

S C H O O L O F  
**ACCOUNTANCY**

**University of the Witwatersrand, Johannesburg**

**An examination of the possible South African transfer pricing and limited income tax considerations relating to business restructuring**

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**Degree:** Master of Commerce (specialising in Taxation)

**Date:** 1<sup>st</sup> November 2010

**Word count:** 20 747 words

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

Johannesburg, 2010

## **Abstract**

Transfer pricing is a key international tax issue. As the internationalisation of South African business activity increases, transfer pricing will be placed high on the agenda for South African multinationals as well as the South African Revenue Service ("SARS").

Business restructurings by multinational enterprises have been a widespread phenomenon in recent years. They involve the cross-border redeployment of functions, assets and / or risks between associated enterprises, with consequent effects on the profit and loss potential in each country. Restructurings may involve cross-border transfers of valuable intangibles, and they have typically consisted of the conversion of full-fledged distributors into limited-risk distributors or commissionaires for a related party that may operate as a principal; the conversion of full-fledged manufacturers into contract-manufacturers or toll-manufacturers for a related party that may operate as a principal; and the rationalisation and / or specialisation of operations.

The interplay between transfer pricing, income tax and business restructuring is tantamount to the effective tax management of a multinational business, particularly those companies with segregated manufacturing and distribution entities worldwide.

## Declaration

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

Jonathan Mark Sweidan

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Jonathan Mark Sweidan

1st (Monday) day of November, 2010

*This journey was longer than my greatest chess games  
but unlike during those games' quiet moments  
I felt your support all the way  
so to a very special person and my family  
you were my real partners during the darkest hours  
thank you all for being at the 'finish line'  
for understanding when I had to stay out on this road  
and for all your love, patience and encouragement  
it carried me through and I love you all for it.*

## **Acknowledgments**

I am grateful to my supervisors, Michele Benetello and Natasha Vaidanis, for their practical insights as well as for their support and encouragement.

In 2006 Professor Alwyn de Koker admitted me into Master of Commerce degree course at the School of Commerce. I greatly appreciate this admission because I was able to further my studies.

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# 1 Introduction

## 1.1 Background and motivation

Transfer pricing is the method by which companies normally within a common group or ownership, use to determine the cost at which goods and services are supplied. The reason that this area has recently fallen under the scrutiny of revenue authorities globally is due to the practice adopted by many connected companies to price various transactions, not with reference to market or other legitimate commercial considerations but to manipulate prices within the multi-national group and "park profits" in favourable tax jurisdictions.

Of all trade carried out within the international arena, it is estimated that in excess of 60% is conducted between related parties. As a consequence of this, the world's tax systems have developed four main approaches to counteract tax avoidance through transfer pricing<sup>1</sup>:

- legislative provisions along with formal, detailed and binding regulations, for example the United States;
- legislative provisions along with detailed guidelines as to acceptable pricing methodology e.g. Germany;
- reliance on the arm's length concept to dictate acceptable pricing practices which rely strongly on the Organisation for Economic Co-operation and Development ("OECD") guidelines: e.g. the United Kingdom; and
- No specific transfer pricing legislation where reliance is placed on normal, general anti-avoidance provisions and tax law to combat transfer pricing, such as Botswana.

In the case of South Africa there are the Section 9D diversionary rules. Diversionary Foreign Business Income involves income that a controlled foreign company ("CFC") generates from certain sales and services transactions conducted with related South African residents. This test acts as a proxy for the transfer pricing regime under section 31. Diversionary Foreign Business Income arises when a CFC engages in transactions with a related South African resident in a manner that will most likely lead to transfer pricing tax avoidance.

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[http://www.saica.co.za/integritax/686\\_Transfer\\_pricing\\_impact\\_on\\_international\\_trade\\_for\\_South\\_African\\_business.htm](http://www.saica.co.za/integritax/686_Transfer_pricing_impact_on_international_trade_for_South_African_business.htm)

As multinational companies expand into new markets and their distribution supply chain evolves, they face a choice of how to best organise themselves from a tax perspective. Europe, in particular, provides a unique challenge. On the one hand, as the European Union further integrates legally and economically, more and more companies are responding by further integrating their European operations by shifting away from purely country-based organisations to pan-regional and pan-European supply chains. On the other hand, despite all the harmonisation that has been achieved in many areas of the European Union (“EU”), the countries that make up the EU still are distinct jurisdictions, each with its own set of direct and indirect tax rules and regulatory bodies that have to be respected and considered.

