5. Tax treaties

Lack of a comprehensive network for many African countries continues to be a challenge for the region. African countries only have a handful of treaties with African and non-African countries which makes it difficult for them to monitor and administer the tax treatment of certain revenue streams such as interest income, dividends, royalties etc. The tax treats are very important in developing countries to reduce the double taxation risks and lack thereof put many developing countries at a disadvantage in relation to other countries that have comprehensive treaty network.

Many African countries do not have the technical knowledge and expertise to negotiate tax treaties successfully. Due to the small number of the tax treaties network in the African region that may mean that most of these countries are not ready to negotiate double tax treaties that will not put them at the disadvantage. Developing countries should seek to get more into negotiations of the double tax agreements as this would also assist them in dealing with transfer pricing as the tax treaty would not only minimise double taxation in Africa but will also ease the business operations amongst nations. The developing of the transfer pricing expertise amongst tax authorities of Africa will also lead to an improved desire and ability to negotiate double tax treaties. (Curtis & Todorova 2012)

Having the tax treaty network in Africa can also help with standardising the method of taxing multinational corporations in Africa (Dean 2009) and through negotiating tax treaties, African

countries may be able to gain efficiently from entering the international tax regime. (Curtis & Todorova 2012)

5.3.6. Power imbalances between MNCs and developing countries

Inequalities between countries is the major source of power imbalance between multinational corporations and developing countries. Developed and developing countries have different transfer pricing expertise and capacity to perform administration and the calculation of the transfer price. Companies have the sold objective of making profits and as a result they build and invest on having individuals of great expertise and experience to assist them in setting up structures that would assist in moving revenues from one country to other without making it suspicious and they undoubtingly have the good infrastructure and continuously ensure that they are not capacity constrained. On the other hand, the tax authorities are faced with inadequate resources, technologies, limited experienced staff to help with the administration of transfer pricing which makes it even difficult to succeed against the multinational companies as a result developing country continue fight a winning battle. (Mc Nair et al 2010)

African developing countries did not have the international tax forums which were specific to Africa to ease engagements when dealing with the transfer pricing in Africa. The UN Committee of Experts on International Tax Matters (the UN Committee) is the only truly multilateral forum which developing countries can engage with on international tax. Majority of the challenges affecting developing countries relating to transfer pricing are defined in the UN committee, the main issues that have been highlighted by the committee includes but not limited to lack of capacity, inadequate transfer pricing regulations and the inability to monitor any misuse of transfer pricing the multinational corporations (United Nations 2019)and the introduction of the African Tax Administration Forum (ATAF) will assist with bridging the gap between developing African countries and the rest of the world.

5.4. Current Strategies to address transfer pricing challenges

As transfer pricing has been declared an international risk for both developed and developing countries there has been strategies that have been implemented to deal with risks surrounding transfer pricing. Some of the strategies includes the United Model Tax Conventions (UN model), Organization for Economic Co-operation and Development (OECD model) and African Tax Administration Forum (ATAF). These strategies are aimed at ensuring that each of every country earns their rightful income. These strategies seek to clarify some of the key concepts that are critical

in dealing with transfer pricing challenges. The aim is to ensure that the countries in which the business operations take place gets the right to tax the profits provided the business operation constitutes permanent establishment (PE).

Permanent establishment is defined at the fixed place of business operation which would generally give rise to the revenue that would attract tax liability in a tax jurisdiction. Transfer pricing rules are put in place to ensure that the income generated in the country are taxed in the correct country.

It is important for African countries to determine the portion of the profits that are generated by the multinational operating in the continent is attributable to the permanent establishment in Africa and therefore ensure that it is taxed accordingly.

5.4.1. OECD guidelines

Sometime during the1960s and 1970s the United States and other countries started becoming aware of the transfer pricing and the OECD guidelines were adopted in the late 1970s with the aim of addressing any transfer pricing risks that were existing at the time. The guidelines were provided after the countries came to the realisation that there is a need for guidance to be provided to countries to assist them in dealing with the impact of double taxation. The OECD guidelines were subsequently revised and updated in the 1980s and the 2000s. (Curtis & Todorova 2012)

The arm's length standards were established to be the transfer pricing standard to be used worldwide. Many countries have adopted the OECD guidelines however the African countries have seen slower in their implementation of the guidelines and the challenges that the continent face due to lack of capacity and resources plays a role on the delay of the model implementation. (Curtis & Todorova 2012)

5.4.2. United Nations Approach

Many countries have been of the view that the OECD guidelines have been developed for the sole objective of protecting the interest of the developed countries that are members of OECD. As the years went by the United Nations started considering designing another model that will seek to address the concerns raised by developing countries and in 2009 the work around building of the UN model commenced and the issues that were aimed to be addressed included the following:

- guidance on the drafting of the transfer pricing legislations;

- setting of special transfer units;
- guidance on identifying and working with transfer pricing databases; and
- development of simplified strategies aimed at determining the appropriate transfer price for transactions between related parties.

The UN also considered the appropriateness and the impact of adoption of the ALS in developing countries.

5.4.3. African Tax Administration Forum

Inefficiency in the tax administration of transfer pricing in the African region was the motivation for the designing and the implementation of ATAF. The sole goal of ATAF was to see efficiency in the African tax administration improve. The creation saw the heads of African tax administration come forward with their representations to discuss African transfer pricing challenges, any progress made at that point, and future steps in addressing the challenges of transfer pricing. In the 21st century. The ATAF was created by 34 tax commissioners from the African countries. (Curtis & Todorova 2012)

African countries were encouraged to adopt a simplified and realistic approach to deal with transfer pricing. Transfer pricing involves a lot of judgement and as a result the tax administrators in Africa were urged to invest some time in the understanding of the taxpayers as that would assist in the negotiations with taxpayers and dispute resolutions. (Curtis & Todorova 2012)

The section below documents additional information contained in the OECD and the UN guidelines where the transfer pricing is concerned.

