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IMPACT OF ALIGNING SOUTH AFRICAN DOMESTIC LAWS WITH THE OECD's MODEL MANDATORY DISCLOSURE RULES AND TRANSFER PRICING PROVISIONS

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ABSTRACT

Over the years, tax administrators have collected declining tax revenues in part due to transfer pricing complexities. Complexities in transfer pricing legislation and the loopholes thereby created resulted in several tax disputes, some of which led to court cases.[1] Taxpayers in South Africa and world-wide have exploited the complexities in transfer pricing, hiding profits in associated enterprises with lower tax rates in order to minimise group tax and maximise group profits. It has been relatively simple to exploit transfer pricing legislation in South Africa due to the narrow scope of the definition of connected persons and the minimal disclosure requirements, as well as the lack of transfer pricing specific penalties. Taxpayers had low costs associated with transfer pricing compliance. With the changes in legislation implemented in order to absorb the OECD mandatory disclosure rules, the definition of connected persons was replaced with the associated enterprises definition and transfer pricing penalties were introduced. Tax revenue is likely to increase and companies are likely to incur higher costs in complying with the new rules and minimising tax.

Key Words: Advance Pricing Agreement, Affected Transactions, Anti-avoidance, Arm's Length Principle, Associated Enterprises, BEPS, Connected Persons, CRS Avoidance Arrangements, Mandatory Disclosure Rules, OECD, Opaque Offshore Structures, Tax Avoidance, Taxation, Taxpayer, SARS

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[1] Examples of these court cases are, the Altera case (Altera Corporation & Subsidiaries. v. Commissioner, Nos. 16-70496, 16-70497(9th Cir. June 7, 2019)) where the dispute was about whether it was a valid rule to require that the related entities must share the costs of employee stock compensation for their costs sharing arrangements to be classified as qualified cost-sharing arrangements not needing tax adjustments, and the Absolut case (The Absolut Company AB v. Skatteverket, Case No. 1913-18., 2018) where the dispute was about the Swedish Tax Agency increasing the 2007 financial year taxable income (tax payable) because it deemed to be incorrect, in respect to the dealings with one of the related entities.

DECLARATION

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

(Zanele Bitris Ngeyane)

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1. INTRODUCTION

1.1 Background and significance of the research

Transfer pricing is a key international tax topic with various challenges. The legislation provides guidance on the pricing of goods or services that are transferred between multi-national connected persons and/ or associated enterprises. Over the years, companies and tax administrators experienced various challenges in interpreting the legislation which led to countries seeking possible solutions. For example, in the United States case Altera Corporation & Subsidiaries v. Commissioner (2019),[2] the taxpayer and the tax administrator agreed that the arm's length principle applies; however, they disagreed on how it may be met. Most companies have dealt with transfer pricing challenges by keeping up with the Organisation for Economic Co-operation and Development (OECD) Tax Convention model developments. South Africa has not been an exception to this rule and has experienced such challenges; although, thus far there have been no transfer pricing court cases.

Since the introduction of transfer pricing legislation, South Africa has adopted the OECD's model of the 'arm's length principle' in dealing with the taxation of transactions between connected persons. The arm's length principle rules have been incorporated into the country's legislation in section 31 of the Income Tax Act 58 of 1962 as amended. The disclosure rules are set out in section 25 to section 32 of the Tax Administration Act 28 of 2011 as amended. Penalty rules are set out in section 210 to section 214 of the Tax Administration Act 28 of 2011; however, these are general penalty rules, not specific to transfer pricing.

South Africa has since attempted to align its transfer pricing rules with the OECD

[2] Altera Corporation & Subsidiaries. v. Commissioner, Nos. 16-70496, 16-70497 (9th Cir. June 7, 2019).

model, even though it is not a member of the OECD. However, not all of the OECD rules have been incorporated into the legislation. As further guidance, the SARS Practice Note 7 of 1999 refers the taxpayers to the OECD Guidelines. The note acknowledges "the OECD Guidelines are acknowledged as an important, influential document that reflects unanimous agreement amongst the member countries, reached after an extensive process of consultation with industry and tax practitioners in many countries" (Benetello, 2019, para. 3.2.1). SARS justifies that these Guideline should be adopted since they are also followed by many countries which are not OECD members and are therefore becoming a globally accepted standard. The Note further specifies that:

> The OECD has issued a report entitled "Harmful Tax Competition – An emerging global issue". In this report, failure to adhere to international transfer pricing principles is identified as a contributing factor to the proliferation of harmful preferential tax regimes. A tax authority's view on appropriate arm's length prices, if they impact on how an enterprise conducts its cross-border activity, can directly affect the competitive position of that enterprise. Following the OECD Guidelines will thus promote tax equality and reduce the possibility of South Africa contributing to the establishment of a harmful preferential regime [...] The OECD Guidelines should be followed in the absence of specific guidance in terms of this Practice Note, the provisions of s 31 or the tax treaties entered into by South Africa.[3]

While tax administrators do all in their powers to collect the tax due to their states, taxpayers on the other hand continue to develop innovative strategies to reduce their tax liabilities. Some of these strategies involved Base Erosion and Profit Shifting (BEPS), meaning that multi-national groups shift profit to countries with low tax rates. The prevalence of the BEPS strategy led to the OECD to identifying and recommending measures to counter the strategy. Wiesener makes the following statement with this regard:

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[3] Benetello, M., 2019. Chapter 10 Transfer Pricing and Thin Capitalisation. In: Silke on International Tax. LexisNexis. At paras 3.2.2 – 3.2.3.

Base erosion and profit shifting (BEPS) has been an issue identified by governments around the globe and the Organisation for Economic Co-operation and Development (OECD) was tasked to identify and recommend measures to counter this. The OECD BEPS initiative resulted in an action plan including 15 specific actions, which were published in 2015. This Action Plan was designed to counter BEPS. Four of these actions specifically related to transfer pricing.[4]

The OECD final reports on the 15 BEPS action plans were completed and published in 2015; and are briefly explained below. The following actions indirectly affected transfer pricing taxation rules:

- The first action plan (Action 1)[5] addressed the tax challenges of digital economy, referred to as a process that has resulted in cheaper technology that has widely contributed to improved business processes. The implementation of transfer pricing rules requires incorporation of the rules into the business processes as the compliance thereof is important to any business. Transfer pricing transactions are also captured and communicated using information technology.

  One of the issues explored in relation to intangibles and the solution was to make sure that the transfer pricing guidelines ensure that the transfer pricing analysis is not weakened by information asymmetries between the tax administration and the taxpayer in relation to hard-to-value intangibles, or by using special contractual relationships, such as a cost contribution arrangement.

  Action 1 is currently being updated to take into account the effect of continuous changes in technology. The aim of the update is to look at the

[4] Wiesener, C., 2019. Budget2019 | Can transfer pricing help increase. *bbrief*, 19 February, the impact of transfer pricing related profit shifting on tax collections, p. 1. https://www.bbrief.co.za/2019/02/18/budget-2019-can-transfer-pricing-help-increase-tax-collections/
[5] OECD (2015), *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. *http://dx.doi.org/10.1787/9789264241046-en*

significant impact that digitalisation is making on the tax broader environment, the update will then consider the history of work relating to tax arising from digitalisation and provide the necessary recommendations to the changes in the tax rules (including transfer pricing rules) because of the changes in technology.[6] OECD has recently requested for public comments into the issues identified in the interim report for incorporation into the final report.[7]

- The second action plan (Action 2)[8] dealt with measures that could be implemented in an attempt to neutralise the effect of hybrid mismatch arrangements. The aim of the article was to avoid a deduction of a dividend declared by one national to another where the dividend from the receiving country will be exempt. The article is not directly related to transfer pricing, however, it still involves transactions with connected (related) multi-national entities.

- The third action plan (Action 3)[9] dealt with situations whereby the multi-national companies transfer their profits to low tax countries through an establishment of a foreign controlled company (CFC). The recommended measures included creation of building blocks around the definition of CFC, CFC exemptions and thresholds, definition of CFC income, how the CFC income is computed and attributed to the different taxpayers, and how to prevent or eliminate double taxation. The CFC taxation rules would be considered in transfer pricing rules for attributing the adjustment.

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[6] OECD (2018), *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. *http://dx.doi.org/10.1787/9789264293083-en*

[7] OECD (2019), *Addressing the Tax Challenges of the Digitalisation of the Economy – Public Consultation Document,* 13 February – 6 March 2019

[8] OECD (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. *http://dx.doi.org/10.1787/9789264241138-en*

[9] OECD (2015), *Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. *http://dx.doi.org/10.1787/9789264241152-en*

- The fourth action plan (Action 4)[10] dealt with interest deductions and other financial payments. Three risk scenarios identified were groups placing higher levels of third party debt in high tax countries, groups using intragroup loans to generate interest deductions in excess of the group's actual third party interest expense, and groups using third party or intragroup financing to fund the generation of tax exempt income. A fixed ratio approach of rate from 10% to 30% was recommended as a measure to limit the deduction of interest for the group multinational entities, after taking into account the different positions of the group companies.

- Action 5[11] dealt with transparency and substance to counter harmful tax practices. The measures recommended included a framework of rulings that could give rise to BEPS concerns in the absence of compulsory exchange agreements. Transfer pricing was one of the key categories covered in the framework.

- Action 6[12] considered the granting of Treaty benefits in inappropriate circumstances. The action addressed the risk of income being allocated into countries where the economic activities resulting to the income, in an attempt to avoid tax. Transfer pricing is one of the areas where the income can be transferred from one group entity to another to minimise group tax.

- Action 7[13] related specifically to permanent establishment. Permanent

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[10] OECD (2015), *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.
http://dx.doi.org/10.1787/9789264241176-en
[11] OECD (2015), *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. *http://dx.doi.org/10.1787/9789264241190-en*
[12] OECD (2015), *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6* - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241695-en
[13] OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7* - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. *http://dx.doi.org/10.1787/9789264241220-en*

establishment is an important area that helps in allocating income to the economy where the activities that are used in generating the relevant income are being carried. The measures recommended by the action were to ensure the achievement of this.

- Action 11[14] dealt with the measuring and monitoring of BEPS. One of the indicators of BEPS identified was that the profit rates of multi-national entities allocated to the low tax rates countries were higher than those allocated to the rest of the world. Transfer pricing is one of the major areas where profit can be shifted to low tax countries.

- Action 12[15] dealt with mandatory disclosure rules. The objectives of the action are stated as follows:

> The main objective of mandatory disclosure regimes is to increase transparency by providing the tax administration with early information regarding potentially aggressive or abusive tax planning schemes and to identify the promoters and users of those schemes. Another objective of mandatory disclosure regimes is deterrence: taxpayers may think twice about entering into a scheme if it has to be disclosed. Pressure is also placed on the tax avoidance market as promoters and users only have a limited opportunity to implement schemes before they are closed down.[16]

Information plays a vital role in the determining of whether the transactions between the related, associated or connected entities are at arm's length to assess the correctness of tax payable or paid.

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[14] OECD (2015), *Measuring and Monitoring BEPS, Action 11 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241343-en

[15] OECD (2015), *Mandatory Disclosure Rules, Action 12 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241442-en

[16] OECD (2015), *Mandatory Disclosure Rules, Action 12 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, Executive summary, para. 4. http://dx.doi.org/10.1787/9789264241442-en

- The fourteenth action plan (Action14)[17] dealt with measures to make dispute resolution mechanisms more effective. Through action plan 14, the countries agreed on minimum standards to be met by each country to smooth the treaty disputes processes. These are, ensuring that treaty obligations related to the mutual agreement procedure (MAP) are fully implemented in good faith and that MAP cases are resolved in a timely manner, ensuring the implementation of administrative processes that promote the prevention and timely resolution of treaty-related disputes, and ensuring that taxpayers can access the MAP when eligible. These standards apply to all tax issues, including transfer pricing.

- Action 15[18] dealt with multilateral instruments to modify bilateral tax treaties. The action encouraged countries to come up with innovative strategies to deal with multilateral instruments' international tax issues.

The actions that specifically relate to transfer pricing are actions 8, 9, 10 and 13. The BEPS Action Plan identified that the existing international standards for transfer pricing rules can be misapplied so that the outcomes of the allocation of profits is not aligned with the economic activity that produced the profits. Actions 8, 9 and 10 of the BEPS Action Plan targeted this issue, to ensure that transfer pricing outcomes are aligned with value creation. The work on the plan focused on three key areas: (i) transactions involving intangibles such as intellectual properties, (ii) contractual allocation of risks and the resulting allocation of profits to those risks, and (iii) other high risk areas for base erosion and profit shifting. The work on actions 8 and 9 is summarised as follows:

Work under Action 8 looked at transfer pricing issues relating to transactions involving

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[17] OECD (2015), *Making Dispute Resolution Mechanisms More Effective, Action 14 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241633-en

[18] OECD (2015), *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. *http://dx.doi.org/10.1787/9789264241688-en*

intangibles, since misallocation of the profits generated by valuable intangibles has contributed to base erosion and profit shifting. Work under Action 9 considered the contractual allocation of risks, and the resulting allocation of profits to those risks, which may not correspond with the activities actually carried out. Work under Action 9 also addressed the level of returns to funding provided by a capital-rich MNE group member, where those returns do not correspond to the level of activity undertaken by the funding company.[19]

The actions 8-10 report recommended the application of the arm's length principle conditions under Article 9 of the OECD Model Tax Convention[20] for use or transfer of the intangibles between associated enterprises. Article 9 deals with transactions whereby associated enterprises are involved directly or indirectly in the management or control of one another at a price that is not at arm's length and allows the tax administrators to adjust the price to an arm's length price. Action 8 therefore recommended that the use of intangibles between the associated enterprises be at arm's length and if not, tax administrators are entitled to adjust the prices.

The actions 8-10 report, under action 9, recommended that transactions between associated enterprises be identified and transfer pricing be based on economic reality rather than contractual arrangement. Only in that way the transactions between the associated entities will be at arm's length.

Work under Action 10 focused on other high-risk areas, including the scope for addressing profit allocations resulting from transactions which are not commercially rational for the individual enterprises concerned (re-characterisation), the scope for targeting the use of transfer pricing methods in a way which results in diverting profits from the most economically important activities of the MNE group, and neutralising the use of certain types of payments between members of the MNE group (such as management fees and

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[19] OECD (2015), *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. *http://dx.doi.org/10.1787/9789264241244-en,* pp. 11-12 of 190.
[20] OECD (2017), *Model Tax Convention on Income and on Capital: Condensed Version 2017*, OECD Publishing.http://dx.doi.org/10.1787/mtc_cond-2017-en

> head office expenses) to erode the tax base in the absence of alignment with value creation.[21]

Actions 8, 9. 10 focused mainly on the measures that can be put in place to counter BEPS, benefitting the tax administrator while action 13 focused on the disclosure rules to ensure that the tax administrator receives the necessary documented information to make an informed decision on the treatment of the multi-national entities' transactions for taxation purposes. In arriving at the measures, the compliance costs for the taxpayer were taken into consideration. An extract from the executive summary of BEPS action 13 reads:

> Action 13 of the Action Plan on Base Erosion and Profit Shifting requires the development of "rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNEs provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template"[22]

The results of Action 13 were an introduction of Country-by-Country Reporting which entails the transmission of Country-by-Country reports for each group of companies, to other tax jurisdictions in terms of the Multilateral Competent Authority Agreement (MCAA) and the bilateral Competent Authority Agreement, as well as the exchange of transfer pricing documentation on request between the participating authorities as explained in SARS website.

Companies liable for Country-by-Country reporting are required to do so no later than 12 months after the last day of the reporting fiscal year of the multi-national-entity group. Guidance on the implementation of Country-by-Country Reporting[23]

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[21] OECD (2015), *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241244-en, p. 12 of 190.

[22] OECD (2015), *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241480-en, p. 11 of 74.