From a South African perspective the relaxation of exchange controls, lifting of trade barriers and the growth in e-commerce in recent years have contributed to an increase in trade between South Africa and foreign entities. The South African tax authorities have followed the approach of most major commercial countries in collecting their proportionate share of profits generated by the increase in global trade. SARS has indicated its intentions to participate in this world-wide trend in collecting taxes from transfer pricing audits.

South African transfer pricing legislation was introduced in 1995 by section 31 of the Income Tax Act (“the Act”). In August 1999 SARS issued Practice Note Number 7 (“the Practice Note”). The Practice Note contains guidelines for the application and interpretation of transfer pricing rules in South Africa. The Practice Note is based on the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (“the OECD Guidelines”). Currently, transfer pricing is a high priority for SARS. This is evident from both questionnaires relating to transfer pricing sent by SARS to multinational entities since 2000 as well as the first assessments issued by SARS regarding transfer pricing to multi-national entities. Whilst SARS initially focused on inter-company loans and management fees, there is potential for SARS to now also focus on inter-company transactions such as the supply or acquisition of goods or services as a result of business restructures.

Due to the international importance of the OECD Guidelines, the Practice Note was based on, *inter alia*, those guidelines, despite the fact that South Africa is not a member (but does have observer status) of the OECD. The Practice Note also states that the OECD Guidelines should be followed in the absence of specific guidance in terms of the Practice Note, the provisions of section 31 of the Act or the tax treaties entered into by South Africa.

The profit-earning potential of a particular undertaking is linked to the functions carried out by that undertaking. Risk is attached to functions performed and assets utilised which gives rise to the potential for profit. At arm's length, reward tends to follow risk.

Business restructurings are typically accompanied by a reallocation of profits among the members of the multi-national enterprise ("MNE") group, either immediately after the restructuring or over a few years. One major objective of this research report is to discuss the extent to which such a reallocation of profits is consistent with the arm's length principle and more generally how the arm's length principle applies to business restructurings. The implementation of integrated business models and the development of global organisations, where they are done for bona fide commercial reasons, highlight the difficulty of reasoning in the arm's length theoretical environment which treats members of an MNE group as if they were independent parties. This conceptual difficulty with applying the arm's length principle in practice is acknowledged in the OECD Guidelines themselves.<sup>2</sup> Notwithstanding this problem, the OECD Guidelines reflect the OECD Member countries' strong support for the arm's length principle and for efforts to describe its application and refine its operation in practice.<sup>3</sup>

## **1.2 The research problem**

### **1.2.1 The statement of the problem**

This research report will evaluate the legislative approaches to transfer pricing as adopted by South Africa and the potential transfer pricing and income tax issues relating to business restructures in light of the discussion draft released by the OECD on 19 September 2008 entitled Transfer Pricing Aspects of Business Restructures ("OECD TP Restructures").

### **3.2 The Sub-problems**

- The first sub-problem when contemplating the restructuring of a business is to evaluate how to establish the optimal structure from a pricing point of view and determine where to place the various functions and risks of a restructured company. This is the most important step in putting an appropriate structure in place and will guide the inter-company pricing. An area of specific focus will be on the conversion of a fully-fledged distributor into limited-risk distributor or commissionaire for a related party.

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<sup>2</sup> (see paragraphs 1.9-1.10 of Transfer Pricing Guidelines)

<sup>3</sup> see paragraph 1.14

- The second sub-problem where a business is restructured, local tax authorities may argue that arm's-length compensation is payable to the restructured entity for any value transferred to a foreign-related party.
- The third sub-problem is to evaluate the South African effective management considerations of a company incorporated offshore in an ex-post group restructuring and comment on what substance and activities will be necessary in that jurisdiction from a South African income tax perspective.
- The fourth sub-problem is to comment on the potential exposure post-restructuring for an offshore company having South African sourced income and a permanent establishment in South Africa as a result of its activities, taking into account the relevant double taxation agreement between the offshore jurisdiction and South Africa.
- The fifth sub-problem relates to the state of South African legislation with respect to the acceptable transfer pricing methods in a market in order to benchmark the appropriate arm's length return for the respective entities in the instance of an ex-post corporate restructuring.
- The sixth sub-problem is to examine the mechanisms adopted and endorsed by the OECD as international best practice when examining the application of the arm's length principle and the OECD Guidelines to post-restructuring arrangements.

### **1.3 Research methodology**

A qualitative approach is used in this report. This is achieved by an examination of the available literature on the subject. The study relies on both primary and secondary sources. On primary sources regard is given to domestic tax legislation, international case law as well as the reviews of both international and national organisations. Secondary source references are taken from various background papers, books and relevant articles published in academic journals. Various Internet sites have also been consulted in order to obtain current information on the topic.