5.5. Article 9: Arm's length principle

Arm's length principle is detailed in article 9 of the OECD model, the emphases is drawn to the importance of tax treaties mainly the bilateral tax treaties which involves both OECD members and non-member. The basis for article 9 is on the setting the transfer price on the basis of arm's length principle which provides guidance that when the conditions that exist between enterprises that are associated are different to those between independent enterprises then the profits that would have been generated had the conditions between independent enterprises existing will be deemed to be the profit in the transaction between associated enterprises and shall be taxed accordingly. (OECD 2017a)

The arm ‘s length principle seeks to regulate profits between related parties to the multinational corporation that are not concluded at arm’s length. OECD guidelines in article 9 provides that the principle relies mainly on two conditions mainly the related party (also referred to as an associate) and the arm’s length principle which others also refers to as fair value or market value. A company is an associate of another company if it involved in the management of the business or have control over the business directly or indirectly and arm ‘s length principle states that transfer of goods and services between companies who are related should be concluded at market value or price. (OECD 2017a)

OECD also provides guidance and methods on the determination of the transfer price that considers the arm’s length principle and the details on that have been detailed in chapter three in this dissertation.

5.6. The resident principle

The resident principle is outlined in Article 4 of OECD and Article 4 of UN model. The two models provide conditions on how the resident principle can be tested when seeking guidance on how multinational corporations are to be tested. Article 4 is the duplication of the OECD article 4 and therefore the two model provides for the same meaning on the resident principle. The company or entity is regarded as a resident of a country for tax purposes if it was established or incorporated in that country according to the law of that country (e.g. in South Africa it would be in accordance with the Companies and Intellectual Property Commission – CIPC) or if its management place of residence is situated that country.

In terms of the resident principle in the model the multinational company will be liable for the tax in the country it was incorporated, or the place of effective management is situated in that country (OECD 2017a). In accordance with the South African rules on the tax on the income or profits, South African residents are taxed on world-wide income while non-residents get taxed on the income that is generated in South Africa (also referred to as source rules).

The tax authorities in developing countries in Africa needs to be equipped and qualified to be able to assess and determine the residency status of the multinational corporations that invest in Africa.

5.7. Permanent establishment

Permanent establishment is defined at the fixed place of business operation which would generally give rise to the revenue that would attract tax liability in a tax jurisdiction. OECD also provides

guidance on the permanent establishment and article 5 in the model refers to it as the fixed place of the company where the company is owned either partly or wholly. The size of the building is not a determining factor in ascertaining the actual place of residence for the MNC (i.e. whether it is a small office, branch, factory etc) but rather to establish where the permanent establishment of the company is consideration is given to the place of business, fixed place and the business operations that are carried.

Transfer pricing rules are put in place to ensure that the income generated in the country are taxed in the correct country. It is important for African countries to determine the portion of the profits that are generated by the multinational operating in the continent is attributable to the permanent establishment in Africa and therefore ensure that it is taxed accordingly.

The tax disputes that have been encountered in the past were as a result of having two countries that were claiming the right to the revenue or profits generated by the multinational corporations. The PE concept is an important element in the transfer pricing when the tax authorities seek to establish the residency status of the company that is a multinational. Successful assessment of the residency status of the permanent establishment will ease the treatment of transactions between companies in the same group and to also avoid the double taxation risks.

5.8. Business profits

Where the business profits are taxed is driven by the residency status of the multinational corporation and what the tax rules in the country where the investments are. According to the OECD the profits earned by the company will be taxed in the country where the business operations are carried (also referred to as the permanent establishment). When there is a permanent establishment the business profits will be taxed in the country where the income generated by the PE were made.

In conclusion, despite transfer pricing still impacting developed and developing countries, there is no doubt that the countries that have implemented the guidelines designed either the OECD, UN or ATAF have seen some improvements in their attempts to curb the transfer pricing challenges.

CHAPTER SIX

TANZANIA AND KENYA - TRANSFER PRICING REGIMES

6.1. Transfer pricing overview on Tanzania

6.1.1. Introduction

When the social ideologies in Tanzania came to an end the country gained liberation and the country opened the boarders for free trading with the objective to grow the economy. The decision to adopt free economy opened the country to more foreign investments and due to multinational corporations playing an important role in the growth of the economy the country also became prone to the transfer pricing manipulation that is imposed on developing countries by MNCs. Tanzania is one of the developing countries in East Africa that has over the years developed transfer pricing regulations with the objective to deal decisively with the transfer pricing risks such as the income tax base erosion and profit shifting problems. Tanzania developed a legislation that supports the arm's length principle and the country has a few tax treaties to address the double taxation risks.

6.1.2. Transfer pricing in Tanzania

The tax treatment of transfer pricing in Tanzania is provided for under the transfer pricing guidelines that are provided for in the Tanzania revenue authority documents which were signed into law by the then commissioner general, Rished Bade on 1 May 2014.

In 2014 the Tanzania Revenue Authority (TRA) published the transfer pricing regulations which were drafted in the form of the practical guide and were not prescribed to the nation. The practical guide merely outlined the terms which were critical in dealing with transfer pricing and it was further provided in the guidelines that the transfer pricing cases that will arise in Tanzania will be dealt with on a case by case basis taking into accounts the business strategies and commercial judgement impacting each taxpayer.

The guidelines in 2014 were to be reviewed and revised periodically.