[23] *OECD (2018), Guidance on the Implementation of Country-by-Country Reporting – BEPS Action*

was issued in 2018 and assists both the tax administrator and the taxpayer in interpreting the requirements to counter for the challenges they may encounter in implementing the requirements. South Africa has already adopted the country-by-country disclosure rules and incorporated them into its legislation.

The research presented here has been triggered by all these OECD developments, and specifically by the 2018 developments. In March 2018, the OECD introduced Mandatory Disclosure Rules for CRS Avoidance Agreements and Opaque Offshore Structures in addition to the mandatory disclosure rules that were already in place. South Africa's 2019 budget review[24] suggested the possibility of amendment of the domestic legislation to align it with these rules (Mandatory Disclosure Rules for CRS Avoidance Agreements and Opaque Offshore Structures) and the possible amendment to the definition of the affected transactions by replacing *connected persons* in relation to a company, with *associated enterprises* to align it with the OECD model.

The research presented in this report is aimed at identifying the possible impact of the two proposed changes from both the taxpayer and the tax administrator's perspective. Furthermore, an assessment will be provided as to whether the amendments to the legislation are indeed necessary or if there are other possible solutions to the challenge of aligning South African legislation with global developments.

1.2 The research problems and sub-problems

1.2.1 The research problem

This research evaluates the impact of the proposed changes to the definition of

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13, OECD, Paris. www.oecd.org/tax/guidance-on-the implementation-of-country-by-country-reporting-beps-action-13.pdf

[24] Mboweni, T. T., 2019. *Budget Speech,* Pretoria: National Treasury.

affected transactions in section 31 of the Income Tax Act 58 of 1962 through the replacement of the term *connected persons* in relation to the company with *associated enterprises* to align the legislation with the OECD model. An analysis is presented regarding the impact of the amendment of the legislation to adopt the OECD's Mandatory Disclosure Rules for CRS Advance Arrangements and Opaque Offshore Structures. Through this evaluation, a determination will be made as to whether the proposed changes are necessary and the implementation thereof is practical from both the taxpayers' and tax administrator's perspective or whether alternative solutions present a more effective approach.

1.2.2 <u>The sub-problems</u>

The first sub-problem is to evaluate whether there is a need to effect the proposed changes through the comparison of the current legislation and the OECD model focusing on the proposed changes. South Africa is not an OECD member and therefore is not obliged to abide by OECD's rules. Transfer pricing is however an international taxation issue and therefore there may be a need for South Africa to keep up with international trends to stay relevant. This need is demonstrated by the abundance transfer pricing challenges throughout the world which are increasing due to the fact that country-by-country transfer pricing rules are misaligned.

According to Jennifer Mcloughlin, Osman Mollagee, a PwC partner in South Africa, believes that the proposed changes in the definition of affected transactions will broaden South Africa's transfer pricing rules.[25] The definition of connected persons, in relation to a company is provide for minimum percentages of control and vote participation, whereas the definition of associated entities does not provide for minimum percentages. It seems therefore that the definition of associated enterprises could apply to a wider range of transactions.

[25] Mcloughlin, J., 2019. South Africa Mulling Transfer Pricing Tweak. *Tax Notes International*, 25 February, para.5.

The second sub-problem is to evaluate the practicality of the proposed changes for implementation purposes by the taxpayer and the tax administrator which will include a cost/benefit analysis. Both the taxpayer and the tax administrator need people with the necessary expertise to handle transfer pricing issues and it is not always easy and cheap to obtain the right people. It is also not always easy to obtain and interpret the necessary information.

The more detailed and complimented the government makes the legislation, the more difficult it is to understand. Government, therefore needs more qualified experts to enforce it, and taxpayers need experts to remain compliant. This may even decrease compliance, if the costs and effort get too cumbersome. Policies and procedures also need to be put in place together with the necessary information technology systems to ensure a smooth implementation and enforcement processes.

The third sub-problem is to evaluate whether the proposed changes are effective and efficient in addressing the identified need. For the changes to be effective and efficient, they need to provide a solution to the problem identified at the lowest possible cost or at cost of no more than the benefit to be derived. From the tax administrator's perspective, more tax should be collected than the total cost incurred in implementing the changes and continuous maintenance of the administration related to the changes. The implementation and compliance costs of the taxpayer should not be too high that the taxpayer's profit margins are compromised resulting to even lesser tax to be collected.

The fourth sub-problem is to evaluate whether the proposed changes are the only solution to the identified need for a change and to evaluate other possible solutions in comparison to the practice of other countries worldwide. Other countries, such as, China, Egypt and Singapore for example have adopted Advance Pricing Agreements to address transfer pricing challenges.[26]

[26] OECD, 2012. *ctp/tax-global/4.%20Advance_Transfer_Pricing_Arrangements.pdf.* [Online]

1.3 The research methods used

The information in the report has been obtained from various sources, the main sources being the South African Income Tax Act 58 of 1962 as amended, the Tax Administration Act 28 of 2011 as amended, SARS Practice Note 7 of 1999, OECD Model Mandatory Disclosure Rules for CRS Avoidance Arrangements and Opaque Offshore Structures and the OECD Model Tax Convention on Income and Capital. Other sources include various OECD reports, various articles and internet websites.

Available at: http://www.oecd.org/ctp/taxglobal/4.%20Advance_Transfer_Pricing_Arrangements.pdf [Accessed 2020].

2. THE CURRENT LEGISLATION AND THE PROPOSED CHANGES

This chapter provides a detailed analysis of the current transfer pricing rules as set out in section 31 of the Income Tax Act 58 of 1962 as amended. A focus is placed on the definition of connected persons in relation to the company compared to the definition of associated enterprises, aiming at identifying the differences between the two definitions that could have led to the proposed changes of replacing connected persons with associated enterprises for the companies. The chapter also provides a detailed analysis of the current disclosure rules versus the proposed disclosure rules and the proposed transfer pricing penalties.

2.1 Current transfer pricing rules

The current transfer pricing rules are set out in section 31 of the Income Tax Act 58 of 1962 (Income Tax Act) as amended which is the primary income tax legislation in South Africa, and the SARS Practice Note 7 of 1999 (Practice note 7) which serves as additional guidance in implementing the transfer pricing rules. The disclosure and penalty rules are set out in section 25 of the Tax Administration Act 28 of 2011 as amended (Tax Administration Act). The current rules, as set out in section 31 of the Income Tax Act 58 of 1962 as amended, are based on the arm's length principle.

Section 31 starts by providing a definition of an affected transaction. The definition of the affected transaction is necessitated by the fact that, transfer pricing adjustments only apply to affected transactions. An affected transaction in simple terms means a transaction that has been entered into between or for the benefit of related or connected persons (persons that are not independent from each other). The definition of an affected transaction as in section 31 is as follows:

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

(a) that transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected between or for the benefit of either or both— i) (aa) a person that is a resident; and

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

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

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

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

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

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

(bb) any other person that is a controlled foreign company in relation to any resident, and those persons are connected persons in relation to one another; and

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

From the definition, it can be learned that, for the transfer pricing adjustments to apply (the transaction to be an affected transaction), it is necessary that the transaction be entered into between a South African Taxpayer and someone who is not a South African taxpayer, in relation to the concerned transaction and that transaction is not conducted at arm's length. Transfer pricing rules are there to ensure that tax is paid to the rightful country where the economic activities producing the taxed income have been carried.

The rules are therefore there to prevent transfer of one country's wealth to another country. If the transaction entered into is not at arm's length but is conducted between taxpayers of the same country's in relation to the transaction, the income would still be taxed in the rightful country and therefore transfer pricing rules would not be needed or applicable.

To avoid the transfer of one country's wealth to another country, section 31 requires that when an affected transaction has been entered into and a tax benefit derived, the transaction must be treated as though it has been entered into between independent parties at an arm's length price. The arm's length price is not specifically defined in section 31, however, it is clear from the rules that it necessitates that the price charged for exchange of goods or services between two independent parties is the equivalent to that which would be charged between two independent or unrelated parties. The rules are set out in section 31(2) and read:

> (2) Where—
> (a) any transaction, operation, scheme, agreement or under-standing constitutes an affected transaction; and
> (b) any term or condition of that transaction, operation, scheme, agreement or understanding—
> (i) is a term or condition contemplated in paragraph (b) of the definition of "affected transaction"; and
> (ii) results or will result in any tax benefit being derived by a person that is a party to that transaction, operation, scheme, agreement or understanding, the taxable income or tax payable by any person contemplated in paragraph (b) (ii) that derives a tax benefit contemplated in that paragraph must be calculated as if that transaction, operation, scheme, agreement or understanding had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm's length.

Section 31 continues to state that if it is determined that there is a difference between the affected transaction price and the arm's length price, the difference should be deemed a dividend for the company and subject to dividends tax. For any person other than a company, the same difference should be deemed to be a donation, subject to donations tax. Section 31(3)'s wording regarding the adjustment persons other than a company is as follows:

> (3) To the extent that there is a difference between—
> (a) any amount that is, after taking subsection (2) into account, applied in the calculation of the taxable income of any resident that is a party to an affected transaction; and

(b) any amount that would, but for subsection (2), have been applied in the calculation of the taxable income of the resident contemplated in paragraph (a), the amount of that difference must, if that person is a resident and the other person to the affected transaction is a person as contemplated in paragraph (a) (i) (bb) or (a) (iii) (bb) of the definition of "affected transaction"—

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

(ii) if that resident is a person other than a company, be deemed, for purposes of Part V, to be a donation made by that resident to that other person, on the last day of the period of six months following the end of the year of assessment in respect of which that adjustment is made: Provided that where the amount of that difference was prior to 1 January 2015 deemed to be a loan that constitutes an affected transaction, so much of that loan as has not been repaid before 1 January 2015 must—

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

(b) if that resident is a person other than a company, be deemed, for purposes of Part V, to be a donation made by that resident to that other person, on 1 January 2015.

In relation to transactions involving financial assistance, section 31's definition of a connected person simply refers to the definition in section 1;[27] however, the section 31 definition provides an exception to the section 1 definition for the purpose of the transfer pricing provisions: as long as one company holds at least 20% of equity shares or voting rights in the other company those companies are regarded as connected persons even if there is a shareholder holding more than 50% of voting rights in the other company. Transfer pricing rules, therefore, in relation to financial assistance, apply even if there is a shareholder with majority voting rights. For other transactions, the definition in section 1 apply in full. Section 31(4) reads:

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

(a) the granting of any financial assistance; or

[27] Section 1 of Income Tax Act 58 of 1962 as amended.

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

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

The definition in section 1 reads:

'' connected person'' means–

(d) in relation to a company –

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

(iv) any person, other than a company as defined in section 1 of the Companies Act that individually or jointly with any connected person in relation to that person, holds, directly or indirectly, at least 20 per cent of –

(aa) the equity shares in the company; or

(bb) the voting rights in the company;

(v) any other company if at least 20 per cent of the equity shares or voting rights in the company are held by that other company, and no holder of shares holds the majority voting rights in the company;

(vA) any other company if such other company is managed or controlled by –

(aa) any person who or which is a connected person in relation to such company; or

(bb) any person who or which is a connected person in relation to a person contemplated in item (aa); and

(vi) where such company is a close corporation –

(aa) any member;

(bb) any relative of such member or any trust (other than a portfolio of a collective investment scheme) which is a connected person in relation to such member; and

(cc) any other close corporation or company which is a connected person in relation to –

(i) any member contemplated in item (aa); or

(ii) the relative or trust contemplated in item (bb);

The definition in section 1 caters for different types of persons (taxpayers) and provides a definition for each. In relation to a company, a connected person is:

- any other company which is part of a group of companies, where at least one of the companies directly owns at least 50% of another company within the group,
- any person other than a company who alone or together with his or her connected person, directly or indirectly holds at least 20% of equity shares or voting rights in the first mentioned company,
- any other company if it holds at least 20% of equity shares or voting rights of the first mentioned company,
- any other company managed or controlled by a connected person to the first mentioned company or a person connected to the connected person of the first mentioned company,
- and if the first mentioned company is a close corporation a member or relative of a member of that close corporation or their connections.

Section 31's definition of a financial assistance reads:

'**"financial assistance"** includes any—

(a) debt; or

(b) security or guarantee.'

Section 31 provides a number of exclusions with regard to the granting of financial assistance by a headquarter company. These are listed in subsection 5 which reads:

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

(a) any other person that is not a resident and that transaction, operation, scheme, agreement or under-standing is in respect of the granting of financial assistance by that other person to that headquarter company, this section does not apply to so much of that financial assistance that is directly applied as financial assistance to any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting rights;
(b) any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting rights and that transaction, operation, scheme, agreement or under-standing comprises the granting of financial assistance by that headquarter company to that foreign company, this section does not apply to that financial assistance;
(c) any other person that is not a resident and that transaction, operation, scheme, agreement or under-standing is in respect of the granting of the use, right of use or permission to use any intellectual property as defined in section 23I (1) by that other person to that headquarter company, this section does not apply to the extent that the headquarter company—
(i) grants that use, right of use or permission to use that intellectual property to any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting rights; and
(ii) does not make use of that intellectual property otherwise than as contemplated in subparagraph (i); or
(d) any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting rights and that transaction, operation, scheme, agreement or understanding comprises the granting of the use, right of use or permission to use any intellectual property as defined in section 23I (1) by that headquarter company to that foreign company, this section does not apply to that granting to that foreign company.

In summary subsection 5 exempts, from transfer pricing adjustments, any transaction, operation, scheme, agreement or understanding between the head quarter company and,

- any non-resident, for the provision of financial assistance to the headquarter company if the headquarter company directly applied the financial assistance provided in providing financial assistance to a foreign company where the headquarter company holds at least 10% of equity shares or voting rights;
- any foreign company if the headquarter company is the granter of the financial assistance to the foreign company, and the headquarter company holds at least 10% of the equity shares or voting rights in the foreign company provided with the financial assistance;
- any non-resident involving granting of the use or right to use intellectual property by the non-resident to the headquarter company if the headquarter company in turn grants the use or right of use of the intellectual property to a foreign company where the headquarter company holds at least 10% of equity shares or voting rights, and does not use the intellectual property or right of use thereof in any other form; or
- any foreign company where the headquarter company holds at least 10% of equity shares or voting rights if the headquarter company grants the use or right of use of the headquarter intellectual property to that foreign company.

Subsection 6 exempts transactions entered into between a South African resident and a controlled foreign company which has a foreign business establishment and of which the tax payable by that controlled foreign company to countries other than South Africa is at least 75% of the total tax that would have been payable to South Africa had that controlled foreign company been a South African resident. The subsection reads:

> (6) Where any transaction, operation, scheme, agreement or understanding that comprises the granting of—
> (a) financial assistance; or

> (b) the use, right of use or permission to use any intellectual property as defined in section 23I, by a person that is a resident (other than a headquarter company) to a controlled foreign company in relation to that resident or in relation to a company that forms part of the same group of companies as that resident, this section must not be applied in calculating the taxable income or tax payable by that resident in respect of any amount received by or accrued to that resident in terms of that transaction, operation, scheme, agreement or understanding if—
> (i) . . . . . .
> (ii) that controlled foreign company has a foreign business establishment as defined in section 9D (1); and
> (iii) the aggregate amount of tax payable to all spheres of government of any country other than the Republic by that controlled foreign company in respect of any foreign tax year of that controlled foreign company during which that transaction, operation, scheme, agreement or understanding exists is at least 75 per cent of the amount of normal tax that would have been payable in respect of any taxable income of that controlled foreign company had that controlled foreign company been a resident for that foreign tax year:

Subsection 6 further states that the aggregate tax amount should be determined after taking into account double taxation agreements of the relevant countries and the credits and rebates that may be applicable to the taxable amount, but disregarding any loss from a company other than that foreign company. The subsection is worded as follows:

> Provided that the aggregate amount of tax so payable must be determined—
> (aa) after taking into account any applicable agreement for the prevention of double taxation and any credit, rebate or other right of recovery of tax from any sphere of government of any country other than the Republic; and
> (bb) after disregarding any loss in respect of a year other than that foreign tax year or from a company other than that controlled foreign company.