### **1.4 Scope and limitations**

The purpose of this research is to determine what the potential South African income tax and transfer pricing effects may be from a proposed business restructuring of a MNE. There will be a high-level discussion of several distribution models typically used by MNE's when restructuring with a specific focus on commissionaire/commission agent structures.

Whilst there may be inter-company synergies and savings that may be harnessed from adopting such an approach when selling into a foreign jurisdiction such as South Africa, caution needs to be exercised to ensure that there is commercial substance and legal compliance to mitigate against unnecessary tax charges.

Evaluating the indirect tax effects of a business restructuring from a Value-Added Tax and Customs perspective are however beyond the scope of this research.

## **1.5 Organisation of report**

### **1.5.1 Introduction**

This introductory chapter will introduce the background and significance of the research, the problems and sub-problems identified and the research methods used.

### **1.5.2 The legislative approach to transfer pricing in South Africa**

This chapter will examine the legislative approach to transfer pricing as adopted by South Africa as per section 31 of the Act as well as the documentation requirements contained in the Practice Note.

### **1.5.3 The examination of distribution structures**

This chapter will detail the ex-ante examination of establishing an optimal offshore structure from a transfer pricing point of view.

This will require the examination of the different types of distribution structures that may be considered when restructuring the functions of a company and placing into an offshore company, in this instance the classical distributor type structures will be examined. This will have a specific focus on the conversion of a fully-fledged distributor into limited-risk distributor or commissionaire for a related party.

### **1.5.4 The examination of potential income tax and transfer pricing issues post-restructuring**

This chapter will examine the South African income tax considerations with specific reference to potential effective management and potential permanent establishment exposures that may be applicable to the restructured offshore entity. In addition there may be potential capital gains tax imposed by SARS as compensation for the value given up by the restructured entity.

## **1.5.5 Conclusion**

This chapter will summarise on the findings of the research drawing on the inter-play between South African legislation and the proposals in the OECD TP Restructures document, and propose areas requiring further research.

## 2 Transfer pricing aspects of business restructurings

### 2.1 Introduction

Transfer pricing is defined by Arnold & McIntyre as follows:<sup>4</sup>

*‘A transfer price is a price set by a taxpayer when selling to, buying from, or sharing resources with a related person. For example if ACo manufactures goods in Country A and sells them to its foreign affiliate, BCo, organised in Country B, the price at which that sale takes place is called a transfer price. A transfer price is usually contrasted with a market price, which is the price set in the market place for transfers of goods and services between unrelated persons.’*

The above definition illustrates how it would be possible for a MNE to price intra-group transactions so that profits are taxed in low tax jurisdictions while deductions are obtained in high tax jurisdictions.

Profit may also be shifted intra-group to high tax countries which have special tax benefits, such as tax holidays, or to countries where the MNE is able to utilise tax losses. In the absence of specific transfer pricing provisions this may be easily achieved as transactions within a MNE are usually eliminated for financial accounting purposes.<sup>5</sup>

The overall tax burden of the MNE could be substantially reduced in this manner. With the recent dramatic increase in globalisation, MNE's have also had a commercial need to shift profits from one country to another. The cumulative effect of the above has been the loss of tax revenue of high tax countries. Consequently, most tax authorities have the statutory power to adjust transfer prices set by related parties.<sup>6</sup>

Internationally, most countries follow to a greater or lesser extent the OECD Guidelines, which were originally published in 1995 and which would not only apply in context of the OECD Model Tax Treaty but also where domestic transfer pricing legislation or guidelines refer to these OECD Guidelines. The OECD Guidelines comprehensively cover the arm's length principle, the traditional transactions methods and other methods to determine an arm's length price, administrative approaches to avoiding and resolving transfer pricing disputes, documentation, special considerations for intangible property, special considerations for intra-group services and cost contribution arrangements.

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<sup>4</sup> Arnold & McIntyre "International Tax Primer", Kluwer Law International (2002) pg: 55

<sup>5</sup> Vann "International Aspects of Income Tax" in Thuronyi *Tax Law Design and Drafting* (1998) pg:781

<sup>6</sup> <sup>6</sup> Arnold & McIntyre "International Tax Primer", Kluwer Law International (2002) pg: 56

## 2.2 Transfer Pricing in South Africa

Comprehensive legislation regulating transfer pricing was introduced in South Africa with effect from 19 July 1995, when a revised section 31 was inserted into the Act. Previously the transfer pricing contraventions could have been attacked by the South African revenue authorities in terms of the limited transfer pricing provisions contained in the original section 31, which made legislative provision for the adjustment of profits to comply with article 9 (discussed below) or its equivalent, on the basis of the expenditure being excessive in terms of the general deduction formula, or in terms of the old general anti-avoidance (section 103 (1) of the Act, now section 80).<sup>7</sup>