6.1.3. Transfer pricing definition from the perspective of Tanzania

The transfer pricing definition in the TRA is in line with the definition provided in the OECD or the UN guidelines, in Tanzania transfer pricing refers to an arrangement whereby the transactions for the

transfer of goods, services, and intangible properties between companies that are related are treated as if they were concluded between independent parties. Tanzania promotes that when the transfer pricing is determined the transaction entered in between related companies needs to be treated considering the dynamics of the market forces to reflect objectivity and not bias.

TRA adheres to the arm's length principle just like South Africa and the country is of the view that it is the most appropriate and objective standard to determine the transfer price between companies that are related. Some guidelines in the ITA were adopted directly from the OECD and the UN models with minor differences to ensure compliance with the Income Tax Act chapter 332 and well as other circumstances that exist in Tanzania that affect only the country and not the rest of the world. The guide also provides for illustrative examples which taxpayers cannot take and treat as real-life scenarios and thus each case is deal with on an individual basis by the authorities taking into accounts the facts and circumstances that impacts the taxpayer.

The Income Tax Act in Tanzania (also referred to as the ITA) and the transfer pricing rules contained in the guide do not provide clarity on the arrangement of the price that need to be done for transactions between related parties.

The main objective for Tanzania to issue the guidelines, it was to provide the taxpayers with procedures to be followed win the determination of the arm's length price. The guide also provides regulations that are consistent with the Income Tax Act, Chapter 332.

The guidelines provide the following factors to be considered when determining the arm's length price: (Tanzania Revenue Authority 2014)

- thought process behind adopting the arm's length principle;
- acceptable transfer pricing method application framework;
- transfer pricing comparability analysis framework;
- preparation and maintenance of the arm's length price documentation;
- intercompany transaction treatment
- treatment of intra group transactions; and
- other relevant principles contained in the OECD and the UN guidelines

6.1.4. Scope of the Transfer Pricing guidelines based on Tanzania Revenue Authority 2014

Tanzania issued the transfer pricing regulations in line with the global trends and to follow in the steps of other African countries such as South Africa. The scope of the transfer pricing regulations was the following:

- the regulations are aimed at dealing with the acquisition or supply of property or services between related parties where at least one party in the arrangement is a resident of the United Republic of Tanzania;
- shall be applied to local transactions between related parties where the prices charged are not at arm's length; and
- permanent establishment transactions.

6.1.5. Law position in Tanzania

section 33 of the Income tax Act, chapter 332 deals with the transfer pricing rules, the strategies to combat transfer pricing schemes contained in *section 33 (1)* which states that "in any arrangement between persons who are associates the persons shall quantify, apportion and allocate amounts to be included or deducted in calculating income between the persons as is necessary to reflect the total income or tax payable that would have arisen for them if the arrangement had been conducted at arm's length". (TRA 2014)

6.1.6. Arm's length principle from the Tanzania view

According to the transfer pricing rules in Tanzania the arm's length principle is the only preferred approach when dealing with transactions between related parties. Based on the arm's length principle the transfer pricing for the transaction is acceptable if the transactions between the related parties are concluded at arm's length (i.e. treated as if it is an arrangement between parties that are independent). (Tanzania Revenue Authority 2014)

6.1.6.1. Application of the arm's length principle (Tanzania Revenue Authority 2014)

- in determining the arm's length price for the companies within the same group, one must treat the associated parties as a single business unit and not separately.

- The adoption of the arm's length principle requires that the controlled and uncontrolled transactions be compared in terms of the price, margins or other conditions that may be deemed relevant for the comparison.

6.1.6.2. Determination of arm's length transactions

To determine the arm's length transaction requires the taxpayer to identify and deal with the following points as detailed in (a) to (e)

- Analysis of transactions and functions impacted
- Risks assumed by tax payers
- Characteristics of the business
- Comparable transaction
- Tested party

(a) Analysis of transactions and functions

This step entails obtaining an understanding of all the functions that would impact a transaction, for example transactions which were entered between companies within the same group of companies, company operations, duties or functions that are performed in the business operation, risks impacting the business etc.

The aim of the functional analyses includes but not limited to:

- to understand the business overview of the organization and its operations;
- understand the functions performed, risks impacting the business and the assets that were invested in the operation; and
- to assess the significance and the importance of functions, risks and assets invested.

Functions that are performed in any business operation need to be clearly outlined and assigned to the relevant person who will be responsible for the performance of the activities. Examples of functions that are performed in the business includes but not limited for procurement, marketing, distribution, sales, finance, etc. The functions that are economically significant for the organization need to be defined first, the activities that are performed for other companies within the group need to also be outlined and each activity need to be allocated a cost to enable the calculation of the recovery/profit amount.

performing additional marketing and advertising function is expected to have a higher return from the activity than if it did not undertake these functions.

It is important for multinational companies to identify the assets that were contributed into the business as investments on incorporation. The assets can either be intangible or tangible, but the company documents need to clearly provide an analysis of the type of assets, nature of the assets as well as the value of the assets that were brought into the business.

Every investor expects to earn returns from their investments and as such the assets that would have been brought into use in the MNC would be expected to earn returns in the long-run. The expected returns should be in line with the risks that the investor would have assumed (i.e. the higher the risk taken the higher the expected return and the opposite is true as well).

(b) Risks assumed

Multinational corporations need to evaluate the risks that are assumed when they determine the transfer price. When comparing controlled and uncontrolled transactions that have different in the risks assumed the results generated becomes unreliable and as result one cannot make reasonable adjustments to the price. The example of risks that should be considered includes but not limited to the following:

- operational risk which includes risks such as liabilities for manufacturing, system failures, regulatory risks, unreliable suppliers etc
- market risk such as political or fluctuations in demand and the prices
- product risk like warranty risks
- business risks associated to ownership of assets or facilities; and
- financial risk like currency, commodity, interest rate and funding risks

The risks assumed should be allocated to the transactions based on the functions that are performed in the business. The analysis that is performed is conducted in order to identify risks, differentiation between the corporation that bears and controls the risks on legal circumstances vs the party that bears and controls the risks based on the economic substance of the transaction.