Subsection 7 provides an exemption in relation to a transaction comprising financial assistance in debt form, entered into by a resident or a company from the same group as the resident if the resident owns at least 10% of equity shares and voting rights in that company. The subsection reads:

(7) Where—

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

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

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

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

this section must not apply to that debt.'

The current transfer pricing rules can be summarised as follows:[28]

- Section 1 of the Income Tax Act no 58 of 1962 (ITA), which defines "connected persons". A 'connected person" in relation to a company can be either another company within a group or a person subject to certain specified percentages of equity shares and voting rights indicating an economically significant interest in that company (see Question 1).
- Section 31(1) of the ITA defines an "affected transaction" as one that is direct or indirect, entered into or effected between connected persons, and any term or condition which is not at arm's length.
- Section 31(2) of the ITA, which provides for the primary adjustment (see Question 1).

[28] The current Transfer Pricing rules as summarised in Miller, K., Bennett, A., Alexander, C. & Wentzel, W., 2018. Transfer pricing in South Africa: overview. *Thomson Reuters*, Primary Legislation.

- Section 31(3) of the ITA, which states that the primary adjustment gives rise to a secondary adjustment in the form of a deemed dividend consisting of a distribution of an asset in specie in the case of a company or a deemed donation in the case of a person other than a company.
- Section 64E of the ITA, which imposes a 20% dividends tax charge on the affected transactions in the case of a company.
- Section 64 of the ITA which imposes a 20% donations tax charge on the affected transaction in the case of a person other than a company.

Question 1 referred to in bullet 3 of the summary of the transfer pricing rules above, is section one of the same article about the main characteristics of transfer pricing and policy in South Africa. The section reads:

> South Africa's transfer pricing rules are based on the Organisation for Economic Co-operation and Development's arm's length standard. The rules require a legal connection between the parties to the transaction and although the definition of a connected party is complex, for companies it can be summarised as including members of a group where the common shareholding is more than 50%, and companies which own a shareholding of at least 20% in a company in which no other holder of shares holds the majority voting rights in the company. A transfer pricing primary adjustment attracts a secondary adjustment in the form of a deemed dividend in its current form (in specie) in the case of a company, which is equal to the primary adjustment and subject to dividends withholding tax at a rate of 20%. In the case of a person other than a company, the secondary adjustment is subject to donations tax of 20%.[29]

Miller, et al. (2018) further explain that, the transaction is only re-characterised if the conditions differ from those found between unrelated parties, and that it is the taxpayer's responsibility to do its own assessment to apply the transaction at arm's length in its tax return. This is because the onus is on the taxpayer to prove that the transaction is at arm's length should the taxpayer be subject to audit in any tax period. The explanation is as follows:

[29] Miller, K., Bennett, A., Alexander, C. & Wentzel, W., 2018. Transfer pricing in South Africa: overview. *Thomson Reuters*, 1 July, para.1 & 3.

The legislation permits re-characterisation of a transaction where any of the terms and conditions differ from those found between unrelated parties. The legislation is a self-assessment provision in that, the taxpayer must file a return based on the transaction being in accordance with the arm's length principle. If the taxpayer is party to a transaction that is not priced on an arm's length basis, the taxpayer must adjust the pricing to an arm's length amount when filing the return (primary adjustment).[30]

The disclosure rules

The current disclosure rules relating to transfer pricing are as set out in the Tax Administration Act. All the transfer pricing transactions need to be disclosed in the taxpayer's tax return and the rules for submission of the taxpayer's return are set out in section 25 of the act as follows:

25. (1) A person required under a tax Act to submit or who voluntarily submits a return must do so—

(a) in the prescribed form and manner; and

(b) by the date specified in the tax Act or, in its absence, by the date specified by the Commissioner in the public notice requiring the submission.

(2) A return must contain the information prescribed by a tax Act or the Commissioner and be a full and true return.

(3) A return must be signed by the taxpayer or by the taxpayer's duly authorised representative and the person signing the return is regarded for all purposes in connection with a tax Act to be cognisant of the statements made in the return.

(4) Non-receipt by a person of a return form does not affect the obligation to submit a return.

(5) SARS may, prior to the issue of an original assessment by SARS, request a person to submit an amended return to correct an undisputed error in a return.

(6) SARS may extend the time period for filing a return in a particular case, in accordance with procedures and criteria in policies published by the Commissioner.

(7) The Commissioner may also extend the filing deadline generally or for specified classes of persons by public notice.

[30] Miller, K., Bennett, A., Alexander, C. & Wentzel, W., 2018. Transfer pricing in South Africa: overview. *Thomson Reuters*, 1 July, para. 2.

(8) An extension under subsection (6) or (7) does not affect the deadline for paying the tax.

All the necessary supporting documentation relating to transfer pricing needs to be kept safe for audit purposes for 5 years in accordance with the requirements of section 29 of the act which reads:

29. (1) A person must keep the records, books of account or documents that—
(a) enable the person to observe the requirements of a tax Act;
(b) are specifically required under a tax Act; and
(c) enable SARS to be satisfied that the person has observed these requirements.
(2) The requirements of this Act to keep records for a tax period apply to a person who—
(a) has submitted a return for the tax period;
(b) is required to submit a return for the tax period and has not submitted a return for the tax period; or
(c) is not required to submit a return but has, during the tax period, received income, has a capital gain or capital loss, or engaged in any other activity that is subject to tax or would be subject to tax but for the application of a threshold or exemption.
(3) Records need not be retained by the person described in—
(a) subsection (2)(a), after a period of five years from the date of the submission of the return; and
(b) subsection (2)(c), after a period of five years from the end of the relevant tax period.

Section 30 prescribes the form in which these documents should be kept and the section reads:

30. (1) The records, books of account, and documents referred to in section 29, must be kept or retained—
(a) in their original form in an orderly fashion and in a safe place;
(b) in the form, including electronic form, as may be prescribed by the Commissioner in a public notice; or
(c) in a form specifically authorised by a senior SARS official in terms of subsection (2).
(2) A senior SARS official may, subject to the conditions as the official may determine, authorise the retention of information contained in records, books of account, or documents referred to in section 29 in a form acceptable to the official inspection of records

> 31. The records, books of account and documents referred to in section 29 whether in the form referred to in section 30(1) or in a form authorised under section 30(2), must at all reasonable times during the required periods under section 29, be open for inspection by a SARS official in the Republic for the purpose of—
> (a) determining compliance with the requirements of sections 29 and 30; or
> (b) an inspection, audit or investigation under Chapter 5.

Section 32 prescribes the period within which the records need to kept in the event of audit, objection or appeal as the period from the submission of return until the audit, appeal or objection process is concluded. The section reads:

> 32. Despite section 29(3), if—
> (a) records are relevant to an audit or investigation under Chapter 5 which the person subject to the audit or investigation has been noticed of or is aware of; or
> (b) a person lodges an objection or appeal against an assessment or decision under section 104(2), the person must retain the records relevant to the audit, objection or appeal until the audit is concluded or the assessment or the decision becomes final.
> ‘understatement penalties can apply.

<u>Recent developments</u>

Transfer pricing rules are being adjusted as new developments (weaknesses) are identified by the OECD and other countries experiencing transfer pricing complexities. South Africa follows these developments to keep current. The recent developments already incorporated in South Africa’s legislation are those of country-by-country (CbC) reporting, as stipulated in OECD BEPS Action 13.

On the 23rd of December 2016, a notice (Notice R.1598)[31] of regulations specifying the changes to the CbC reporting standard for multi-national entities (MNE) groups specifically required for South Africa’s circumstances was published under the Tax Administration Act. In addition, a public notice (Public Notice 1117)[32] under section

[31] Public Notice R.198 of 23 December 2016.
[32] Public Notice 1117 of 20 October 2017.

25 of the Tax Administration Act requires the filing of the CbC reports, master files and/or local files. An extension of the initial deadline for filing these reports was granted in Public Notice 1308 of 8 December 2017. Miller, et al., 2018, state the following with regards to these rules:

> South Africa has adopted certain of the minimum standards proposed under the Organisation for Economic Co-operation and Development's (OECD) base erosion and profit shifting (BEPS) recommendations. Section 29 of the Tax Administration Act No 28 of 2011 (TAA) has been extended to include document retention requirements for transfer pricing. These are onerous and go beyond the requirements proposed by the OECD under Action 13 relating to master file and local file requirements. There is also a particular section of the annual tax return which requires specific transfer pricing disclosure, mostly relating to financial data on transactions (para. 5)

Section 29 does not specify that transfer pricing documentation should be retained. The section simply refers to documentation supporting the information in a tax return. As there is a specific transfer pricing section in the tax return, it should be easy for the taxpayer to identify which documentation needs to be retained for transfer pricing transactions.

> In addition to the documentation retention provision, the South African Revenue Service (SARS) has also recently issued transfer pricing documentation requirements as part of its implementation of the mini mum standard requirement under BEPS. These requirements are in line with Action 13 recommendations and involve the completion of the Country-by-Country reporting template (CBCR) and the Master File and Local File documents. The transfer pricing documentation requirements apply to taxpayers that have aggregated connected party transactions of a value of ZAR100 million or more. If this threshold is met, documentation should be completed for all transactions of ZAR5 million or more.[33]

Although, taxpayers that have aggregated connected party transactions of a value of less than ZAR100m are exempted from the Country-by-Country reporting template (CBCR), they still need to keep the necessary documentation to support

[33] Miller, K., Bennett, A., Alexander, C. & Wentzel, W., 2018. Transfer pricing in South Africa: overview. *Thomson Reuters*, 1 July, para. 6-7.

the information disclosed in annual return. A further exemption is granted for parent companies with less than R10 billion even if their aggregated connected party transactions are R100m or more.

> The CBCR reports must be completed by parent companies of groups that have consolidated turnover of ZAR10 billion or more. SARS has also recently extended the administrative penalty under section 210 of the TAA for non-compliance relating to the submission of the CBCR, Master File and Local File.[34]

SARS Practice note 7 of 1999 provides guidance on implementation of transfer pricing legislation. The practice note provides guidance in accordance with the OECD model and where the OECD model requirements from recent developments have not been incorporated into the practice note, the practice note simply refers the user to the OECD model.

<u>Penalties</u>

The current applicable penalties are the generalised penalties in section 210 to section 214 of the Tax Administration Act 28 of 2011. Section 210 entitles the tax authority to charge a taxpayer for not complying with the obligation imposed by a Tax act and made available for public, in addition to the non-compliance penalties already provided for in the Tax act. Section 210 reads:

> **210**. (1) If SARS is satisfied that non-compliance by a person referred to in subsection (2) exists, excluding the non-compliance referred to in section 213, SARS must impose the appropriate 'penalty' in accordance with the Table in section 211.
> (2) Non-compliance is failure to comply with an obligation that is imposed by or under a Tax act and is listed in a public notice issued by the Commissioner, other than______
> (a) the failure to pay tax subject to a percentage-based penalty under part C; or
> (b) non-compliance subject to an understatement penalty under Chapter 16.

[34] Miller, K., Bennett, A., Alexander, C. & Wentzel, W., 2018. Transfer pricing in South Africa: overview. *Thomson Reuters*, 1 July, para. 7-8.

Section 211 reads:

211. Fixed amount penalty table. — (1) For the non-compliance referred to in section 210, SARS must impose a 'penalty' in accordance with the following Table—

Table: Amount of Administrative Non-Compliance Penalty

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

(2) The amount of the 'penalty' in column 3 will increase automatically by the same amount for each month, or part thereof, that the person fails to remedy the noncompliance within one month after—
(a) the date of the delivery of the 'penalty assessment', if SARS is in possession of the current address of the person and is able to deliver the assessment, but limited to 35 months after the date of delivery; or
(b) the date of the non-compliance if SARS is not in possession of the current address of the person and is unable to deliver the 'penalty assessment', but limited to 47 months after the date of non-compliance.
(3) The following persons, except those falling under item (viii) of the Table or those that did not trade during the year of assessment, are treated as falling under item (vii) of the Table—
(a) a company listed on a recognised stock exchange as referred to in paragraph 1 of the Eighth Schedule to the Income Tax Act;
(b) a company whose gross receipts or accruals for the 'preceding year' exceed R500 million;

(c) a company that forms part of a “group of companies” as defined in section 1 of the Income Tax Act, which group includes a company described in item (a) or (b); or
(d) a person or entity, exempt from income tax under the Income Tax Act but liable to tax under another tax Act, whose gross receipts or accruals exceed R30 million. (4) SARS may, except in the case of persons referred to in subsections (3) (a) to (c), if the taxable income of the relevant person for the ‘preceding year’ is unknown or that person was not a taxpayer in that year—
(a) impose a ‘penalty’ in accordance with item (ii) of column 1 of the Table; or
(b) estimate the amount of taxable income of the relevant person for the ‘preceding year’ based on available relevant material and impose a ‘penalty’ in accordance with the applicable item in column 1 of the Table.
(5) Where, upon determining the actual taxable income or assessed loss of the person in respect of whom a ‘penalty’ was imposed under subsection (4), it appears that the person falls within another item in column 1 of the Table, the ‘penalty’ must be adjusted in accordance with the applicable item in that column with effect from the date of the imposition of the ‘penalty’ issued under subsection (4).

Although, the penalty amounts are small, with the highest being only R16 000, they could prove to be quite significant should the non-compliance persist for a longer period. The sizes vary according to taxable income size allowing business continuity for businesses even though they are non-compliant.

Section 212 imposes a penalty in respect of a failure to disclose a reportable arrangement. The reportable arrangement is an arrangement that result to large tax benefits and as a result, the penalties being imposed by the section are significantly higher than the penalties in section 211.Section 212 reads:

212. Reportable arrangement penalty. — (1) A ‘participant’ who fails to disclose the information in respect of a reportable arrangement as required by section 37 is liable to a ‘penalty’, for each month that the failure continues (up to 12 months), in the amount of—

(a) R50 000, in the case of a ‘participant’ other than the ‘promoter’; or Copyright subsists in this work. No part of this work may be reproduced in any form or by any means without the publisher’s written permission. Any unauthorised reproduction of this work will constitute a copyright infringement and render the doer liable under both civil and criminal law. Whilst every effort has been made to ensure that the information published in this work is accurate, the editors, publishers and printers take no responsibility for any loss or damage suffered by any person as a result of the reliance upon the information contained therein.
(b) R100 000, in the case of the ‘promoter’.
(2) The amount of ‘penalty’ determined under subsection (1) is doubled if the amount of anticipated ‘tax benefit’ for the ‘participant’ by reason of the arrangement (within the meaning of section 35) exceeds R5 000 000, and is tripled if the benefit exceeds R10 000 000. Part C Percentage Based Penalty 213. Imposition of percentage based penalty. —
(1) If SARS is satisfied that an amount of tax was not paid as and when required under a tax Act, SARS must, in addition to any other ‘penalty’ or interest for which a person may be liable under this Chapter, impose a ‘penalty’ equal to the percentage of the amount of unpaid tax as prescribed in the tax Act.
(2) In the event of a change to the amount of tax in respect of which a ‘penalty’ was imposed under subsection (1), the ‘penalty’ must be adjusted accordingly with effect from the date of the imposition of the ‘penalty’.

2.2 Connected persons vs associated enterprises

The focus of the research report presented here is on connected persons in relation to the company. The definition of connected persons in simple terms according to Miller, et al., 2018, p. 1 is as follows:

> The rules require a legal connection between the parties to the transaction and although the definition of a connected party is complex, for companies it can be summarized as including, members of a group where the common shareholding is more than 50%, and the companies which owns shareholding of at least 20% in a company in which no other holder of shares holds the majority voting rights in the company.