The associated enterprises clause in a tax treaty remains important where a tax treaty exists despite the deletion of the original section 31. Honiball is of the opinion that the original wording of section 31 had limited application in that it restricted the Commissioner's adjusting powers to the import and export of commodities within a tax treaty context. The original wording of section 31 provided that the Commissioner could determine the taxable income of the South African importer or exporter as if the commodity had been purchased or sold at a price determined in accordance with the associated enterprises article of the relevant tax treaty.<sup>8</sup>

With regard to the general anti-avoidance section, sections 80A – 80L of the Act, paragraph 12.7.1 of the SARS Practice Note states:

*'Taxpayers should be aware that the exercising of the discretion by the Commissioner in terms of section 31 will not limit or exclude the application of the general anti-avoidance section contained in the Act.'*

It is evident from the above therefore that there are tax measures other than section 31 which the SARS can use to attack transactions which are not at arm's length.

With the introduction of the revised section 31 (covered in section 3 below), the SARS now has the power, in addition to the above, to adjust prices of a much wider range of goods or services which are not regarded as being at arm's length. Section 31, in broad terms, gives credence to some of the wording of section 770 of the UK Income and Corporation Taxes Act of 1988 as it read at the time of the introduction of the revised section 31. Section 31 affords SARS discretion as to when it may adjust prices which are not considered as being at arm's length. Section 31(1) of the Act sets out the definitions whilst section 31(2) provides for the transfer pricing adjustment mechanism. Section

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<sup>7</sup> Michael Honiball & Lynette Olivier International Tax, A South African Perspective (2008) pg: 485-6

<sup>8</sup> De Koker 2002 paragraph 17.54

31(2) provides that where goods or services are supplied or acquired between a resident and non-resident (previously it was an international agreement) and the acquirer is a connected person, as defined in section 1, in relation to the supplier, and where the price of the goods or services is not at arm's length, the Commissioner may adjust the price to be an arm's length price. The SARS has issued Practice Note 7 to provide guidance in these situations.

Additionally section 31 gives the Commissioner adjusting powers for the determination of taxable income. Section 26A includes the taxable capital gain as determined in terms of the Eighth Schedule into taxable income. Consequently, while it is arguable that section 31 could also apply to adjustments on capital account, a weak argument is that it will only apply to adjustments on revenue account, *inter alia*, because of its location outside the Eighth Schedule to the Act (this is covered in greater detail in section 5.1.7 which details exit charges applicable to restructures), which contains the capital gains tax provisions. Further, the Eighth Schedule contains its own arm's length provisions applicable to transactions on capital account between connected persons, such as Paragraph 38 of the Eighth Schedule. Therefore, should the SARS require any adjustment on capital account, it would be more appropriate for it to do so in terms of Paragraph 38 of the Eighth Schedule.

## **2.3 Business restructures<sup>9</sup>**

### **2.3.1 Background**

Internationally, companies face growing competition because of globalisation. They are under pressure to organise their company structure in an international way, use economies of scale, produce efficiently and generate cost savings. Restructurings play an important role in all of this. In this context, companies try to transfer profit potential to low tax countries to exploit tax rate differentials.

If this succeeds, it leads to a reduction of the consolidated tax rate. In particular a transfer of functions to overseas corporations is suitable for this. As a legally independent entity, a corporation is also a taxable entity. As a result it is an unlimited taxpayer. A company's interest in saving taxes contrasts with that of the tax authority to generate them. So the affected states would try to implement rules to avoid or reduce such business restructurings, for instance with an exit charge.

There is no legal or universally accepted definition of business restructuring. For the purpose of determining the scope of this research it is proposed that business

restructuring be defined as the cross-border redeployment by a multinational enterprise of functions, assets and / or risks. A business restructuring may involve cross-border transfers of valuable intangibles. Typical business restructurings primarily consist of internal reallocation of functions, assets and risks within a MNE, although relationships with third parties (e.g. suppliers, sub-contractors, customers) may also be a reason for the restructuring and / or be affected by it.

Since the mid -1990's, business restructurings have typically consisted of:

- Conversion of full-fledged distributors into limited-risk distributors or commissionaires for a related party that may operate as a principal;
- Conversion of full-fledged manufacturers into contract-manufacturers or toll-manufacturers for a related party that may operate as a principal;
- Rationalisation and / or specialization of operations (manufacturing sites and / or processes, research and development activities, sales, services); and
- Transfers of intangible property rights to a central entity (e.g. a so-called "IP company") within the group.