An additional factor to consider in examining the economic substance of a purported risk allocation is the consequence of such an allocation in an arm’s length transaction. In an arm’s length dealing, it generally makes more commercial sense for one party to be allocated a greater share of those risks

over which they have relatively more control and from which they can insulate themselves less costly than the other party.

(c) Characterization of business

For the purposes of transfer pricing calculations, the business characteristics are assigned based on the nature of the activities performed in the business, complexities of the operations, for example either as manufacturing, marketing, distribution or sales. (TRA 2014)

(d) Identification of comparable transactions (TRA 2014)

Transactions are compared based on the level at which the transaction will be compared at, the company should decide in terms of the level at which the transaction will be compared at:

- based on the terms and price of the product;
- compare combined transactions;
- based on the gross margin;
- based on the net margin; and
- based on other measures such as capital ratio.

(e) Tested party

When dealing with controlled transaction would lead to the identification of the tested party. The transfer pricing method in Tanzania is applied tested party (i.e. company in a multinational) would be regarded as the party to which the transfer pricing method. The information that impacts the tested party would be compared to the comparable (i.e. independent party) based on the facts and circumstances that are similar. (TRA 2014)

6.1.6.3. Selection and application of Transfer pricing methodologies

The transfer pricing methods applied in the calculation of the arm's length price are provided for in terms of section 11 in the transfer pricing regulations in Tanzania. The methods involve the comparison of the price charged for the transactions between related parties and price charged for the similar transaction arranged between independent parties. (TRA 2014)

Tanzania Income Tax Act, chapter 332 outlines the acceptable methods to calculate the transfer price in *section 33 of the Act,* section 33 provides that " in any arrangement between persons who are associates, the persons shall quantify, apportion and allocate amounts to be included or deducted in calculating income between the persons as is necessary to reflect the total income or tax payable that would have arisen for them if the arrangement had been conducted at arm's length".

Where there are instances of non-compliance with of *section 33 of the Income Tax Act chapter 332, and regulation 33 of the Income Tax,* the commissioner has the authority to adjust prices for transactions that are not at arm's length.

6.1.7. Documentation requirements

Taxpayers are required to keep enough transfer pricing records in terms of *Section 80 of the Income Tax Act, chapter 332* to enable the tax authorities to determine the profit or losses generated by the multinational company. The details of the information that is required to be kept by the taxpayer so that it can be accessed by the tax administrators are listed in *Sections 80, 139 and 140 of the Income Tax Act, chapter 332*.

The Tanzanian documentation requirements for transfer pricing provides for the list of the documents that are required to be submitted by the taxpayer to the TRA, it further outlines the reasons for the information and the list of the supporting evidence to elaborate on the information that that has been completed in the tax return. (TRA 2014)

The information provided in the tax return needs to be retained in the for five years from the last year of assessment to which the tax return completed relates to and the documents that are available at the time of the filling of the tax return should be made available to the Commissioner upon request.

6.1.7.1. Transfer pricing documentation required by the Tanzanian Revenue Authority

(a) Organizational structure

Organizational structure should show the information concerning the taxpayer such as organogram showing all companies associated with the taxpayer, ownership interest and any changes that have taken place that may impact the arrangement of the transaction)

(b) Group financial report

Represents the multinational corporation financial report showing the financial results of the company (i.e. income statement), the financial position of the corporations, cash flow information etc

(c) Nature of the business/industry and market conditions

- information related to the history of the company, industry they are operating in and other factors impacting them such as legal considerations, economic factors, technological factors, social and environmental factors;
- business plans providing more information on the nature and the purpose of the operations and explanations on the role and transactions entered with the related parties; and
- analysis on the competitive environment where the MNC operate

(d) Controlled transactions

- nature of the transactions, for example sale of property or services, the scope of the transaction, timing, frequency of the transaction and the value attached to the transaction;
- personal details of all the related parties to the MNCs (names, physical addresses and the nature of the relationship with the MNC;
- the terms and conditions of the transaction;
- description of the business operations and the functions;
- budgets and financial estimates for each component within the group
- policies on the pricing of controlled transactions;
- methods, factors and assumptions considered assumption in preparation of the pricing policies;
- characteristics of the factors such as nature of the assets invested, risks assumed, and the functions performed;
- details showing the nature and the value of each asset invested in the business;
- comparable information that may be relevant when comparing controlled and uncontrolled transactions;
- data that is collected for the transfer pricing analysis to assist in the controlled and uncontrolled transaction;
- identification of any internal comparable;
- information outlining the data and the method that have been considered in the calculation and the analysis of transfer pricing;

- application of the transfer pricing method; and
- a list of any advance pricing arrangements entered by members of the multinational corporation;

6.1.8. Interest and penalties

According the Income Tax Act, 2004 there are penalties that are imposed to deal with the non-compliance of transfer pricing rules contained in the ITA however the penalties imposed are not specific to non-compliance with arm's length practices. There are additional penalties are aimed at addressing non-compliance such as late submission of the returns, no or underpayment of the tax instalment, tax liabilities that remain unpaid after the due date. (Tanzania Revenue Authority 2014)

The penalty is set at a minimum of 3,500 currency points in the currency point system as prescribed from time to time by the Commissioner at the currency point of TZS15,000 which would result in a penalty of TZS52,500,000 and this penalty is in addition of the possible of 100% on the adjusted amount which is imposed here taxpayers fail to comply with the arm's length principles when dealing as related parties.(PwC 2019)