The proposed amendment to the legislation as per the Income Tax Amendment Act of 2019 is an insertion of associated enterprises in the definition of affected transactions which does not remove the definition of the connected persons but instead makes use of both definitions in an *either, or* framework. This is possible because the definition of associated enterprises is wider and, therefore, if the definition of the connected persons does not apply, the definition of associated enterprises will automatically apply. Whether the definition of connected persons is removed or not does not really matter as it is covered in the definition of associated enterprises: hence the use of the *either, or* structure. The definition of connected persons, therefore, has in effect been replaced.

The proposed definition of associated enterprise is as follows:

> ‘‘**associated enterprise’** means an associated enterprise as contemplated in Article 9 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development’.[35]

Article 9 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development reads:

> 1. Where
> a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State,
> or
> b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly,

[35] Income Tax Amendment Act of 2019.

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

The definition of associated enterprise is focused mainly on participation, direct or indirect, in the control, management or capital of another enterprise, the two enterprises being from different states. There is no mention of how much participation is required, in percentage, or otherwise. There must simply be control in place, in order to qualify for the provisions of article 9 of the OECD model. It can be concluded, therefore, that if there is some participation in management, control or capital, no matter how small or big, the provisions of the article will be applicable as long as the other criteria are met.

The definition of a connected person in relation to a company on the other hand provides minimum percentages for the control required between the enterprises (referred to as 'companies') in the definition. The definition of a connected person refers to ownership of equity shares or voting rights, no mention of management of one enterprise by the other enterprise.

The management of one enterprise by the other enterprise coupled with the lack of minimum levels of controls or participation makes the definition of associated enterprises wider than the definition of connected persons. This conclusion is supported by Mollagee.[36]

[36] Miller, K., Bennett, A., Alexander, C. & Wentzel, W., 2018. Transfer pricing in South Africa: overview. *Thomson Reuters*, 1 July, para. 4.

Els also supports the conclusion as follows:

> If a broad interpretation of associated enterprises is adopted, this could result in a wider application of these transfer pricing rules, and may lead to the arm's-length principle being applied to situations for which it was not intended," Michiel Els, an EY partner and head of transfer pricing in South Africa, said in a statement issued on the firm's website. "Further, the reference to associated enterprises could change the way taxpayers document their international transactions, as the element of 'control' would play a far greater role in determining what constitutes an affected transaction.''[37]

2.3 Current disclosure rules vs. proposed disclosure rules

The current disclosure rules relating to transfer pricing are mainly governed by disclosure in terms of the income tax return and the retention of documentation relating to the disclosures in the return (sections 25 and 29 of the Tax Administration Act). A summary of these disclosure rules is presented as follows (Mazars, 2017, pp. 4-6):

Submission of return

> Taxpayers must indicate on the corporate tax return (ITR 14) whether any cross-border related party transactions have been entered into during the year of assessment as set out in section 31(a) of the Income Tax Act. Disclosure needs to be made as to whether expenditure has been incurred or income received/accrued in respect of the cross-border related party transactions for the year of assessment. The value of transactions has to be disclosed per jurisdiction. In the event that there are more than five jurisdictions, the five highest value jurisdictions have to be disclosed. Various financial ratios have to be disclosed on the ITR 14, such as Debt: Equity, Debt: EBITDA etc. Various compliance questions have to be considered and completed on the ITR 14, such as:
> • Whether there is transfer pricing documentation (for the specific year of assessment) to support the relevant transactions;

[37] Mcloughlin, Jennifer. (2019) '*South Africa Mulling Transfer Pricing Tweak'*, Tax Notes International, February 25, para. 5.

• Whether there have been any changes in the operations of the group during the year of assessment effecting the cross border transactions;
• Whether there are there any transactions with tax havens;
• Whether the tested party is located out of South Africa and if so where.[38]

The information provided and the answers to the compliance questions establish the basis for the audit questions. Taxpayers need to be honest in the information they disclose and need to keep the supporting documentation as they do not know when an audit may be conducted. Failure to provide the necessary supporting documentation could result in unnecessary tax adjustments. Taxpayers, therefore, could end up paying more tax than they should have payed.

Duty to keep records

Where the Mater File and Local File mandatory application applies, the Master File and Local File is to be submitted within 12 months from the end of the close of the financial year. Documentation requested in respect of the Regulation for additional mandatory transfer pricing documentation issued 28 October 2016 would have to be provided within 21 days from the date of the request received from SARS.[39]

Failure to comply with the 12 months and the 21 days' period will result in penalties that would be an addition to the financial distress of the taxpayer.

[38] Mazars, 2017. Challenges & benefits of SARS new Transfer pricing guidelines. *Financial Planning*, 27 July, p. 4.
[39] Mazars, 2017. Challenges & benefits of SARS new Transfer pricing guidelines. *Financial Planning*, 27 July, pp. 4-5.

> In general, where the cross-border related party transactions are below the threshold of R 100 million for Master file and Local file, SARS have indicated that a form of simplified documentation should be kept and that it should broadly follow the guidance as set out in the OECD Transfer Pricing Guidelines. With regard to instances where the Master file and Local file is applicable the external business requirement specification (BRS) issued on 22nd of June 2017 should be followed. The content requested matches the criteria as set out in BEPS Action 13. The R 100 million threshold is reached without setting off of any cross-border related party transactions.[40]

The simplified documentation form is as important as the master file and the local file. The documentation is all in support of what is disclosed in the income tax return: the only difference is that; a taxpayer will not be penalised for not retaining the information in a prescribed form.

> On 28 October 2016 a Regulation was issued for mandatory additional transfer pricing documentation to be kept and submitted in the event of a transfer pricing audit. The regulation would be applicable to entities where the cross-border related party transactions in aggregate, without setting off amounts, are in excess of R 100 million.

Mazars, 2017, pp. 5-6 divides the list of documentary requirements into two. The first list is the master file, mainly qualitative and provides one with the understanding of the group to enable risk assessment amongst other things.

> 1st list of documentary requirements relates to the structure and operations of the group
> • Description of ownership structure, including description of foreign connected parties and nature of connection;
> • Name, address of principal office, legal form and jurisdiction of tax residence of each party;
> • Business operation summary, including the following
> o description of the business
> o market conditions
> o organogram showing title and location of senior management

[40] Mazars, 2017. Challenges & benefits of SARS new Transfer pricing guidelines. *Financial Planning*, 27 July, p. 5.

o major economic and legal issues impacting the business

o description of any business restructurings or intangible transfers the parties have been involved in;

o market shares within the industry, main competitors and competition in the market;

o key value drivers of business and industry;

o industry policies, incentives etc.; and

o role of the parties in the group supply chain[41]

The second list related to the local file and provides all the necessary information to understand the intergroup transaction of the local taxpayer to allow decisions with regards to the completeness, validity and accuracy of the information disclosed in the tax return.

2nd list of documentary requirements relates to cross-border related party transactions in excess of R 5 million included within the R 100 million. (Information to be kept for each transaction in excess of R 5 million.)

• Nature and terms of transaction;

• Copies of contracts/agreements;

• South African Reserve Bank documentation;

• Indication and explanation of tested party (if tested party is outside of SA further specific documentation to the tested party);

• Detailed functional analysis indicating the relevant functions undertaken, risks assumed and assets used;

• Analysis of intangible assets used;

• Operational flows, including information flows, cash flows, product flows etc.

• Financial analysis;

• Economic analysis;

• Selection of transfer pricing methodology;

• Details of benchmarking(s) / comparable searches performed;

• Adjustments made in terms of section 31(2) of the IT Act;

• Financial assistance transactions;

• Analysis and summary of financial forecasts, projected as far as meaningful to the relevant transactions;

[41] Mazars, 2017. Challenges & benefits of SARS new Transfer pricing guidelines. *Financial Planning*, 27 July, pp. 5-6.

• Analysis and summary of the financial strategy of the business;

• Financial assistance transactions, term exceeding 12 months;

• Description of the funding structure, including source of funds, date obtained, reasons for obtaining the funds, how the funds were or will be applied etc.;

• Group structure relevant to the funding transactions;

• Relevant financial statements and management accounts prior to and post the funding transaction;

• Copies of any unilateral, bilateral and multilateral advance pricing arrangements and any other tax rulings impacting the transaction.'[42]

The proposed disclosure rules are intended to address the Common Reporting Standards (CRS) Avoidance Arrangements and Opaque Offshore Structures and are in addition to the current disclosure rules. The purpose of the new disclosure rules is summarised as follows:[43]

> The purpose of the new rules is to provide tax administrations with information on arrangements that (purport to) circumvent the Common Reporting Standard (CRS Avoidance Arrangements) and on structures that disguise the beneficial owners of assets held offshore (Opaque Offshore Structures). The information required to be disclosed includes the taxpayers using such structures or arrangements and those involved with their design and set-up. This information will provide tax administrations both with additional intelligence for their tax compliance activities as well as for designing future tax policy. It is also expected that the rules will have a deterrent effect against the design, marketing and use of these arrangements and schemes and bolster the overall integrity of the Common Reporting Standard.

The mandatory disclosure rules place an obligation to an intermediary to report any CRS Arrangement and/ or Offshore Structures if the intermediary:[44]

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[42] Mazars, 2017. Challenges & benefits of SARS new Transfer pricing guidelines. *Financial Planning*, 27 July, p. 6.

[43] OECD (2018), *Mandatory Disclosure Rules for Addressing CRS Avoidance Arrangements and Opaque Offshore Structures Questions and Answers*, Tax notes Doc 2018-11144, p. 1.

[44] OECD (2018), *Model Mandatory Disclosure Rules for CRS Avoidance Arrangements and Opaque Offshore Structures*, OECD, Paris. www.oecd.org/tax/exchange-of-information/ *model-mandatory-disclosure-rules-for-crs-avoidance-arrangements-and-opaque offshore-structures.pdf*, p. 21.

(a) makes that CRS Avoidance Arrangement or Opaque Offshore Structure available for implementation, or provides Relevant Services in respect of that CRS Avoidance Arrangement or Opaque Offshore Structure through a branch located in [Jurisdiction Name];

(b) is resident or has its place of management in [Jurisdiction Name]; or

(c) is incorporated in, or established under the laws of, [Jurisdiction Name].

An intermediary that is a South African resident or has its place of management in South Africa, or an intermediary that is incorporated in, or established under the laws of South Africa will be obliged to report any CRS Avoidance Arrangement or Opaque Offshore Structure if the intermediary makes that CRS Avoidance Arrangement or Opaque Offshore Structure available for implementation, or provides relevant services in respect of that CRS Avoidance Arrangement or Opaque Offshore Structure through a branch located in South Africa.[45]

The CRS Avoidance arrangements, Opaque Offshore Structures and Intermediary are defined as:[46]

Rule 1.1: CRS Avoidance Arrangement

A "CRS Avoidance Arrangement" is any Arrangement for which it is reasonable to conclude that it is designed to circumvent or is marketed as, or has the effect of, circumventing CRS Legislation or exploiting an absence thereof, including through:

(a) the use of an account, product or investment that is not, or purports not to be, a Financial Account, but has features that are substantially similar to those of a Financial Account;

[45] Rule 2.1 of OECD (2018), *Model Mandatory Disclosure Rules for CRS Avoidance Arrangements and Opaque Offshore Structures*, OECD, Paris. *www.oecd.org/tax/exchange-of-information/ model-mandatory-disclosure-rules-for-crs-avoidance-arrangements-and-opaque offshore-structures.pdf*.

[46] OECD (2018), *Model Mandatory Disclosure Rules for CRS Avoidance Arrangements and Opaque Offshore Structures*, OECD, Paris. www.oecd.org/tax/exchange-of-information/ *model-mandatory-disclosure-rules-for-crs-avoidance-arrangements-and-opaque offshore-structures.pdf*, pp. 14-15.

(b) the transfer of a Financial Account, or the monies and/or Financial Assets held in a Financial Account to a Financial Institution that is not a Reporting Financial Institution or to a jurisdiction that does not exchange CRS information with all jurisdictions of tax residence of a Reportable Taxpayer;

(c) the conversion or transfer of a Financial Account, or the monies and/or Financial Assets held in a Financial Account, to a Financial Account that is not a Reportable Account;

(d) the conversion of a Financial Institution into a Financial Institution that is not a Reporting Financial Institution or into a Financial Institution that is resident in a jurisdiction that does not exchange CRS information with all jurisdictions of tax residence of a Reportable Taxpayer;

(e) undermining or exploiting weaknesses in the due diligence procedures used by Financial Institutions to correctly identify:

(i) an Account Holder and/or Controlling Person; or

(ii) all the jurisdictions of tax residence of an Account Holder and/or Controlling Person;

(f) allowing, or purporting to allow:

(i) an Entity to qualify as an Active NFE;

(ii) an investment to be made through an Entity without triggering a reporting obligation under the CRS Legislation; or

(iii) a person to avoid being treated as a Controlling Person; or

(g) classifying a payment made for the benefit of an Account Holder or Controlling Person as a payment that is not reportable under CRS Legislation;

where it is reasonable to conclude that such Arrangement is designed to circumvent or is marketed as, or has the effect of, circumventing CRS Legislation or exploiting an absence thereof.

It should be noted that all that is needed for a transaction to be declared a CRS avoidance scheme is a reasonable conclusion and therefore it will still be the taxpayer's onus to prove otherwise through supporting documentation as is the case for all other transfer pricing transactions.

OECD clarifies further that an Arrangement is not considered to have the effect of circumventing CRS Legislation solely because it results in non-reporting under the relevant CRS Legislation, provided that it is reasonable to conclude that such non-reporting does not undermine the policy intent of such CRS Legislation.[47]

An Opaque Offshore Structure is an offshore vehicle that does not present the economic substance of its activities and that hides the through identity of the real owner. An issue appears when the owners of the structure are tax residents in different countries as legal entity, as it would seem that the revenue has accrued to one country's tax resident while in terms of the substance of the arrangement, the revenue would actually have accrued to the resident of the other country. The detailed definition is as follows:[48]

Rule 1.2: Opaque Offshore Structure

(a) An Opaque Offshore Structure means a Passive Offshore Vehicle that is held through an Opaque Structure.

(b) Subject to paragraph (c) below, a "Passive Offshore Vehicle" means a Legal Person or Legal Arrangement that does not carry on a substantive economic activity supported by adequate staff, equipment, assets and premises in the jurisdiction where it is established or is tax resident.

(c) A Passive Offshore Vehicle does not include a Legal Person or Legal Arrangement (i) that is an Institutional Investor or that is wholly-owned by one or more Institutional Investors or

(ii) where all Beneficial Owners of that Legal Person or Legal Arrangement are only resident for tax purposes in the jurisdiction of incorporation, residence, management, control and establishment (as applicable) of the Legal Person or Legal Arrangement.

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[47] OECD (2018), *Model Mandatory Disclosure Rules for CRS Avoidance Arrangements and Opaque Offshore Structures*, OECD, Paris. www.oecd.org/tax/exchange-of-information/ *model-mandatory-disclosure-rules-for-crs-avoidance-arrangements-and-opaque offshore-structures.pdf*, p. 15.

[48] OECD (2018), *Model Mandatory Disclosure Rules for CRS Avoidance Arrangements and Opaque Offshore Structures*, OECD, Paris. www.oecd.org/tax/exchange-of-information/ *model-mandatory-disclosure-rules-for-crs-avoidance-arrangements-and-opaque offshore-structures.pdf*, pp. 15-16.