In January 2005, in recognition of the widespread phenomenon of business restructurings by MNEs and of the tax issues they raised, the OECD Centre for Tax Policy and Administration organised a Roundtable on Business Restructurings which was attended by senior officials from OECD member countries as well as from China, Singapore and notably South Africa. The discussions at the January 2005 CTPA Roundtable demonstrated that business restructurings raise difficult transfer pricing and treaty issues for which there is currently insufficient OECD guidance with respect to their treatment under both the OECD Guidelines and the OECD Model Tax Convention ("OECD Model").

### **2.3.2 OECD Discussion Draft on Business Restructures**

In 2005 the OECD realised that restructurings or the deployment of a MNE's functions, assets and risks as the organisation defines them raised difficult transfer pricing issues and that there was insufficient guidance on the topic. With the volume of restructurings increasing and prompted by tax authorities most affected by them, the OECD formed a working party, made up of representatives from national tax administrations, to look into the issues. The group put out a discussion draft for comments in September 2008. The

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<sup>9</sup> [www.oecd.org/ctp/tp/pe](http://www.oecd.org/ctp/tp/pe)

OECD TP Restructures document in general discusses how the arm's length principle applies to business restructures.

The OECD TP Restructures document is concerned with the treaty and transfer pricing aspects of business restructurings, that is, essentially with the applications of Articles 5 (Permanent establishment), 7 (Business profits) and 9 (Associated enterprises) of the OECD Model. As noted previously business restructurings are typically accompanied by a reallocation of profits among the members of the MNE group, either immediately after the restructuring or over a few years. One significant objective of the OECD TP Restructures document in relation to article 9 is to analyse the extent to which such a reallocation of profits is consistent with the arm's length principle and more generally how the arm's length principle applied to business restructurings. This is a particularly relevant question in the current context where many MNEs are reevaluating the efficiency of their business models.

### **2.3.3 The OECD's proposals**

The OECD TP Restructures document is separated into the following four issues notes:

- The first issues note provides general guidance on the allocation of risks between related parties in the context of article 9 of the OECD Guidelines;
- The second looks at arm's length compensation for the restructuring itself, discusses the application of the arm's length principle and transfer pricing guidelines to the restructuring itself, in particular the circumstances in which at arm's length the restructured would receive compensation for the transfer of functions, assets and/or risks, and/or indemnification for the termination or substantial renegotiation of the existing arrangements;
- The third examines the application of the arm's length principle and the transfer pricing guidelines to post-restructuring arrangements;
- The fourth issues note discusses some important notions in relation to the exceptional circumstances where a tax administration may consider not recognising a transaction or structure adopted by a taxpayer.

The key positives may be summarised as follows:

- If restructurings are commercially rational, then in all but exceptional terms, the transactions should not be subject to re-categorisation;

- Profit/loss potential is not an asset in itself but a potential which is carried out by other rights or assets and contractual rights can be valuable intangible assets; and
- An entity's ability to take on risk is based on its financial capacity to bear that risk and on its capacity to take decisions to put capital at risk.

Whilst the key negatives may be summarised as follows:

- The OECD TP Restructures document broadens the number of possible interpretations of the transfer pricing guidelines which lead to more incidences of double taxation;
- The OECD TP Restructures document definition of business restructuring implies some sort of inter-company transfer occurs, which will not necessarily be the case;
- The OECD TP Restructures document gives tax authorities greater scope for ignoring or re-categorising both the pre and post-restructure;
- It is implied that tax authorities may gain additional remit to challenge or imply contractual terms that differ from the terms of the actual transaction;
- It may permit tax authorities to re-examine past business restructurings and apply retrospective recommendations.

## 3 Legislative approach to transfer pricing in South Africa

### 3.1 Section 31 of the Act

South Africa has legislation governing the pricing of inter-company transfer of goods and services. The goods relate to tangible property and the services to intangible property, financial assistance and other services across international boundaries. As noted previously the specific transfer pricing legislation was introduced in South Africa in July 1995 under section 31 of the Act.

#### 3.1.1 The law

Section 31 of the Act applies in respect of transactions entered into between connected persons. A connected person is inter alia defined in section 1 of the Act as:

*“(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’ 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’;*

*(iv) any person, other than a company as defined in section 1 of the Companies Act, 1973 (Act No 61 of 1973), who individually or jointly with any connected person in relation to himself, holds, directly or indirectly, at least 20 per cent of the company's equity share capital, or voting rights;*

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

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

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

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

*(vi) where such company is a close corporation-*

*(aa) any member;*

*(bb) any relative of such member or any trust which is a connected person in relation to such member; and*

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

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

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

*(e) in relation to any person who is a connected person in relation to any other person in terms of the foregoing provisions of this definition, such other person;”*

**“Goods”** are comprehensively defined in section 31 of the Act to include any corporeal movable thing, fixed property and any real right in any such thing or fixed property.