6.2. Transfer pricing overview on Kenya

6.2.1. Introduction

Kenya is one of the developing countries in Africa that has responded to the globalisation call to open the borders for international trade and investments. Since then the country has attracted investments from different countries across the globe, countries from which investments are with includes the United Kingdom, Mauritius, Netherlands, France, the Republic of South Africa, US, Denmark etc. (Warris 2017)

AS a result of globalisation and allowing of free-trading in countries, transfer pricing is becoming increasingly challenging to revenue authorities in planning and implementing their mandate of collecting revenue through taxation. Transfer pricing has grown into a global issue because of the increase in international transactions which generate revenue for multinational enterprises (MNEs), and the realization by these multinational businesses can report higher profits when compared to other business within the same industry through manipulation of tax rules in different countries.

Globalization has resulted in multinational corporation playing a significant role in the growth of the economy. Approximately two-thirds of all the multinational transactions worldwide are arranged

between parties that are related. to play a significant role in the economy of most nations. It has been estimated that approximately two-thirds of all business transactions worldwide take place between related parties. International organizations need to consider a development of the transfer pricing financing issue because without adequate tax revenues countries economic growth is hindered. (Sundaram 2012)

As a result of the high volume of transactions that take place between members of the same group (i.e. estimated at more than 60%) Kenya and some of the countries in East Africa have developed an interest in monitoring of the activities and operations conducted by the multinationals in that region. The focus had been given to the arrangements concerning the pricing of transactions between related parties. This step was taken to ensure that the transactions that are concluded between members of the same group take place at arm's length basis. In Kenya the abuse of transfer pricing laws and regulations is illegal and multinationals that are found to have been implicated in the act are investigated and held accountable. (Maina 2016)

6.2.2. Transfer pricing overview in Kenya

When observing the activities of the developing countries in Africa Kenya was amongst the first countries in the continent to take a stand and implement the regulations governing international taxation which included the rules on transfer pricing. The Kenya Revenue Authority was set up in 1995 however even prior to that the revenue office managed under the Ministry of Finance and Treasury was divided into four departments or districts. The district that was looking after corporate income tax and transfer pricing was district four and the transfer pricing in district four included a special unit that was responsible for multinational enterprises. (Warris 2017)

Kenya introduced their first regulations in transfer pricing on 1 July 2006 and the regulations released on that date were aligned to the OECD transfer pricing guidelines. The regulations however have not been highly been effective as Kenya according to the Global Financial Integrity (GFI) has reportedly been losing approximately KShs 11.5 billion annually from the transfer pricing manipulations by the multinational companies trading in Kenya. (Maina 2016)

The transfer pricing rules are contained in s18(3) effective from 2006 and 18A which became effective in 2017.

The Kenya Revenue Authority (KRA) has been aggressive in their approach to deal with non-compliance with the transfer pricing regulations. The multinational corporations doing business

operations in Kenya are subject to through investigations and audits to ensure that the country protects their rightfully earned tax profits by ensuring that all the revenue or profits generated by the MNCs in Kenya are subject to tax in Kenya. In 2014 the KRA reported that Kenya has recovered KShs 25 billion from the forty (40) MNCs that were audited that year. (Maina 2016)

The transfer pricing rules that were introduced into law to deal with tax base erosion in Kenya did not result in 100 percent compliance by multinationals as they have identified loopholes in the legislation and continued to repatriate profits from Kenya. Due to the early response by the Kenyan government a new legislation referred to as the Tax Procedure Act was enacted in law. The new legislation contains specific guidance on tax avoidance offence and the penalties that arise due to non-compliance which are twice the amount of tax that would have been determined as having been avoided by the tax payer. (Maina 2016)

In 2005 the High Court of Kenya held, in the case of *Unilever Kenya Limited v The Commissioner for Income Tax,* that in absence of any guidelines on transfer pricing in Kenya, OECD guidelines were acceptable. Following the Unilever case in 2005 the Kenyan Minister of Finance decided to enact the transfer pricing rules in the Income Tax Act in Kenya in 2006. (Warris 2017)

After the *Unilever Kenya Limited v. The Commissioner for Income Tax* Kenya went back to the drawing board and implemented several measures aimed at dealing with transfer pricing and as a result the transfer pricing regulations were implemented in 2006, the KRA employees were trained so that they can be skilled and experienced in dealing with the transfer pricing cases. Kenya is now one of the leading countries in Africa that has the capacity and resources to deal with mispricing by multinationals decisively. (Warris 2017)

6.2.3. Documentation requirements in Kenya

Multinational corporations who are taxpayers are Kenya are required to submit the annual tax return which needs to be completed by the taxpayer by declaring the transactions that are between the taxpayer and any related party to the transaction, the value of the intercompany transaction and lastly the taxpayer have to declare that they have prepared all the necessary documentation required for transfer pricing (including the calculation of the transfer price with the methodology and comparables provide). This requirement is applicable to annual tax years from 31 December 2010

6.2.4. Arm’s length principle

The arms’ length principle is also the most preferred and only method prescribed in Kenya to calculate the arm’s length transfer price. Like South Africa and Tanzania Kenya has adopted the transfer pricing methods as recommended by the OECD guidelines (PwC 2012). The Kenya Tax

Authorities have the legal obligation of ensuring that the transfer pricing submitted by taxpayers is at arm's length and to adjust in instances where the transfer price submitted is not deemed arm's length. (Curtis & Todorova 2012)