(d) An Opaque Structure is a Structure for which it is reasonable to conclude that it is designed to have, marketed as having, or has the effect of allowing, a natural person to be a Beneficial Owner of a Passive Offshore Vehicle while not allowing the accurate determination of such person's Beneficial Ownership or creating the appearance that such person is not a Beneficial Owner, including through:

(i) the use of nominee shareholders with undisclosed nominators;

(ii) the use of means of indirect control beyond formal ownership;

(iii) the use of Arrangements that provide a Reportable Taxpayer with access to assets held by, or income derived from, the Structure without being identified as a Beneficial Owner of such Structure;

(iv) the use of Legal Persons in a jurisdiction where there is:

- no requirement to keep, or mechanism to obtain, Basic Information and Beneficial Owner information, as defined in the latest Financial Action Task Force Recommendations, on such Legal Persons that is accurate and up to date;
- no obligation on shareholders or members to disclose the names of persons on whose behalf shares are held; or
- no obligation on, or mechanism for, shareholders or members of such Legal Persons to notify the Legal Person of any changes in ownership or control;

(v) the use of Legal Arrangements organised under the laws of a jurisdiction that do not require the trustees (or in case of a Legal Arrangement other than a trust, the persons in equivalent or similar positions as the trustee of a trust) to hold, or be able to obtain, adequate, accurate and current Beneficial Ownership information regarding the Legal Arrangement; where it is reasonable to conclude that the Structure is designed to have, marketed as having, or has the effect of allowing a natural person to be a Beneficial Owner of a Passive Offshore Vehicle while not allowing the accurate determination of such person's Beneficial Ownership or creating the appearance that such person is not a Beneficial Owner.

An intermediary is a third party that is helping the owners of the structure or arrangement in the design or marketing of the CRS Avoidance Arrangement or Opaque Offshore Structure. The formal definition of an intermediary is as follows:[49]

[49] OECD (2018), *Model Mandatory Disclosure Rules for CRS Avoidance Arrangements and Opaque Offshore Structures*, OECD, Paris. www.oecd.org/tax/exchange-of-information/ *model-mandatory-disclosure-rules-for-crs-avoidance-arrangements-and-opaque offshore-structures.pdf*, p. 16.

Rule 1.3: Intermediary

"Intermediary" means:

(a) any person responsible for the design or marketing of a CRS Avoidance Arrangement or Opaque Offshore Structure ("Promoter"); and

(b) any person that provides Relevant Services in respect of a CRS Avoidance Arrangement or Opaque Offshore Structure in circumstances where the person providing such services could reasonably be expected to know that the Arrangement or Structure is a CRS Avoidance Arrangement or an Opaque Offshore Structure ("Service Provider"). The standard of "reasonably be expected to know" must be determined by reference to the Service Provider's actual knowledge based on readily available information and the degree of expertise and understanding required to provide the Relevant Services.

The above definitions can be simplified as follows:[50]

CRS Avoidance Arrangements are arrangements that are designed to circumvent, or are marketed as, or have the effect of, circumventing the Common Reporting Standard, as implemented in relevant domestic laws. An arrangement circumvents the Common Reporting Standard where it avoids the reporting of CRS information to all jurisdictions of tax residence of the taxpayers in a way that undermines the policy intent of the CRS.

Opaque Offshore Structures are structures that involve the use of a passive entity in a jurisdiction other than the jurisdiction of tax residence of one or more of the beneficial owners and that are designed to, marketed as or have the effect of disguising the identity of the beneficial owner(s). Amongst others, this may include the use of nominee shareholders, the exercise of indirect control over entities or the use of jurisdictions with weak rules for the identification of beneficial owners. In order to minimise reporting in low-risk situations there is a carve-out from the definition of Offshore Structure for Institutional Investors.

[50] OECD (2018), *Mandatory Disclosure Rules for Addressing CRS Avoidance Arrangements and Opaque Offshore Structures Questions and Answers,* Tax notes Doc 2018-11144 a, p. 2.

Intermediaries are those persons responsible for the design or marketing of the arrangement or structure ("Promoters") as well as certain persons that provide assistance or advice with respect to the design, marketing, implementation or organisation of that arrangement or structure ("Service Providers").

Promoters are those persons that are responsible for the design or marketing of the scheme or arrangement. This in particular includes instances where the Promoter has introduced features into the arrangement in light of its Common Reporting Standard treatment or for preventing the identification of the beneficial owners or where the Promoter has marketed the scheme or arrangement as having such outcomes. This definition would include a wealth planner or financial advisor that encouraged their client to enter into an arrangement on the basis that it was not subject to CRS reporting.

Service Providers are persons that provide assistance or advice with respect to the design, marketing, implementation or organisation of the scheme or arrangement. This may for instance include the advice provided by a lawyer, accountant or financial advisor, as well as account management or compliance services.

The proposed disclosure rules impose an obligation to an intermediary involved in the design or marketing an Offshore Opaque Structure or CRS Avoidance Arrangement to report the structure or arrangement directly to the tax authorities. For the obligation to apply, however, the intermediary needs to know or needs to be reasonable expected to know that the structure is an Offshore Opaque Structure or the arrangement is a CRS Avoidance structure that needs to be reported to the tax authorities. The intermediary need to be able to conclude on the nature of the structure or arrangement from his or her analysis and therefore need not to hire someone to draw the conclusion. OECD (2018) states the following:

> A Service Provider is, however, only required to disclose an arrangement or scheme under the rules when that person knows or can be reasonably expected to know that the arrangement or scheme is subject to disclosure. This would typically be the case when the Service Provider, based on the information that is on file or readily available, has knowledge, or can be expected to have such knowledge in light of the expertise required for the services provided, that the arrangement or scheme has the effect of circumventing the Common Reporting Standard or disguising the beneficial owners.

The rules apply to specialised areas only as described in the OECD model.[51] OECD makes the following example as part of the exclusions to the rules:

> The definition would not be expected to apply to financial institutions carrying out routine transactional banking functions where the financial institution could not be expected to have the requisite knowledge or expertise to determine whether those services were being supplied in respect of an arrangement or structure that was disclosable under the rules.[52]

Some of the important areas that OECD considered in developing the new disclosure rules include how or in what form the information is to be shared by the intermediaries and what needs to be done once the information is received which include assessment of whether the arrangement result in a tax benefit.[53] This is because without the specification, the information provided could be prove to be insufficient to enable the tax authority to conclude on the nature of the structure or arrangement. In some instances, the information could be too detailed to allow quick decision-making. The information could also be complex and require experts to be hired to interpret it, adding on tax collection costs.

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[51] *Model Mandatory Disclosure Rules for CRS Avoidance Arrangements and Opaque Offshore Structures*, OECD, Paris. www.oecd.org/tax/exchange-of-information/ *model-mandatory-disclosure-rules-for-crs-avoidance-arrangements-and-opaque offshore-structures.pdf*.

[52]OECD (2018), *Mandatory Disclosure Rules for Addressing CRS Avoidance Arrangements and Opaque Offshore Structures Questions and Answers,* Tax notes Doc 2018-11144 a, p. 2.

[53] Johnston, S. Soong; Stewart, *David D. (2014) 'OECD Unveils Full Global Standard on Automatic Information Exchange'*, Tax Notes International, July 22 and Johnston, Stephanie Soong; Stewart, David D. (2017) '*OECD Launches AEOI Avoidance Scheme Disclosure Facility'*, Tax Notes International, May 8.

Conclusion

South African government has legislated most of the OECD’s transfer pricing provisions and disclosure rules, the latest being the country-by-country reporting. The proposed changes will add to the current legislated rules. The use of the associated enterprises, instead of connected persons for group companies will widen the scope of transfer pricing provisions. No minimum control percentage for associated enterprises and the associated enterprises requirements include management involvement requirement which is not a requirement for connected persons. The disclosure by intermediaries of CRS Avoidance Arrangements and Offshore Opaque Structures is an addition to the current disclosure rules and currently no transfer pricing specific penalties applicable in South Africa.

3. THE IMPACT OF THE PROPOSED CHANGES TO THE TAX ADMINISTRATOR

This chapter aims to identify if there is a need for the proposed changes in current legislation and provides the analysis of whether the proposed changes will address the need. The chapter also provides an analysis of whether it is practical to implement the proposed changes, considering the cost, availability of skills to examine the information and enforce transfer pricing compliance and any other relevant resources. The chapter also considers the practice of other countries and if there are any other alternatives to the proposed changes.

3.1 The need for the proposed changes in current legislation

Transfer pricing is an international issue and it is complex as it involves transactions between two or more countries. It is the price that is charged for the exchange of goods and/or services between two related parties, referred to as, 'connected persons', in the current South African legislation. The main objective of regulating tax on transfer pricing transactions is to ensure that the tax administrator, SARS in the case of South Africa collects the necessary tax, fairly due to the state, taking into account the actual facts (substance) of the transaction between the related persons. To achieve this objective, s31 requires that the taxation between connected persons be determined at an arm's length transaction price which is the price that would have been charged if the parties were not connected.

The manipulation of profits by the companies through BEPS has necessitated the need for the countries to stay alert of the BEPS schemes and continue to develop strategies to counter BEPS. The increasing rate of globalisation has resulted in transfer pricing becoming a global forecast for states. The augmented focus on transfer pricing rules has been addressed as follows (Pearson, 2018, para. 5-9):

> Why has transfer pricing become such a focus area recently?
>
> Answer
>
> Increased globalisation has created the potential for multi-national enterprises (MNEs) to manipulate profits and shift them to lower tax jurisdictions, resulting in revenue authorities becoming increasingly protective of their tax base. The Organisation for Economic Cooperation and Development (OECD) was therefore commissioned by the G20 to look into BEPS by MNEs. The main goal of BEPS is to ensure that profits are taxed in the country in which the economic activity that gave rise to those profits took place. The OECD came up with 15 action points to address BEPS. SARS represented South Africa (as a G20 member) in the OECD's BEPS project and agreed to implement, as part of the minimum standards, a number of the BEPS action points. One of these was Action 13 which deals with revised Transfer Pricing Documentation requirements and the introduction of Country-by-Country Reporting.

The proposed changes are the results of a continuation of the strengthening of the 15 action points to address BEPS, with South Africa keeping up with the OECD developments. The Transfer Pricing Documentation requirements and the Country-by-Country Reporting have already been incorporated into the South African legislation and are already in force. The Opaque structures and the CRS avoidance schemes disclosure are an addition the current rules and their enforcement will result in enhancement of SARS's awareness of the tax avoidance schemes by multi-national companies. The need to strengthen transfer pricing rules by addressing BEPS was re-emphasised by the preceding minister of finance (Malusi Gigaba) in his 2018 budget speech: [54]

> Finance Minister Malusi Gigaba in his 2018 Budget Speech has re-emphasised the Government's commitment to address Base Erosion and Profit Shifting (BEPS) by multinational companies and that the implementation and tightening of the various measures in line with G20 recommendations would continue. The Minister also indicated that the ability of companies to structure their tax affairs to reduce their tax base in South Africa and shift their profits to low-tax countries threatened the sustainability of our tax base, a challenge with which most governments are struggling. Country by Country

[54] Pearson, B., 2018. Transfer Pricing – Key questions answered. *Deloitte*, 28 February, para. 1.

> Reporting is seen by Government as a key measure to ensure that companies pay their fair share of tax.

The Minister's main concern in the tightening of transfer pricing rules was to ensure that every company pay their share of South African tax to guarantee sustainability of South African tax base. It is the tax administrator's responsibility to ensure that tax dues are collected to secure a better future for South Africa.

Although some measures such as Transfer Pricing Documentation and CbC have been put in place to reduce the effect of base erosion, there is clearly still a long way for South Africa to go to successfully combat base erosion schemes. The following statement was made which supports the statement that more work is still needed to combat base erosion schemes (Sprackland, 2018c, p. 1):

> On February 20 Ramaphosa responded to concerns from opposition lawmakers that legislation must be passed to deal with base erosion, illicit financials flows, and transfer pricing concerns. "Institutions like SARS, the Reserve Bank, the Financial Intelligence Centre, and our law enforcement agencies work together to detect and prosecute tax evasion," Ramaphosa said. "South Africa will continue to play a leading role in international efforts — through structures like the OECD and G-20 — to tackle the various forms of tax avoidance," he said.

The above statement was made by the current president of South Africa in which he emphasised the need to follow the OECD model in tackling tax avoidance and tax evasion, and in fulfilling the country's pledge made in 2016. Ramaphosa continued to state the following (Sprackland, 2018c, p. 1):

> 'In 2016 South Africa pledged to create a public beneficial ownership register, and it has pledged to meet OECD standards on tax-related issues. Details of its latest efforts are expected to emerge in the coming days after the annual budget is submitted to Parliament'.

While collecting tax is important, there is also an obligation to the government to ensure that the tax liabilities created are not too burdensome for some taxpayers while others escape with a much lighter liability – it is the responsibility of the tax administrator that a balance be maintained within the tax system. The Canadian Department of Finance has kept a focus on this requirement:[55]

> ‘A fair and efficient tax system is fundamental to an economy that works for everyone—making life more affordable for Canada's middle class and people working hard to join it.’

There is a need for SARS to ensure that every South African resident pays their dues when it comes to tax to support the country's economy. It is SARS's responsibility therefore to fashion the mechanisms to combat tax avoidance and/ or tax evasion. Without fighting BEPS, through strengthening transfer pricing rules, SARS is unlikely to collect sufficient tax revenue as transfer pricing is one of the major areas in which the wealth of one country is at risk of being transferred to another country. In support of this concept Adams & Adams Attorneys (2016, p. 1) wrote the following :

> Transfer pricing between related parties in different tax jurisdictions has become a major issue for revenue collectors due to the varying corporate tax rates applied across such parties. Techniques used by multinational corporations to manipulate their taxable income across jurisdictions result in huge losses in domestic tax revenue for many countries. Transfer pricing control therefore refers to the mechanisms employed by revenue collectors to curb such pricing manipulation.

Transfer pricing as a complex tax area and therefore requires tight and clear legislation to avoid disputes that could result in tax administrator losing to the taxpayer due to lack of regulation. Countries have continuously lost substantial tax revenue in this regard which would not have been the case had transfer pricing regulations been tighter. Examples include, *The Absolut Company AB v. Skatteverket*, Case No. 1913-18.[56] in which the respondent won a case against the

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[55] Ontario, O., 2019. Department of Finance Canada Consulting on Draft. *Tax Notes International*, 30 July, p. 1.
[56] Finley, R., 2019a. Absolut Wins Swedish Transfer Pricing Case. *Tax Notes International*, 21 June, pp. 1-2.

tax administrator, because the tax administrator failed to demonstrate the misapplication of the transfer pricing method used. The main area of dispute in the case was the financial year to be used as part of average three years where a company encountered abnormal years. The tax administrator had no back up legislation to support its argument of the financial year to be used and therefore lost to the taxpayer.

The complexity of transfer pricing could also be minimised through regular monitoring of how other countries deal with the transfer pricing challenges. Because the transfer price involves at least two countries, it is even more important to continuously check the regulations on transfer pricing against other countries. Keeping up with regulations of other countries ensures that, the local regulation is not far off from other country's regulation to prevent complex situations that may rise when the states' regulations conflict with each other. SARS has always relied on the taxpayer to provide proof of an arm's length transaction with very little disclosures required on request whenever there is a need.

While SARS does everything to increase tax collection, the taxpayers on the other hand do everything in their power to minimise their tax liability and this is the case globally. Transfer pricing has been a major scheme for minimising the tax liability for multinational companies or group of companies by shifting taxable income (through base erosion and profit shifting (BEPS)) to countries where the tax consequences are minimal. BEPS on transfer pricing transactions is the reason that transfer pricing has been made a strategic focus for SARS.