**“Services”** are comprehensively defined in section 31 of the Act as anything done or to be done, including:

- the granting, assignment, cession or surrender of a right, benefit or privilege;
- the making available of any facility or advantage;
- the granting of financial assistance, including a loan, advance or debt, and the provision of any security or guarantee;
- the performance of any work;
- an agreement of insurance; or
- the conferring of rights to or to the use of incorporeal property.

After 1 October 2007 the definition of “international agreement” was deleted by section 44 (1) (a) of the Revenue Laws Amendment Act No 35 of 2007.

There followed the substitution for subsection (2) of the following subsection:

*“(2) Where any supply of goods or services has been effected—*

*(a) between—*

*(i) (aa) a resident; and*

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

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

*(bb) a permanent establishment in the Republic of any other person who is not a resident, or*

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

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

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

*(c) at a price which is either—*

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

*(ii) greater than the arm's length price, then, for the purposes of this Act in relation to either the acquiror or supplier, the Commissioner may, in the determination of the taxable income of either the acquiror or supplier, adjust the consideration in respect of the transaction to reflect an arm's length price for the goods or services.”.*

It follows that companies no longer need an international agreement as formerly defined, but rather, a supply of services or goods between connected parties' one resident and the other not to fall within the ambit of section 31.

In light of the above, it is further necessary to establish when a company is a resident for purposes of the Act. The term resident is defined in section 1 of the Act in relation to a person that is not a natural person as a:

*“(b) person which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic, but does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation”.*

*“(2) Where any supply of goods or services has been effected—*

*(a) between—*

*(i) (aa) a resident; and*

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

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

*(bb) a permanent establishment (a branch for example) in the Republic of any other person who is not a resident, or*

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

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

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

*(c) at a price which is either—*

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

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

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

The overriding principle of the transfer pricing legislation is if cross border intra-group transactions between connected persons are not conducted at arm's length, then SARS may adjust pricing to reflect what it regards as an arm's length price for the supply or acquisition of goods or services involved. The onus is on the taxpayer to prove that the price was an arm's length price.

#### *Connected person definition*

Section 31 of the Act applies in respect of cross-border supplies entered into between connected persons. A connected person is *inter alia* defined in section 1 of the Act as:

*(c) in relation to a member of any partnership—*

*(i) any other member; and*

*(ii) any connected person in relation to any member of such partnership; ..'*

Whilst section 31 of the Act does not require that the selling or purchasing of any services or goods in terms of cross-border supplies between connected persons must be at an arm's length price, the Commissioner for SARS may adjust the consideration in

respect of a transactions which are not priced at arm's length to reflect an arm's length price for the goods or services.

The terms in the above statement can be explained as follows:

- the arm's length price is the price that services or goods might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's length; and
- a connected person includes *inter alia* a holding company of a subsidiary company and *vice versa*, as well as co-subsiary companies of the same holding company.

Should the price of such a transaction be different from what an arm's length price would have been, the Commissioner may, in the determination of the taxable income of any of the persons involved, adjust the price in order to reflect an arm's length price.

In addition to section 31 of the Act, the Practice Note was issued in 1999 to act as a guideline to taxpayers with regard to transfer pricing. The Practice Note is by no means prescriptive, nor is it exhaustive, and merely acts as a practical guide as to the interpretation and application of section 31 of the Act.

Following is a discussion of the transfer pricing rules applicable to South African residents, as set out in a combination of section 31, the Practice Note and the OECD Guidelines:

The overriding principle of transfer pricing legislation is that transactions between connected persons should be conducted at arm's length. This means that the transaction should have the substantive financial characteristics of a transaction between independent parties, where each party will strive to get the utmost possible benefit from the transaction.

The arm's-length principle is the international transfer pricing standard that OECD member countries have agreed should be used for tax purposes by multi-national enterprises and tax administrations. The authoritative statement of the arm's-length principle is set forth in Article 9, Paragraph 1 of the OECD Model Tax Convention, which forms the basis of bilateral tax treaties involving OECD member countries and an increasing number of non-member countries (such as South Africa).