Kenya is advanced in relation to having the comparables used to calculate the arm's length price. The country makes use of different databases for different information required, for example commodities information, industry data, historical sales prices and volumes, intellectual properties etc. but Kenya Revenue Authority only makes use of the Orbis database. In 2017 Orbis contained information about approximately 100 million private companies, 65 thousand listed entities and an estimated individual taxpayer of around 90 million. (Warris 2017)

Lack of comparable information remains a challenge for developing countries to perform comparable transfer pricing analysis to determine the appropriate transfer price. Many taxpayers including MNCs in Kenya make use of Amadeus to source data for comparables, Amadeus is the sub-set of Orbis. Due to the database containing not only the African continent but include for the rest of the world the comparable results that are generated are often unreliable and thus inaccurate to base the arm's length price on. In 2016 Orbis had reported 2,662,476 companies from Africa and 12,529 out of the total African companies were listed as companies from Kenya. (Warris 2017)

6.2.5. Burden of proof

In Kenya the taxpayer carries the burden of proof to demonstrate to the authorities that the controlled transaction between related parties has been concluded at arm's length (i.e. as if the conditions were of those who are independent)

6.2.6. Interest and penalties

Kenya does not have any set rules prescribing transfer pricing penalties but there are instances that upon the finalisation of the audits and investigations conducted by the commissioner of domestic tax the tax may be adjusted which may give rise to the penalties. S72D and 94 in the Act states that additional transfer pricing adjustments may give rise to penalties at 20% and 2% interest on late payments for than 30 days or one month. (Curtis & Todorova 2012)

6.2.7. Transfer pricing challenges in Kenya

- Absence of Advanced Pricing Agreements (APAs) requirement in the Kenya Income Tax Act. APAs are one of the measures that tax authorities can use to regulate the transfer pricing rules as the APA terms would ensure that taxpayer is held accountable for the terms that would have been agreed upon between the taxpayer and the related party to the taxpayer.
- APAs protects both the taxpayer and the tax authority as it allows the taxpayer to agree the terms of the transaction with the related party and affords the tax authority with the

opportunity to resolve the transfer pricing disputes without incurred additional costs by conducting audits and intense investigations. APAs also protects the taxpayer from incurring interests and penalties due to non-compliance and from being double taxed. (Maina 2016)

- The transfer pricing regulations in Kenya do not contain guidance on the threshold of cases that would be subject to filling for tax returns, audits or documentation requirements which leads to lack of clarity and uncertainty for the taxpayers impacted.

Tanzania and Kenya transfer pricing rules shows how the two countries have developed different rules to curb the transfer pricing challenges, but it is undisputed that the two countries still have some work to do in order to successfully defeat such challenges.

CHAPTER SEVEN

SOUTH AFRICA, KENYA AND TANZANIA ANALYSIS

7.1. Introduction

Many multinational corporations that conducts business operations do not have the company or a legal entity that is registered to trade in the continent. Due to the strict requirements around the taxing of such profits from the business activities conducted the country where such operations are taking place should have the domestic tax legislation in places that gives that country the rights to tax such profits. However, the domestic rights may be restricted in instances where there is a tax treaty as in most cases the country legislation mirrors the wording contained in the tax treaties. (Media Corporation 2018)

African transfer pricing rules have posed great difficulties and such difficulties are as a result of the availability of few comparable prices that are relevant to benchmark the prices and terms agreed on by the related parties when trading amongst each other. The prescriptions of the arm's length principles in the tax treaties and domestic laws when dealing with intragroup transactions have posed some jurisdiction struggles.

The leeway granted to individuals to analyse their own facts and circumstances when dealing with transfer pricing have proved to promote subjectivity in the audit and the administration of the transfer pricing and such subjectivity further creates an environment where there is uncertainty for tax payers and the potential investors as it is becoming hard to predict the tax outcomes. Tax authorities that finds themselves competing with the large accounting firms to determine the appropriate tax revenue to be included in the tax return and as such they have found the process of analysing individual facts and circumstances complex, resource intensive and time-consuming.

7.2. Table of Comparison

In the table below the comparisons of the Transfer Pricing regimes in Kenya and Tanzania as set out in chapter six (6) above is compared to South Africa as documented in chapter four (4) and it is important to note that the comparison below is necessary to find the common gaps in the strategies currently being applied between these countries to ensure that the issues surrounding transfer pricing are addressed sooner.

General	Kenya	*Kenya Income Tax Act* sets out the adherence to the arm's length principle

		in *section 18(3) of the Act.* Further guidance is also provided that clearly points out the transfer pricing rules in Kenya follow the OECD method which also includes what they refer to as the "most appropriate method". In Kenya the preferred method to determine the transfer price that is at arm's length when the comparables exist is the CUP method regardless of having most of their policies adopting the profit-based methods. (Curtis & Todorova 2012)
	Tanzania	The transfer pricing rules in Tanzania were signed into law and became effective for the first time in May 2014 and were later amended again in April 2018. The new rules contained in the 2018 new regulations introduce additional transfer pricing rules that were never included in the 2014 rules.
	South Africa	South Africa has transfer pricing rules, regulations and guidance in place which is mostly in line with the latest global developments and local requirements across the globe. SA first implemented the rules on transfer pricing in 1995 and since then the transfer pricing rules have been transformed. While Practice Note 7, despite the updates over time, is not in sync with the modernised legislation, it is understood that SARS is in the process of completing new guidance, presumably in the form of an interpretation note, which should be finalised in the next coming years.)
Documentation requirements for Transfer Pricing	Kenya	Kenya transfer pricing rules promotes and require that the documentation that is maintained demonstrate the following: - the process followed in the selection of the transfer pricing method and demonstration of the rationale behind selecting a method; - showing calculations that were made and any price adjustments when the entity is applying the method selected; - any policies, assumptions made, and the strategies applied in the selection of the method; - additional background information that may be required by the commissioner regarding the transaction. (Curtis & Todorova 2012)
	Tanzania	The 2018 new transfer pricing rules in Tanzania provide an overview of the information that should be included when preparing the transfer pricing documentation to support the determination of the arm's length price adopted by the tax paper. Below are some of the new rules contained in the regulations:

		- taxpayers are required to provide workings showing how the transfer pricing for controlled transaction was determined (EY 2018); - in 2018 it was reported that taxpayers would be required to file transfer pricing documentation with the final return of income transactions between related parties with a value exceeding Tanzanian shillings (TZS) 10 billion in a taxable year (EY 2018); and - it is not a legal requirement for taxpayers whose revenue threshold do not exceed TZS10 billion to submit the transfer pricing documentation but should be able to provide it to the tax regulators upon request. (EY 2018)
	South Africa	The maintenance of transfer pricing documentation is not a legal requirement in South Africa, but practice note 7 promotes that it is in the best interest of the taxpayer to maintain documentation and in instances where SARS requires the documentation the taxpayer should be in a position to produce the required documentation within 7 to 21 days from the date of issuing the instruction by SARS.. The note further appreciates that the transfer pricing documentation in SA differs from one taxpayer to another depending on the facts and circumstances. (Curtis & Todorova 2012)
Thin Capitalisation rules	Kenya	The thin capitalisation rules that are currently in place in Kenya prescribes debt to equity ratio of 3:1. (Curtis & Todorova 2012)
	Tanzania	The Income Tax Act of 2004 provides for the restrictions in the interest that is tax deductible only in cases where the taxpayer is an “exempt-controlled resident entity” which is being referred to as the resident entity that had 25% or more ownership held by non-resident persons or companies associated of the non-resident person during a given year of assessment. The total amount of interest that an exempt-controlled resident entity may deduct from the income during any year of assessment is limited to the sum of interest which is equivalent to a debt-to-equity ratio of 7:3. (KPMG 2017)
	South	Prior to 1 April 2012 the thin capitalisation rules in South Africa were set

	Africa	separately from the Act at debt-equity ratio of up to 3:1. From 1 April 2012 the thin capitalisation rules are no longer separate from the Act but forms part of the transfer pricing rules and as a result the taxpayers must apply an arm's length analysis to any transactions between a resident and a non-resident person. (Curtis & Todorova 2012)
Capacity	Kenya	In 2012 KRA was on the forefront of the transfer pricing in Africa as at that point the country established a transfer pricing unit which subscribed to the Pan-European databases (e.g. Amadeus), has become the member of ATAF and have had the transfer pricing case to court *(Unilever Kenya Ltd v the commissioner of Income tax*). (Curtis & Todorova 2012)
	Tanzania	In 2017 Tanzania invested in the formulating of a specialised unit for the international tax which will have the mandate to carry out any transfer pricing audits and investigation for the cases that are brought to the TRA. The specialised technical accounting is continuously provided to the revenue authorities working in the transfer pricing unit in that country and the training is provided by the international experts who have access to other countries to gain emerging transfer pricing insights. (Gachewa 2017)
	South Africa	SARS invested significantly in the capacity and development of the transfer pricing. In 2012 SARS had SARS approximately 15 000 employees and 15 of which were working in their transfer pricing unit and it was reported that time that they were looking to increase the number to 30 or 40 (Curtis & Todorova 2012). Like any other countries in Africa SARS continues to experience difficulties relating to lack of local comparable.
Tax treaties	Kenya	By December 2019 it was reported that Kenya had 13 double tax treaties (DTTs) other countries of which 2 of which are with fellow African countries (PWC 2019).
	Tanzania	Tanzania has signed 9 tax treaties with other countries for which 2 are African countries namely Canada, Denmark, Finland, India, Italy, Norway, South Africa, Sweden and Zambia.
	South Africa	By December 2019 South Africa reported to be having tax treaties with 79 other countries of which 15 are with other African countries (PWC 2019).
Interests and Penalties	Kenya	Kenya does not have any set rules prescribing transfer pricing penalties but there are instances that upon the finalisation of the audits and investigations conducted by the commissioner of domestic tax the tax may be adjusted

		which may give rise to the penalties. S72D and 94 in the Act states that additional transfer pricing adjustments may give rise to penalties at 20% and 2% interest on late payments for than 30 days or one month. (Curtis & Todorova 2012)
	Tanzania	The penalty is set at a minimum of 3,500 currency points in the currency point system as prescribed from time to time by the Commissioner at the currency point of TZS15,000 which would result in a penalty of TZS52,500,000 and this penalty is in addition of the possible of 100% on the adjusted amount which is imposed here taxpayers fail to comply with the arm's length principles when dealing as related parties.
	South Africa	South Africa does not have any specific transfer pricing penalties in place to deal with non-compliance, but adjustment may be subject to general penalty provision which may range from 0 to 200% of the tax payable as a result of the transfer pricing. (Curtis & Todorova 2012)

Based on the comparison above one can conclude that lack or minimal documentation requirements by the regulators, capacity and tax treaties are the key contributors to the issues or challenges that Kenya, Tanzania, and South Africa continues to experience where transfer pricing is concerned.

- Kenya requires that documentations be kept and with the country being in the forefront in terms of having the skilled transfer pricing staff however appears to be slacking in terms of signing the tax treaties with other African countries to ensure that the profits are retained within the African continent.
- Tanzania placed a threshold in terms of which tax payers must maintain the documents for transfer pricing, continues to grow their transfer pricing speciality unit but like Kenya they only have 2 treaties with other African countries.
- South Africa does have the transfer pricing documentation prescriptions requirement but strongly recommends that documentation be maintained in case of audits, the country is also growing their transfer pricing specialisation unit within SARS and appears to be ahead in terms of signing the treaties with other African countries as they have 15 tax treaty agreements with fellow African countries.