Over the last few years transfer pricing has been and still is a strategic focus area for the South African Revenue Service (SARS) forming an integral part of SARS's Compliance Programme. International developments around the transfer pricing practices of large multinationals that have been made public together with the G20/OECD BEPS Project have resulted in transfer pricing having a heightened focus not only for SARS and South Africa's National Treasury but also at the highest levels of government.[57] The United Nations (2017, pp. 627-628) wrote the following in support of this concept:

> There appears to be an increasing tendency for parent companies of South African subsidiaries to shift profits via a year-end adjustment to either the cost of goods imported by the South African subsidiary or directly to the operating margin, to bring the South African subsidiary in line with "comparable companies". What occurs is usually a global policy change by the parent company aimed at limiting the return of its subsidiaries (including those based in South Africa) to a guaranteed return (determined by way of a comparable search). The change in policy is often followed by an introduction of year-end transfer pricing adjustments to ensure that South African entities achieve the often low targeted net margin while the residual profit is returned to the parent or holding company.

South Africa is not the only country faced with the challenges of BEPS, other countries are suffering too. This concept has been supported as follows:

- Base erosion and profit shifting (BEPS) has been an issue identified by governments around the globe and the Organisation for Economic Co-operation and Development (OECD) was tasked to identify and recommend measures to counter this. The OECD BEPS initiative resulted in an action plan including 15 specific actions, which were published in 2015. This Action Plan was designed to counter BEPS. Four of these actions specifically related to transfer pricing.[58]

BEPS Action Plan 1[59] highlighted BEPS challenges that create the need for the tax

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[57] United Nations, 2017. *Practical Manual on Transfer Pricing for Developing Countries,* New York: Department of Economic & Social Affairs, p. 617.
[58] Wiesener, C., 2019. Budget2019 | Can transfer pricing help increase. *bbrief*, 19 February. https://www.bbrief.co.za/2019/02/18/budget-2019-can-transfer-pricing-help-increase-tax-collections/, p. 1.
[59] OECD (2015), *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. *http://dx.doi.org/10.1787/9789264241046-en*, p. 82.

authorities to strengthen the tax rules:

> As noted in the BEPS Action Plan (OECD, 2013), BEPS concerns are raised by situations in which taxable income can be artificially segregated from the activities that generate it, or in the case of value added tax (VAT), situations in which no or an inappropriately low amount of tax is collected on remote digital supplies to exempt businesses or multi-location enterprises (MLEs) that are engaged in exempt activities. These situations undermine the integrity of the tax system and potentially increase the difficulty of reaching revenue goals. In addition, when certain taxpayers are able to shift taxable income away from the jurisdiction in which income producing activities are conducted, other taxpayers may ultimately bear a greater share of the burden. BEPS activities also distort competition, as corporations operating only in domestic markets or refraining from BEPS activities may face a competitive disadvantage relative to multinational enterprises (MNEs) that are able to avoid or reduce tax by shifting their profits across borders.

The effect of BEPS is that a country with a low tax rate receives tax revenue that is due to other countries (the countries where the economic activities which produced the revenue subject to tax are carried) which in turn receive lower tax revenue. This concept is supported as follows:

> Transfer pricing can be used as a method to shift profits from one multinational company to another group company in another country where these profits may be subject to a lower corporate tax rate. Ultimately, the effect of base erosion through profit shifting is that the country from which taxable profits are shifted away loses tax revenue, the country to which these profits are shifted would gain tax revenue (usually at a lower tax rate) and the Multinational Group may reduce its overall effective tax rate.[60]

Each and every country therefore need to stay alert on developments and keep on strengthening transfer pricing rules. The concept that BEPS, most importantly on transfer pricing, is a global challenge:

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[60] Wiesener, C., 2019. Budget2019 | Can transfer pricing help increase. *bbrief*, 19 February. https://www.bbrief.co.za/2019/02/18/budget-2019-can-transfer-pricing-help-increase-tax-collections/, p. 2.

> An economic paper puts an upper-end estimate of the effect that the Tax Cuts and Jobs Act has had on the trade deficit through changes in transfer pricing activity at a $51 billion reduction. “For the period studied, tax-motivated transfer pricing, through its effect on flows of related-party trade, had a large negative effect on U.S. export prices and nominal export values and a smaller positive effect on U.S. import prices and nominal import values,” the Congressional Budget Office said in a May working paper, “The Effect of Tax-Motivated Transfer Pricing on U.S. Aggregate Trade Statistics.” The TCJA “lowered the U.S. corporate income tax rate substantially and, by doing so, reduced the incentive for multinationals to shift profit out of the United States through tax-motivated transfer pricing,” the paper states.[61]

It is clear that there has long been a need to keep up with developments in transfer pricing BEPS schemes and to strengthen transfer pricing rules, and furthermore that this need is growing over time. It is important, therefore, for South Africa to continue to strengthen its transfer pricing rules and to legislate effectively in order to ensure the enforcement and compliance. Without proper legislation, it would be impossible to force taxpayers to do comply with rules that they not obliged to comply with due to holes in the legislation.

3.2 Practicality and cost of the implementation of the proposed changes

For the implementation of the proposed changes to be beneficial to the tax administrator, the cost needs to be less than the benefit derived from it. It should also be practicable to implement the proposed changes. Practicability is affected by, amongst other factors, the availability of suitable systems, capital required and people skills required. SARS needs to ensure that measures are in place to effectively and efficiently collect sufficient tax due to the government. An example of the measures that SARS as the tax administrator need to take to ensure effective collection of tax due to the government of South Africa can be found on

[61] Velarde, A., 2019. TCJA’s Transfer Pricing Effect Holds Sway On Trade, CBO Says. *Tax Notes International*, 10 June, para. 1-2.

the following statement:

> The South African Revenue Service (SARS) is re-establishing its Large Business Unit and Illicit Economy Team, which will focus on high-net-worth individuals and large businesses. The unit is pivotal to fighting illicit trade and effectively taxing large corporate taxpayers, SARS said in an August 24 statement. The unit was abolished during a re organization in 2014-2015 undertaken by Commissioner Tom Moyane, who was suspended in March and is facing an administrative inquiry.[62]

Although the SARS large business unit mentioned in the quote above does not deal exclusively with transfer pricing, but the effective taxing of large corporate taxpayers would automatically include taxation relating to transfer pricing adjustments. The costs incurred in the establishment of the business unit will likely to contribute significantly towards the total cost of enforcing the proposed transfer pricing rules considering that an office park building would been needed. The addition on a building would necessitate other costs, such as the furnishing required and the recruitment and hiring of new staff to ensure that suitable and qualified candidates are on staff to facilitate the enforcement of transfer pricing regulations. Systems accommodating the new rules would also need to be implemented and regular maintained to ensure continuity. Due diligence would have been conducted, at a cost, to ensure that benefit would be derived from the re-establishment of the business unit, adding to the total costs of enforcing the rules.

The costs of obtaining the required staff, furniture, systems, buildings, etc., would also be significant, including the maintenance thereof. The costs would include, for example, recruitment costs from advertising until such time is the staff member is

[62] Sprackland, T., 2018b. South Africa Revives Large Business Unit. *Tax Notes International*, 28 August, p. 1.

obtained, security costs to ensure safety of the furniture and staff, cleaning costs to ensure that the building is kept clean and healthy.

The implementation costs would also include measures and personnel to be put in place in a fight against corruption to ensure adequate tax collection for the benefit of the government and not some corrupt SARS officials. Sprackland (2018a, p. 1) made the following statements which serves as an example of the effect that corrupt activities could derail the tax collection process:

> Disruptions in South Africa's tax administration and a weak economy are challenging the country's ability to raise needed revenues, National Treasury Director-General Dondo Mogajane said May 9. The South African Revenue Service (SARS) was plagued with allegations of graft and corruption during Jacob Zuma's nine-year presidency. Since taking office in February, President Cyril Ramaphosa has been working to restore credibility to the tax administration and re-establish economic order. Turmoil at the agency has prevented adequate tax collection, Mogajane said.

It is important for SARS to ensure that the people who are employed in high-level positions and entrusted with the responsibility of tax collection are of high integrity. This affects any and all new ventures entered into by: to ensure successful implementation of the new tax rules well-trained, responsible staff members are essential. The effective implementation of this measure will prevent corruption and national embarrassment as described in Sprackland's article:[63]

[63] Sprackland, T., 2018b. South Africa Revives Large Business Unit. *Tax Notes International*, 28 August, p. 1.

> On March 19 Ramaphosa suspended SARS Commissioner Tom Moyane, a close associate of Zuma, amid charges that Moyane helped Zuma's family and friends evade taxes. Jonas Makwakwa, Moyane's second-in-command, resigned after allegations of mishandling of VAT refunds. In a statement reported by Reuters, Mogajane said it will be a tall order to raise the ZAR 60 billion (about $4.78 billion) necessary to narrow a growing budget deficit. In the fourth quarter of 2017, the deficit reached ZAR 137.5 billion, up from ZAR 99 billion in the third quarter, according to figures released by the South African Reserve Bank.

The effect of these corrupt activities is not just felt by the tax administrator but also by the taxpayers as the losses from the corrupt activities are transferred to the taxpayer through increased taxes. The losses result in funds shortages for government to carry its activities, again directly affecting the lives of the taxpayers who benefit from the success of government programs. It is the government's responsibility to ensure the economic well-being of its citizens and this cannot be achieved through unreasonably high taxes due to the corruption of SARS officials. Sprackland highlights the effect of losses from corrupt SARS officials (Sprackland, 2018a, p. 1):

> In February, the Treasury announced the first VAT rate increase in over 20 years, from 14 percent to 15 percent, which is expected to generate an additional ZAR 23 billion in revenue from 2018 to 2019. Critics of the increase say poor and middle-income South Africans are bearing too much of the economic burden, although the government says measures have been taken to keep costs down for essential food items. South Africa, which was once the economic leader of Africa, has seen the value of its bonds plummet. The transfer of power to Ramaphosa stabilized the country's rating at investment grade, just above junk bond status, according to a quarterly report by Moody's Investors Service.

The above statement indicates that South Africa is struggling financially due to corruption and a deteriorating economy. The implementation of the new measures to increase transfer pricing compliance and collection of tax revenue would be a much-needed success, which would decrease the country's financial struggles. Success will only be possible through the elimination of corruption with anti-corruption training and the hiring of candidates who are moral and committed.

Without the right expertise, it will be impossible to effectively and efficiently implement the proposed rules as the transition requires a high skill level of analysis in order to design the processes to be followed in each stage of implementation. The interpretation of the definition of associated enterprises is likely to be very challenging and will necessitate the skills and knowledge of staff members who will be able to interpret it as intended. The same is true of the interpretation of the information to be submitted by intermediaries in support of the suspected Offshore Opaque Structures and CRS Avoidance Arrangements. It will be vital for SARS to employ people with the right expertise and simultaneously balance this need with that minimising the costs. The importance of the right expertise is supported by the following statement:

> In an August 1 report published by the Inter-American Center of Tax Administrations, risk assessment specialists for Ecuador’s Servicio de Rentas Internas (SRI) argued that an effective system for identifying high-risk cases is critical to the enforcement of a transfer pricing regime. “The tax audit of transfer prices includes the use of personnel with extensive technical knowledge and a significant sacrifice of resources, which is why it is essential to focus control efforts with a risk model, in order to obtain optimal results that result in enough tax collection, “the report says.[64]

SARS will need to make sure that, experts are secured with the ability of identifying areas where transfer pricing transactions could have hidden tax transactions. Without the personnel with the necessary abilities to conduct such audit chances of South Africa increasing tax collection are slim. The tax collected will then need to be protected against corrupt officials to avoid misuse of the collected funds which will worsen South Africa’s financial position.

Even if SARS has excess personnel that can be transferred to transfer pricing

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[64] Finley, R., 2019b. Ecuador Offers Transfer Pricing Enforcement Approach as a Model. *Tax Notes International*, 2 August, p. 1.

specific roles, training would still be needed from the experts to ensure that the personnel is fully equipped to conduct their determined duties. The use of experts to train current staff has been done by other states departments before: ”Several state departments of revenue have sought expert help to train their staff on handling transfer pricing issues.”[65]SARS could potentially undertake a similar on boarding process to reduce the implementation costs. This is likely to be cheaper than employing the new experts, whether full-time or on outsourcing basis.

While SARS certainly already retains staff that are familiar with companies' financial statements and tax law, the staff members that are selected to focus on transfer pricing will require a skillset that very few existing staff members probably retain:

> According to Silva, transfer pricing requires a trio of capabilities — accounting that is deeply familiar with companies' financial statements, tax law, and economics. He said states have the first two capabilities, but generally lack capability in economics, adding that this is true for the federal government as well.[66]

Economics skills are necessary to ensure that economic factors, such as the effect of the decision-making to the taxpayer's financial status, are taken into considerations in implementing the rules. Too much tax to companies could lead to job losses increasing the unemployment rate which would have a negative effect on the country as a whole. Knowledge of economics is an essential skill for a transfer pricing department and SARS may need to employ economics specialists to ensure that a wholesome economic view permeates the department.

SARS could also consider making use of some measures already put in place by the South African Government in implementing the proposed change. This decision

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[65] Muse, A., 2019. States Seek Outside Help with Transfer Pricing Audits. *Tax Notes International,* 22 July, p. 1.
[66] Muse, A., 2019. States Seek Outside Help with Transfer Pricing Audits. *Tax Notes International,* 22 July, p. 1.

will reduce the implementation costs thereby increasing the benefit and ensuring efficiency in collecting the tax. One example of an existing government resource which may be utilised in the development of a transfer pricing department is the Public Beneficial Ownership Register adopted in 2016-2017 national action plan (Johnston, 2016, p. 1).[67] Johnson stated with regard to the plan:

> South Africa will create a publicly accessible beneficial ownership registry containing details on those who ultimately control every company incorporated in the country, in an effort to crack down on illicit activities including tax fraud, money laundering, and corruption. On the sidelines of the May 5-6 Africa Regional Open Government Partnership (OGP) meeting in Cape Town, Ayanda Dlodlo, South Africa's deputy minister for public service administration, announced that the government has adopted a 2016-2017 national action plan "that includes a commitment to create a public beneficial ownership registry in order to protect the integrity and transparency of the global financial and public procurement systems," according to an OGP news release. According to the action plan, the register will include data on legal persons and arrangements, and will be available in an open-data format to the public. The South African Department of Public Service and Administration will implement the system, and several other government actors, including the South African Revenue Service (SARS) and the National Treasury, will be involved in its creation. The G-20 Anti-Corruption Working Group and the Financial Action Task Force (FATF) will also participate in the register's creation, the action plan says.

SARS may also make use of the register to verify the supporting documentation submitted by taxpayers and intermediaries in an attempt to uncover tax avoidance and tax evasion.

[67] Johnston, S. S., 2016. South Africa Commits to Public Beneficial Ownership Register. *Tax Notes International*, 9 May.

> While such corporate vehicles as companies, trusts, foundations, and partnerships do carry out legitimate commercial activities and have an important function in the global economy, "they are also misused by criminals for illicit purposes, including money laundering, bribery and corruption, insider dealings, tax fraud, terrorist financing and other illegal activities," according to the action plan. South Africa pledges to "take concrete actions" to implement the G-20 High-Level Principles on, as well as meet FATF standards on beneficial ownership of companies and other legal structures such as trusts, the plan says. [68]

Tax fraud would be the main focus for SARS. SARS would have a better understanding of the action plan and how it could contribute in the implementation of the proposed changes as they were part of the creation team for the plan. The costs and time from obtaining the understanding of the plan would therefore be saved. The principles applied in the action were believed to ensure that tax authorities, amongst others, have timely access to adequate, accurate, and current information regarding beneficial ownership. This would be less costly and ensure quick decision-making.

> The G-20 leaders had adopted the principles during their November 2014 summit in Brisbane, Australia, which, among other things, called on countries to ensure that law enforcement and tax authorities have "timely access to adequate, accurate, and current information regarding the beneficial ownership of legal persons." The G-20 had also suggested that countries establish central registries of beneficial ownership information, although it did not push for those registries.) For its part, South Africa will ensure that its competent authorities, including officials from law enforcement and the SARS have access to the data in line with G-20 principles.[69]

South Africa is regarded as a country with the ability to effectively implement transfer pricing rules by other African tax administrators, as discussed by Miller (2019, p. 1):

[68] Johnston, S. S., 2016. South Africa Commits to Public Beneficial Ownership Register. *Tax Notes International*, 9 May, p. 1.
[69] Johnston, S. S., 2016. South Africa Commits to Public Beneficial Ownership Register. *Tax Notes International*, 9 May, p. 1.