Article 9 states that:

*“When conditions are made or imposed between two related 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.”*

OECD member countries and other countries have adopted the arm’s-length principle for the evaluation of transfer prices for goods, services, technical assistance, trademarks, or other assets that are transferred or licensed between related or controlled enterprises as a means of achieving the objectives of securing the appropriate tax base in each jurisdiction and avoiding double taxation. The arm’s-length principle provides the closest approximation of the workings of the open market in cases where goods and services are transferred between associated enterprises. This reflects the economic realities of the controlled taxpayer’s particular facts and circumstances and adopts, as a benchmark, the normal operation of the market.

In order to determine the arm’s-length price to be charged between connected persons, a comparable transaction between independent parties (an uncontrolled transaction) should be used as a benchmark against which to appraise the multi-national’s price (the controlled transaction). Any difference between the two transactions can then be identified and adjusted. The arm’s-length price will reflect the economic contributions made by the parties to the transaction.

The determination of an arm’s-length price is not an exact science and the determination of the most appropriate method to determine the transfer price will often result in a range of justifiable transfer prices.

It is important to note that each case must be decided on its own merit, and that the business strategies employed by multinationals are not consistent. Therefore, it is difficult to find identical comparables for a transfer pricing analysis.

In this regard, comparability means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the method (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences.

Furthermore, the assessment of comparability can be affected by:

- the characteristics of the goods or service;

- the relative importance of functions performed;
- the terms and conditions of relevant agreements;
- the relative risks assumed by the taxpayer, other connected persons and any independent person;
- economic and market conditions; and
- business strategies.

Usually, the compensation for the transfer of property between two independent persons will reflect the functions that each enterprise performs, taking into account the risks assumed and the assets used. Therefore, in order to determine whether two transactions are comparable, the functions and risks undertaken by the independent parties should be compared to those undertaken by the connected persons. A practical way of evaluating functional comparability is to prepare a functional analysis. By performing a functional analysis it can be determined how the business functions, assets and risks are divided between the parties involved in the transaction.

This process is essential to determining whether a given uncontrolled transaction is relevant for comparison purposes to the related-party transaction being examined. A functional analysis examines the specific economic activities that are inherent in the transactions being compared. In this manner, a functional analysis acts as a filter for eliminating uncontrolled transactions that are not comparable from a transfer pricing analysis. A functional analysis should therefore describe the activities that a company performs, and allow one to consider the relative weight and importance of those activities in earning profits for the company and the group.

## **3.2 Documentation requirements**

SARS has indicated that the non-existence of supporting documentation will result in the negative assumption that the transactions have not been reviewed to determine an appropriate arm's-length price. The onus will therefore be on the taxpayer to prove that a specific transaction does in fact represent an arm's-length transaction. All of the aforesaid information should be documented to support the contentions made in applying the transfer pricing policies of the taxpayer.

SARS has however issued an addendum to the Practice Note. The Practice Note would be relevant to any South African taxpayer that has cross border transactions with related

parties. For the sake of convenience we shall refer to such taxpayers as "affected taxpayers".

The main points arising from the addendum are as follows:

- It is not a legal requirement that an affected taxpayer must have a transfer pricing policy document;
- However, affected taxpayers must disclose in their tax returns whether they have such a policy; and
- If a taxpayer discloses that it has a policy then a copy of the policy must be submitted together with the tax return.

It is therefore clear that an affected taxpayer without a transfer pricing policy is in no way in breach of its obligations by failing to submit a policy document with its tax return. However, the taxpayer will be required to disclose that it does not have a policy. If it has significant cross-border related-party transactions the absence of a policy would be likely to make it very difficult for the taxpayer to justify the arm's length nature of the pricing of those transactions. It is likely that the disclosure that the taxpayer has no policy will significantly increase the risk of a transfer pricing audit by SARS.

It would appear therefore that an affected taxpayer should do the following:

- If it has significant transactions which are subject to transfer pricing rules, a transfer pricing policy document should be prepared;
- That policy should be submitted annually together with the taxpayer's tax return; and
- On an annual basis the taxpayer should ensure that the policy is up to date, that it deals with all the significant related party international transactions and that it complies with the requirements of the Practice Note.

### **3.3 Transfer pricing methods**

The Practice Note and the OECD Guidelines distinguish between the traditional transaction methods and the transactional profit methods to determine an arm's-length price for transfer pricing purposes.

There are three traditional transaction methods for the application of the arm's-length principle. These methods are the comparable uncontrolled price ("CUP") method, the resale price ("RP") method, and the cost plus ("CP") method. In addition, the Practice Note and the OECD Guidelines address two other non-traditional methods, also referred

to as the transactional profit methods, namely the transactional net margin method (“TNMM”) and the profit split method.

The Practice Note states that the most appropriate of these methods will depend on the particular situation and the extent of reliable data to enable its proper application. The most reliable method will therefore be the one that requires fewer and more reliable adjustments.