CHAPTER EIGHT

CONCLUSION

8.1. Introduction

The literature review analysis conducted in this research report shows that developing African countries are subjected to transfer pricing due to the continent being rich with the natural resources and the manipulation of the transfer price and the profit shifting is due to many factors such as lack of comparable data, limited knowledge and resources, tax treaties to deal with the challenges that comes with the manipulation of the transfer price. Even though the developing countries are aware of the issues and have formulated strategies and regulations to curb the manipulation it appears that a lot still needs to be done to achieve favourable results.

This research has also explored various manipulation schemes that are being applied by Multinational corporations (MNCs) and the strategies currently in place to deal with the challenges faced and this research also includes the comparison conducted between Kenya, Tanzania and South Africa. As various chapters in this report have gone in detail with transfer pricing to address the research questions at the start of this report, this chapter will not repeat what have been already discussed in other chapters in detail but only highlight the most crucial findings.

8.2. Findings

- the source countries continue to lose majority of their taxable revenue due to the transfer pricing manipulation;
- kenya is one of the leading developing countries in Africa that has the most advanced transfer pricing rules and highly skilled transfer pricing staff;
- OECD and UN guidelines remains recommended practices by South Africa and have not been prescribed into law; and
- although South Africa has improved on their transfer pricing rules in relation to other developing African countries there is still have a long way to go.

8.3. Recommendations

8.3.1. South African income tax act amendment to enable for the adequate for the formalization of the transfer pricing rules

The current South African transfer pricing rules currently provides recommendations to the variety of transfer pricing methods as set out in the OECD guidelines as outlined in practice note 7 but the

methods to determine transfer pricing have not been included in s 31 of the Income Tax act which is the relevant section in the act that deals with transfer pricing rules. The lack/absence of such methods in the act has led to taxpayers having more freedom in setting the transfer price that is deemed adequate.

This research report therefore recommends that s 31 of the Act be amended to Promulgate the transfer pricing methods to ensure that those who do not comply are brought to book and SARS will have the grounds to have non-compliant taxpayers prosecuted.

8.3.2. Introduction of transfer pricing concepts and theories as legislative definitions and the methods as set out in the OECD and UN guidelines in the South African Income Tax Act

Currently the South African transfer pricing rules in s31 of the Income tax Act does not define the concepts that are included in the OECD and UN guidelines. Definitions for principles such as associated enterprises, business profits, residents, permanent establishment etc as outlined in the Organisation of Economic Co-operation and Development (OECD) and United Nations (UN) guidelines are currently not contained in s31 of the Income Tax act.

As South Africa currently makes reference of these guidelines in practice note 7 it is therefore in this view that the inclusions of the key principles as mentioned above will achieve alignment of the transfer pricing regulations with the guidelines as outlined in the Organisation of Economic Co-operation and Development (OECD) and United Nations (UN).and will also draw the country closer to reaching the goal to curb the transfer pricing manipulations by the MNCs.

8.3.3. Introduction mechanisms like advance price agreement within the South African transfer pricing rules

Other mechanisms that have been in place and have been adopted by other countries and yield positive results includes the Advanced Pricing Agreements APAs. The countries that adopted such agreements have considered them to be one effective mechanism that is useful in curbing transfer pricing issues. There are referred to as agreements between the tax payer and the tax administration regarding the pricing of a cross-border transaction between the tax payer and the cross-border related party.

APAs are generally concluded for a future period for example 3 years however they may sometimes cover the past periods if they are deemed relevant in the setting of the transfer pricing. APAs

promotes certainty, consistency and avoid conflict of interest. Bilateral APS is regarded as another form to avoid double taxation whilst promoting certainty, the same as the normal APA the bilateral agreements are concluded between related parties in two different tax jurisdictions as well as the relevant tax administrations in the affected countries. One country that has been successful in the usage successful bilateral APAs is India.

To be able to adopt the successful APAs rules South Africa would need to develop their tax administration employees with the necessary relevant skills on the use of APAs, the OECD transfer pricing guidelines and the SA transfer pricing documentation requirement that will see the introduction of the APAs in our Act.

8.3.4. Introducing the Transfer pricing legislation in South Africa between the related parties locally

The current South African transfer pricing is aimed at providing guidance on dealing with transfer pricing on cross-border or international transactions and does not cover related party transactions between local companies within the same group of companies. SARS placed all their focus on assessing the amount of tax revenue losses on international transactions and as a result the revenue losses in domestic transactions are not being assessed as there is currently no regulations. The current transfer pricing rules should be updated to take into considerations the domestic laws on transfer pricing to ensure that local related parties' transactions are also regulated.

8.3.5. Improve transfer pricing skills and experience

Due to the continued tax revenue losses experienced by the country, it is recommended that the South African Revenue Services (SARS) should ensure adequate enforcement capacity in their transfer pricing unit. It should also ensure that the training and capacity building in its transfer pricing unit is enough and improved. In improving the capacity of the skills required at SARS to tackle the transfer pricing issues it is recommended that the teams that are built should comprises of the skills and expertise such as accountants, lawyers, auditors, IT specialists (including the data scientists) etc.

This overall research report has demonstrated that despite efforts that have been taken by the developing African countries to address transfer pricing challenges, the continent still has a long way. The multinational companies established in developed countries continues to rob the continent of its rightful taxes to grow the economy as despite the growth in the multinational corporations

operating in these African countries, South Africa the companies' tax generated by the SARS remains constant instead of increasing in line with the number of these companies generating revenue in the country.

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