> African tax administrations are influenced by the emergence of the developing country view and look more and more towards guidance from countries such as China and India as well as South Africa. They accept that effective transfer pricing rules are key to ensuring that multinationals report and pay tax on the correct proportion of profits they make in Africa.

SARS will, however, still have to overcome the challenges mentioned in the article in order to successfully implement the proposed changes effectively, as Miller continues (p. 1):

> However, they also acknowledge the challenges with effective implementation of such rules. Resource constraints and implementing fledgling legislation is one such challenge. Policy disparity between implementing an effective transfer pricing regime and the existing regulatory environment is another such challenge.

3.3 Practice of other countries

Many countries are members of the OECD and therefore they are compelled to adopt to any developments in the OECD Transfer Pricing rules. Despite that non-members are under no obligation to adopt OECD measure, many non-members (including South Africa) have adopted the OECD transfer pricing rules and have over the years moved to align their tax legislation with these rules, similarly to the member states of the OECD.

Many other countries, unlike South Africa, have always used the arms' length principle and term in line with that defined in the OECD model. Therefore, it is unnecessary for these other countries to redefine the term *connected persons* in relation to companies, and this represents a hurdle that is unique to a small number of countries including South Africa.

Countries which have required larger changes to align with the OECD model include Russia which uses the term *related party* within the context of transfer pricing

According to Lungu (2019a, p. 1), the Russian Ministry recently issued a letter clarifying the term *related party,* clearly indicating the situations where the parties are being deemed to be related for transfer pricing transaction purposes. South Africa is not the only country, therefore, which requires broader changes in its transfer pricing rules to align with the global changes.

As the new mandatory disclosure rules represent a recent development by the OECD, all countries are affected – whether obliged to adhere as OECD members or as non-member keeping up with international to ensure effective and efficient collection of tax and the sustainability of their economies. Several countries have taken steps to adopt the new mandatory disclosure rules and align their tax legislation to these mandatory rules. The European Union (EU) Council, for example, issued a draft directive in 2017 on the automatic exchange of information between intermediaries and tax administrators.[70] The directive imposed an obligation to intermediaries within the EU to report, in detail, any cross-border tax scheme to the tax administrators, within five days of submitting the plan of the scheme to their clients. Sprackland (2017, p. 1) states, with regard to the directive and its rules:

> In June 2017, a draft proposal for the EU Directive had already been put forward, aimed at curbing the use of aggressive tax planning arrangements which would put the onus on industry intermediaries to quickly report new schemes to national tax authorities, who would then automatically exchange that information every three months through a centralised database. The directive would require intermediaries to file details of any cross-border tax scheme with their local tax authorities within five working days of the plan's submission to a client. If, however, the intermediaries are outside the EU or bound by client privilege, the disclosure obligation would fall on the client, a provision that is drawing scepticism from observers.

The mandatory disclosure rules, in the OECD model [71],

[70] Sprackland, T., 2017. EU Directive Would Require Intermediaries to Report Cross-Border Schemes. *Tax Notes International*, 22 June, p. 1.
[71] OECD (2018), *Model Mandatory Disclosure Rules for CRS Avoidance Arrangements and*

are only to the extent that the intermediaries know or can be reasonably expected to know that the schemes are Offshore Opaque Structures or CRS Avoidance Scheme. The EU directive imposed a wider responsibility on intermediaries as it requires that all the cross-border schemes be reported. The wider obligation would eliminate the completeness risk in terms of the schemes that needed to be reported and could therefore increase tax collection. The downside of the wider application is that more time and resources are required to go through all the information collected.

The draft directive was subsequently approved by the EU council in 2018 and started a draft law implementing the directive. [72] This is according to the following statement:

> The EU Council approved the directive in 2018 as Council Directive (EU) 2018/822 of 25 May 2018. On 8 August 2019, a draft law implementing the Council Directive (EU) 2018/822 of 25 May 2018 as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements ("DAC 6") was submitted by the government to the Luxembourg parliament.

Other countries seem to be behind South Africa in terms of keeping up with the developments in transfer pricing guidelines (the OECD model). Bulgaria, for example, only considered mandatory transfer pricing documentation in June 2019.[73] These mandatory transfer pricing documentation rules are already in force in South Africa (they have been incorporated into the tax legislation already and are in force).

Opaque Offshore Structures, OECD, Paris. www.oecd.org/tax/exchange-of-information/ model-mandatory-disclosure-rules-for-crs-avoidance-arrangements-and-opaque-offshorestructures.pdf

[72] Hoor, O. R. & Bently, M., 2019. Luxembourg implementation of the EU Directive setting new transparency rules for intermediaries. *Atoz Alert*, 12 August, p. 1.
[73] Gargouri, S., 2019a. Bulgaria Considering Mandatory Transfer Pricing Documentation. *Tax Notes International*, 20 June.

The Czech Republic is also on the same level as Russia. According to Slim Gargouri (2019b, p. 1), Czech Republic has recently released new transfer pricing guidelines which are more consistent with the OECD model. Slim explains the guidance as follows (Gargouri, 2019a, p. 1):

> Guidance Note D-34, issued May 31 to replace Guidance Note D-332, note that Czech tax law does not specifically require taxpayers to submit transfer pricing documentation.
>
> The new guidelines, which address the documentation requirements under the OECD's transfer pricing guidelines for multinational enterprises and tax administrations, call for a three-part transfer pricing documentation system comprising a local file containing information about domestic entities, a master file containing data on the group as a whole, and country-by-country reporting with information about the group's activities in the countries in which its members operate.

Other countries like India are re-thinking some of its transfer pricing rules.[74] The purpose of re-thinking the rules is to collect more tax to increase the revenue of the state.

Ukraine has recently issued guidance letters, one of which is explaining transfer pricing matters.[75] The statement made by Lurie (Lungu, 2019b, p. 1), in this regard is as follows:

> Guidance Letter 2444/6/99-99-15-02-02-15/IPK (dated May 29 and made public the week of June 10) explains the possible recognition of controlled transactions involving wage payments to resident related parties as comparable, for transfer pricing purposes, with transactions involving wage payments to a non-resident related party. Transactions involving wage payments to related residents may not be used to compare the commercial and financial conditions of controlled transfer pricing transactions involving wage payments

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[74] Sarfo, N. A., 2019. India Rethinking Arm's-Length Standard for PE Attribution. *Tax Notes International*, 10 June.
[75] Lungu, L., 2019b. Ukraine Issues Corporate, Transfer Pricing Guidance Letters. *Tax Notes International*, 12 June.

to a related non-resident, the SFS said.

3.4 Alternatives to proposed changes

The main purpose of amending the legislation to adopt the OECD transfer pricing rules and mandatory disclosure is to compel the taxpayers to provide the necessary information to enable the tax administrator to conduct effective tax audit on international transactions, the purpose being to ensure that tax due from the transactions is collected effectively. There are however other mechanisms that could be adopted to increase the collection of tax. These could prove to be cheaper than amending legislation every time there is a new development in the rules and could also be made legally binding to enforce compliance thereof.

One example of these mechanisms is that of advanced pricing agreements (APAs). With advanced transfer pricing agreements, SARS would agree, in advance, with the multi-national entity that is a South African tax resident, on how the entity's cross-border connected person's transactions will be priced. This would in turn avoid conflicts with SARS. President Cyril Ramaphosa recognised the need for advance pricing agreements in his 2019 state of nation address. The president stated the following (Wiesener, 2019, pp. 3-4):

> So-called Advanced Pricing Agreements (APAs) are a useful mechanism in transfer pricing. An APA is effectively an agreement between a taxpayer and the tax administration regarding what the pricing for a specific cross-border transaction between a taxpayer and its cross-border related parties will be. APAs are often concluded over a future period, for example 3 years, and sometimes they may also cover past periods. APAs are popular and useful in many countries as they avoid conflict and ensure tax certainty and consistency. A further step to achieve certainty and to avoid double taxation are bilateral APAs as these included the taxpayer and its related party in the other country, as well as the respective tax administrations. India for example has been very successful in concluding bilateral APAs. While an APA regime requires skill and experience on the side of the tax administration, the OECD Transfer Pricing Guidelines and the new South African transfer pricing documentation format acknowledge the existence of APAs.

The president highly recommends advanced pricing agreements and therefore we could possible see these being introduced in South Africa soon. In his statement the president indicated that it might be the time to consider APAs and he is confident that they will be a success judging from the experience of other countries like India which have already implemented APAs.

> To date, SARS has not engaged in APAs. However, considering the success achieved by the countries which have already introduced APA regimes and the recent increase in sophisticated transfer pricing regimes within Africa, it may be time to reconsider. It would surely be a good thing if South Africa could offer APAs as a mechanism to attract foreign inbound investors regarding investment into South Africa and to facilitate investment through South Africa to other African countries by offering bilateral APAs with African countries," he added.[76]

The article highlights several benefits that could not be achieved by amending the legislation to enforce compliance. Due to taxpayers consistently trying all means to pay as little tax as possible, chances are there will always be disputes over tax returns which could prove to be costly and time consuming. There will always be a need for developments in mechanisms to fight against the schemes by taxpayers aiming at avoiding or evading tax. This would mean regular amendment to the tax legislation to improve tax collection.

> "South Africa needs an increase in tax collections. While there is still a concern that taxable profits are lost to the South African fiscus due to intentional or unintentional transfer (mis-) pricing activities, transfer pricing can also serve as a mechanism to ensure that a taxpayer pays its fair share of corporate tax in South Africa, and to facilitate investment. An APA regime would serve to establish certainty, consistency and equity regarding corporate tax payable in respect of cross-border related party transactions. In addition, it would be a welcome mechanism to achieve simplicity regarding a complex area of text," concludes

[76] Wiesener, C., 2019. Budget2019 | Can transfer pricing help increase. *bbrief*, 19 February. https://www.bbrief.co.za/2019/02/18/budget-2019-can-transfer-pricing-help-increase-tax-collections/, p. 4.

Wiesener.[77]

As seen from the article, the complexity of transfer pricing has discouraged countries into conducting their businesses internationally and this has affected the South African economy negatively. Advanced pricing agreements would encourage the international investments as they simplify transfer pricing, according to the article. The advanced transfer pricing agreements are said to normally be of long term (three years) and have proven to be successful in the countries that they have been already adopted.

By adopting advanced transfer pricing agreements, South Africa, therefore, will not just increase incoming international investment but also avoid costly and lengthy tax disputes over transfer pricing. The need for regular legislation amendment every time there is a new development in transfer pricing, will also be eliminated or at least not be as urgent as it would be without advanced transfer pricing agreements.

Another mechanism to deal with transfer pricing issues is that of compliance assurance process program (CAP) which involves pre-return submission audit of intercompany transactions. The aim is for the tax administrator and the taxpayer to be able to resolve conflicts prior to tax returns being submitted. The article reads (Martin, et al., 2019, p. 1):

[77] Wiesener, C., 2019. Budget2019 | Can transfer pricing help increase. *bbrief*, 19 February. https://www.bbrief.co.za/2019/02/18/budget-2019-can-transfer-pricing-help-increase-tax-collections/, p. 4.

> In 2018 the IRS announced that its compliance assurance process program would continue with some important changes. Two of those changes relate to transfer pricing: Taxpayers applying for CAP must now complete a template of material intercompany transactions, and for some issues an advance pricing agreement may be required for the taxpayer to remain in CAP. The CAP program, which is under the jurisdiction of the IRS Large Business and International Division, allows a select group of taxpayers to receive a real-time audit of disclosed positions, with the goal of reaching agreement on positions before the filing of a return. When CAP began in 2005, it had 17 participants; as of 2018, it had 169.

As indicated in the article, the program has been very successful with the number of participants increasing significantly over the years since the program inception. The program would help in avoiding or preventing tax disputes post tax return submission. South African legislation currently only deal with transfer pricing issues once the tax return is submitted and then a certain number of returns get to audited. Dispute resolution process then follows, with CAP dispute resolution process would likely be avoided post return submission and the cost of the process and the time be saved. South Africa should consider the use of both CAP and advanced pricing agreements or at least one of them.

Conclusion

There is a need for the government to tighten tax rules to increase the tax collection. The government is financially dependent on tax collected from its economic activities to deliver the necessary services to its citizens. BEPS has resulted in governments all over the world collecting less tax than is due to them. OECD and various countries embark on a continuous fight against BEPS to increase tax collection. The continuous fight results in continuous changes in the OECD transfer pricing provisions and disclosure rules, amongst others.

South African government follows the OECD transfer pricing rules to stay current with the rest of the world and tighten its transfer pricing rules. The legislation of the rules is necessary as entitles the tax administrator to take legal action against the non-compliant taxpayers.

For the implementation of the transfer pricing rules to be effective, the tax administrator need to collect more tax than the cost incurred in implementing those rules. The introduction of the associated enterprises which is wider than the current definition of connected persons, transfer pricing specific penalties and the mandatory disclosure rules by intermediaries on CRS Avoidance arrangements and Offshore Opaque structures will be able to increase the tax collection on transfer pricing transactions.

The tax administrator will have access to information that will enable uncovering tax avoidance schemes through the mandatory disclosure by intermediaries, the wider definition of affected transactions as a result of introducing the associated enterprises definition will result in more transactions to be taxed than before, introduction of transfer pricing specific penalties is likely to increase compliance to the transfer pricing rules and therefore tax collection as the taxpayer will be unable to conceal any of their significant transfer pricing transactions.

The implementation costs are likely to be high, however, with careful planning and utilisation of current resources these could be minimised to an acceptable level. Other countries like Russia, Ukraine, Czech Republic, etc., are also legislating the OECD transfer pricing rules. South Africa still have other options to use as an alternative to legislating the OECD rules. An example of these is the so-called Advanced Pricing Agreements which would be much cheaper than legislating the OECD rules.

4. THE IMPACT OF THE PROPOSED CHANGES TO THE TAXPAYER

This chapter aims at identifying whether the taxpayers will benefit or lose from the implementation of the new changes, evaluating whether the taxpayers' life will be much easier or more difficult than before, will the taxpayers have to incur more costs in order to comply with the new legislation, will the introduction of the penalties force them to be more compliant than before?

4.1 Cost/benefit analysis

The proposed changes are likely to have more negative impact on the taxpayer. The changes will likely result in more tax collected from the taxpayer. The taxpayer always strives to minimise its tax liability each tax year. With the definition of associated enterprises replacing the definition of connected persons when it comes to companies, transactions between companies which were previously not taxed are likely to be taxed as the definition of associated enterprises is wider than that of connected persons.

With tightened mandatory documentation and disclosure rules, including those to be done by intermediaries, the taxpayer's life is likely to be more difficult. For the taxpayer to find ways to minimise its tax liability, the taxpayer is likely to need highly qualified individuals who are likely to have the ability to look for the loopholes in the tightened rules to use against the tax administrator. These highly qualified individuals are likely not to come cheap and therefore are likely to add to the cost of the taxpayer. The mandatory disclosure rules by the intermediaries will make it even more difficult to hide information as the information the taxpayer would normally want to hide to avoid tax would be disclosed by their intermediaries.

For the taxpayer to ensure that they comply with the new requirements they will need the necessary resources, for example more qualified individuals to deal with transfer pricing transactions even if it is incurring extra costs training the current staff. System upgrades or even implementation of new systems could also be needed in order to keep record of the transfer pricing transactions that is required under the new rules. The following statement was made in support of the likely impact of the replacement of connected persons in relation to companies with associated enterprises in the definition of the affected transactions (Mcloughlin, 2019, p. 1):

> “Further, the reference to associated enterprises could change the way taxpayers document their international transactions, as the element of ‘control’ would play a far greater role in determining what constitutes an affected transaction.”’

One other negative impact of the introduction of the new rules to the taxpayer could be increased legal costs due to disputes that may result between the taxpayer and the tax administrator. The taxpayer will always do everything in its power to reduce their tax liability, including going the legal route if they believe they have high chances of winning. The complexity of transfer pricing could however cause the taxpayer to lose the case(s) resulting in even more costs. Taxpayers could also be ordered to pay the tax administrator’s legal costs upon losing the case(s).

Disputing the taxpayer’s tax assessments is already a trend in other countries. Ryan Finley and Justyna Pekalak (2019a, p. 1) have highlighted a number of recent cases where taxpayers are disputing tax assessments from the tax administrators. Some of these are:

Analog Devices Inc.

Analog Devices Inc., a semiconductor manufacturing company headquartered in Norwood, Massachusetts, reported in a May Form 10-Q that as of May 4, 2019, it had received a reassessment from Irish tax authorities of up to $48.2 million for fiscal 2013 for failing to conform to the OECD's transfer pricing guidelines. The company is disputing the reassessment. It also reported that Irish tax authorities opened an examination of its transfer pricing methods for fiscal 2014-2017. Jurisdiction: Ireland

Cisco Systems Inc.

Cisco Systems Inc., a networking hardware company headquartered in San Jose, California, reported in a May Form 10-Q that as of April 27, 2019, it had recorded $1.8 billion in unrecognized tax benefits. The company estimates that it is reasonably possible that the unrecognized tax benefits may be reduced by $50 million because of ongoing transfer pricing related matters. Jurisdiction: Undisclosed

Dr. Reddy's Laboratories Ltd.

Dr. Reddy's Laboratories Ltd., a pharmaceutical company headquartered in Hyderabad, India, reported in a June Form 20-F that it received reassessments related to transfer pricing from Mexican tax authorities for tax years 2006-2008 of MXN 207 million (approximately $10.8 million). The company also reported that it received reassessments from Indian tax authorities totalling INR 2 billion (approximately $28.8 million). The company has recorded no provisions for the charges and is disputing all reassessments with the respective jurisdictions.
Jurisdictions: India, Mexico

From the above scenarios it can be learnt that it is not easy for the companies to just accept a re-assessment that is likely to cause them to pay more tax. The companies are likely to do everything in their power to try and avoid paying the additional tax. In their effort to avoid additional tax they could however incur additional costs in vain if they lose against the tax administrators (authorities).

More costs incurred by the company whether by means of paying more tax and/or incurring more costs in trying to avoid paying more tax affect the company's bottom line. The additional costs incurred are likely not to be deductible in calculating the

tax liability as they are not in production of income.
The relaxation of transfer pricing requirements for low-value adding intragroup services could benefit South African taxpayers, however with the new mandatory disclosures by intermediaries, no low-value adding intragroup services are exempted. Every affected transaction needs to be reported and therefore taxpayers have no relief to the cost of complying with the transfer pricing rules for any low value adding transactions. Gargouri, Slim (2019c, p. 1) stated the following with regards to the relaxation of transfer pricing requirements for low-value adding intragroup services:

> Latvia's Cabinet of Ministers recently amended the transfer pricing rules to relax the transfer pricing requirements for low-value-adding intragroup services. Cabinet Regulation No. 324 aims to reduce the administrative burden on companies subject to transfer pricing regulations under the Corporate Income Tax Law.

Taxpayers take a strain in complying with the transfer pricing requirements. The introduction of the mandatory disclosure rules by intermediaries will force the taxpayer to obtain and keep record of all the affected transactions. The information is likely not to be obtained in a required format and require further arrangement by a qualified person. This could require incurrence of additional costs to train existing staff member or hire a new person to deal with the gathering, re-arranging and keeping record of the required data. An example of the strain taxpayers take in complying with the transfer pricing rules was highlighted by Jansen (Jansen van Nieuwenhuizen, 2014, p. 1) in his article as follows:

A key aspect of transfer pricing is the determination of an arm's length or market related price. A common approach is to establish a range of profit margins through benchmarking against comparable companies' financial data and the profit margins that they earn. One of the challenges for taxpayers in South Africa (and other developing countries), is that besides for listed companies, there is very little publicly available company financial data. The OECD recently produced a paper on "Transfer Pricing Comparability Data and Developing Countries," in response to concerns about the lack of availability and the poor quality of comparable financial data that many developing countries have access to. The document offers four alternative approaches to addressing these concerns, namely:

•Expanding access to sources for comparable data;

•More effective use of comparable data sources for and guidance on making adjustments;

•Approaches to reducing reliance on directly comparable data, including the use of safe harbours;

•Advance pricing agreements and mutual agreement proceedings.

The document suggests 15 possible actions within these four approaches but does note that given the long list of possible actions, there should be some prioritisation of those actions based on country needs and the availability of resources.

4.2 Effect on compliance status of the taxpayer

The introduction of the mandatory disclosure rules is likely to increase compliance with the transfer pricing rules. The taxpayers will be aware that the intermediaries they help them when entering the affected transactions, are more likely than not, to comply with the disclosure rules. This is because should they not comply with the rules and be caught, they will also be in trouble. Their reputations could be ruined on top of possible penalties from non-compliance resulting in lost business.

Introduction of transfer pricing specific penalties is likely to force the taxpayers to be more compliant with the transfer pricing requirements than when it was only general administrative penalties (late submission and late payment). The significance of the impact of the introduction of the transfer pricing specific penalties will likely depend on the value of the penalty itself. The taxpayers are likely to simply ignore the penalties if they are insignificant, especially if they believe they have a chance of not being caught.

Compared to the already implemented documentation rules, the impact of the compliance with the new mandatory disclosure rules is likely to be minimal. The following statement was made by (Pearson, 2018, pp. 3-4) with regards to the already implemented documentation rules:

> All taxpayers that have cross border transactions with related parties should ensure that they have transfer pricing documentation that is compliant with the revised OECD Transfer Pricing Guidelines and that supports the arm's length nature of related party transactions. There may be taxpayers who feel that documentation is not warranted as they transact with related parties on the same basis as unrelated parties and can defend their position. It is important to remember that this stance is no longer acceptable as transfer pricing documentation is now mandatory.

Pearson recognises that some taxpayers tend to lag in complying with any requirements that are not mandatory, however, once the same requirements become mandatory, the taxpayers comply with the requirements.

> Without undertaking a transfer pricing study to determine an arm's length price and documenting this process formally, a taxpayer will not be able to evidence to SARS that related party transactions are occurring at arm's length. In addition, the question in the company's tax return dealing with whether a taxpayer has a transfer pricing document that supports the pricing policy for each of its related party transactions would have to be answered "no" if the taxpayer does not have compliant transfer pricing documentation. This is likely to raise a red flag.[78]

If the taxpayer is already complying with the newly implemented rules therefore is likely to be encouraged to comply with the proposed rules with ease, difficulty will be more likely to be in those taxpayers who are lagging. The article makes it clear that even those taxpayers who are conducting their transactions at arm's length

[78] Pearson, B., 2018. Transfer Pricing – Key questions answered. *Deloitte*, 28 February, p. 4.

still need to keep the necessary documentation, failure of which could result in taxpayers not able to defend themselves when the dispute arises with the tax administrator. The failure to defend themselves could mean that they pay additional tax where they should not be. This is likely to be the reason enough to make the taxpayers more compliant.

A negative attitude towards mandatory rules could hinder the ability of a taxpayer to comply. Taxpayers need to adopt a positive attitude towards the compliance requirements and look at what benefits could the compliance with the mandatory rules bring into their businesses. An example of one of the ways the taxpayers could adopt to ensure positive attitude is taking the compliance requirement as a planning tool. This is supported in an article by Mazars (2017, p. 2). The article reads:

> "Transfer pricing is more than just a compliance requirement; it is often used as a planning tool to develop strategies that align with the company's overall objectives (tax optimisation, cash flow, etc.). For instance, realignment of the supply chain or relocation of certain activities from one taxing jurisdiction to another may result in significant tax savings," Chung says. She adds that tax planning associated with the creation and ownership of valuable intellectual property is an often-overlooked area that may also create favourable tax results. "For instance, developing an effective manufacturing model in a low cost, low tax jurisdiction, may result in the realisation of certain competitive advantages such as manufacturing know-how."

If the taxpayers were to take the transfer pricing rules as not just a compliance requirement but as a planning tool as indicated in the article, their compliance status would likely improve as the focus will be more on their benefit than that of the taxpayers. They would still need transfer pricing experts to help with the development of the planning strategies, however this is unlikely to discourage them as the attitude will be that of benefitting themselves instead of benefitting the tax administrator.

Taxpayers encounter a number of challenges in an attempt to comply with the transfer pricing rules, such as, complexity of the rules and the continuous change in the rules (Wolff, 2014, p. 1). The complexity of the rules could result in misinterpretation of the rules which could lead to non-compliance although the intention of the taxpayer was to comply with the rule. The taxpayers could also miss out on a recent change. Wolf made the following statements with regards to the challenges to the taxpayer to comply with the transfer pricing rules:

> 'The complexity of transfer pricing regulations and the continuously changing transfer pricing environment make it challenging for multinational companies to manage their transfer pricing position and to be compliant with the latest requirements.'[79]

The above statement recognises the fact that even if the taxpayer's intention is to comply with the tax rules, they could still not be able to due to the challenges they face.

> The absence of safe harbours in combination with current compliance requirements (as discussed below) for many South African taxpayers results in an extra effort being required to ensure and to document that intercompany financial transactions comply with the arm's length principle. In all fairness, the abolishment of the general safe harbour rules follows international trends. There are an increasing number of legislators around the globe that are abolishing any safe harbour rules with respect to thin capitalisation.[80]

The extra effort required to comply with the transfer pricing requirements could discourage the taxpayers to comply with the rules. This will increase pressure to the tax administrators to come up with mechanisms to ease the load on taxpayers.

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[79] Wolff, C., 2014. Influence: Transfer Pricing in South Africa five things you need to know. *Accountancy SA*, 1 September, p. 1. https://www.bbrief.co.za/2019/02/18/budget-2019-can-transfer-pricing-help-increase-tax-collections/
[80] Wolff, C., 2014. Influence: Transfer Pricing in South Africa five things you need to know. *Accountancy SA*, 1 September, p. 2. https://www.bbrief.co.za/2019/02/18/budget-2019-can-transfer-pricing-help-increase-tax-collections/

> PN7[81] states that if taxpayers do not maintain appropriate records, reviewing the compliance with the arm's length principle is far more difficult. SARS may be forced to rely on less evidence when reviewing a transfer pricing method, resulting in a greater degree of judgment. Hence the absence of transfer pricing documentation is likely to make discussions with SARS more difficult and/or bear a potentially higher transfer pricing risk.[82]

In terms of the South African transfer pricing rules, the onus is on the taxpayer to prove that the transactions between related parties are at arm's length. With the mandatory disclosure rules, it would be difficult to hide any affected related party transactions. The onus will therefore be on the taxpayer to provide defence as to why transfer pricing adjustments will not be applicable to the transactions. The taxpayers are therefore forced to keep enough documentation to prove their cases. Compliance therefore is likely to be increased.

Conclusion

The legislation of the proposed rules is likely to have a negative impact of the taxpayer. The taxpayer will have a little to play around with in order to minimise the tax liability. The wider definition of associated enterprises is likely to increase the taxpayer's tax liability. Mandatory disclosure by intermediaries is to significantly contribute to the increased tax liability. The taxpayer's compliance cost is likely to increase with the implementation of the proposed rules due to complexity of the transfer pricing transactions. The compliance status of the taxpayer is likely to slightly increase with the introduction of transfer pricing specific penalties as taxpayers would want to avoid penalties which could ruin their reputation resulting in loss of business.

[81] PN7 is an abbreviation for SARS Practice note 7 of 1999.
[82] Wiesener, C., 2019. Budget2019 | Can transfer pricing help increase. *bbrief*, 19 February, p. 3. https://www.bbrief.co.za/2019/02/18/budget-2019-can-transfer-pricing-help-increase-tax-collections/

5. CONCLUSION

Transfer pricing has been a challenge for both the tax administrator and the taxpayer since its introduction world-wide. The world-wide challenge has been the result of the transfer pricing being complex and between multi-national companies. The taxpayer's challenge has been the ability to interpret the transfer pricing rules and the affected transactions and take advantage of any loophole that can help them pay as minimal tax as possible. The taxpayers also have been having a challenge of obtaining and keeping record of the information that is necessary for their defence when they encounter disputes with the tax administrators.

The tax administrators' main challenge on the other hand had always been ability to collect the tax due effectively and efficiently. The difficulty resulted from taxpayers being able to erode tax. In South Africa, the onus had always been on the taxpayers to prove that their intergroup transactions or transactions with related parties, are not affected by the transfer pricing rules, that is, no adjustments needed to be made to their taxable income or tax liability. Although SARS has been able to conduct post returns submission audits, the taxpayers have always been able to hide most of relevant information that could benefit SARS. As the information was not readily available to SARS in any other form, it has always been difficult for SARS to prove them otherwise.

Both the taxpayers and the tax administrators have had to spend substantial amounts in dealing with these challenges. These costs had been costs of hiring experts, training current staff, investing on new systems, amongst other things. OECD has been keeping up with these challenges and making amendments to its transfer pricing rules to address both the taxpayers and tax administrators' challenges, although in the later years the focus had been in addressing base erosion profit shifting which benefit mostly the tax administrators. It has been easy to follow up on these developments for the tax administrators as most countries have adopted the OECD transfer pricing rules as their own transfer pricing rules.

One of the recent developments has been those of introduction of country-by-country reporting which dealt to a greater degree with the challenge of the lack of the availability of documentation for the transfer pricing transactions. These have already been incorporated into the South African tax legislation. South Africa has been making sure that any developments are incorporated into the nations' tax legislation to enhance compliance thereof.

The most recent developments which South Africa is in the process of incorporating them into the legislation are those of the replacement of connected persons, in the definition of an affected transaction, in relation to a company, with associated enterprises, the mandatory disclosures by the intermediaries on CRS Avoidance Arrangements and Opaque Offshore Structures plus possible introduction of the transfer pricing specific penalties in addition to the current administrative and late payment penalties.

The proposed rules are likely to enhance the tax collection in benefit of the tax administrator although the taxpayer is likely to incur costs to ensure that the staff and systems are fully equipped for the implementation of the rules. The taxpayers on the other hand are likely to be more disadvantaged than the tax administrator. The taxpayers are likely to gain from the availability of information for their defence when disputes occur, however, they are likely to be forced to be more compliant and SARS has the necessary information through the intermediaries and there will be additional penalties. The taxpayers will incur costs to improve their compliance while they are likely to be unable to minimise their tax liability, although their tax planning could improve.

CAP and advanced pricing agreements have been identifying as alternatives that could benefit the taxpayer and the tax administrator at the same time. CAP offers pre-audit which will mean less disputes once the return is submitted. This will save on disputes costs as they can be costly and time consuming for both the tax administrator and the taxpayer. Advanced pricing agreements are said to be likely to attract more international investors, something that is needed considering the current state of the economy. This is because they are long term agreements with pre-determined pricing. These therefore provide the benefit of long-term planning and avoid disputes resulting in costs savings. The compliance will be simplified and enhanced.

Advanced pricing agreements are likely to be more beneficial to South Africa due to the long-term nature of the agreements and the attraction of the international investors. Although they have proven to be successful in countries where they have already been implemented, the impact thereof to South Africa, will have to be investigated. Introduction of CAP will also need to be investigated. Consideration of whether the two could be used in separation or parallel will need to be included in the investigation.

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