Certain methods may provide a more reliable result than others. Therefore, some may be preferred above others. The Practice Note, as a general rule, discloses a preference for the traditional transaction methods. That is the CUP method, the RP method and the CP method. Of these methods, the CUP method is preferred, as it looks directly to the product or services transferred, and is relatively insensitive to the specific functions that are performed by the entities being compared. However, the RP method and CP method can be said to rank second as these methods examine gross margins, from which operating expenses are excluded. Therefore, the impact of relative cost structures should not be material for these two methods.

The following analysis provides an overview of the acceptable transfer pricing methods.

### **3.3.1 Traditional transaction methods**

#### **3.3.1.1 CUP Method**

The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. Where it is possible to locate comparable uncontrolled transactions, the CUP method is the most direct and reliable way to apply the arm’s-length principle.

In considering whether controlled and uncontrolled transactions are comparable, product comparability must be closely examined. A minor difference in the property transferred or the service rendered in the controlled and uncontrolled transactions could materially affect the price, even though the nature of the business activities undertaken may be sufficiently similar to generate the same overall profit margin. In addition, other comparability factors include, but are not limited to, functions performed, risks assumed and contractual terms. Where differences exist between the controlled and uncontrolled transactions or between enterprises undertaking those transactions that may have a material effect on price, every effort should be made to adjust the data so that it may be used appropriately in the CUP method.

In practice it is unusual to find an exact or even a closely comparable CUP. However, if there are differences that can be quantified or justified, or if there are only minor differences that cannot be quantified, the CUP method can still be used.

If it is not possible to perform a CUP analysis to determine transfer prices, the next most preferred methods are the RP and CP methods. These methods set a margin for the price of goods or services to be transferred to related parties, and closely follow the way in which commercial agreements are structured.

### **3.3.1.2 Resale Price Method**

In order to determine the arm's-length price according to this method, the formula for the calculation can be set out as follows:

Resale price of product (purchased from a connected person) charged to an independent third party

- LESS: The resale price margin (an appropriate gross margin reflecting selling and other operating expenses as well as an appropriate profit (in light of functions performed, taking into account assets used and risks assumed))
- LESS: Adjustment for other costs associated with the purchase of the product such as customs duties
- EQUALS: An arm's-length price for the original transfer of property between the connected persons.

The resale price margin of the reseller in a controlled transaction may be determined with reference to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions. However, if no such comparables are available, the resale price margin earned by an independent enterprise in comparable uncontrolled transactions may serve as a guide. Again, an uncontrolled transaction is comparable to a controlled transaction if none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the resale price margin in the open market or reasonably accurate adjustments can be made to eliminate the material effects of such differences. Fewer adjustments are normally needed in the RP method than with the CUP method.

Furthermore, in terms of the OECD Guidelines broader product differences can be allowed in the RP method. However, the property transferred in the controlled transaction

must still be compared to that being transferred in the uncontrolled transaction. The RP method is also dependent on the comparability of functions performed (taking into account assets used and risks assumed).

A RP margin is the easiest to determine where the reseller does not add substantially to the value of a product. However, where a reseller further processes goods or incorporate goods into a more complicated product so that the identity is lost or the goods are transformed, it is more difficult to apply the RP method to arrive at an arm's-length price.

Furthermore, a RP margin is more accurate where it is realised within a short time of the reseller's purchase of the goods.

The level of activities performed by the reseller influence the RP margin. Examples of such activities may include the following: the taking on of full risk and ownership together with the full responsibility for and the risks involved in advertising, marketing, distributing and guaranteeing the goods, financing stock and other connected services. Furthermore, the exclusive right to resell goods may also influence the RP margin.

### **3.3.1.3 Cost Plus Method**

The CP method is typically used in circumstances where semi-finished goods are sold between related parties, where related parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services. The CP method evaluates the arm's-length nature of an inter-company charge by reference to the gross profit mark-up on costs incurred by suppliers of services (or property) for services provided (or property transferred). Under the CP method, an arm's-length price equals the controlled party's cost of providing the services (or producing the tangible property) plus an appropriate gross profit mark-up, defined as the ratio of gross margin to costs for a comparable uncontrolled transaction. The cost plus mark-up of the supplier of goods or services in the controlled transaction should ideally be established by reference to the cost plus mark-up that the same supplier earns in comparable uncontrolled transactions. The cost plus mark-up earned by an independent enterprise in comparable transactions may also serve as a guide.

When applying the CP method, it is particularly important to consider differences in the level and types of expenses, both operating expenses and non-operating expenses including financing expenditures, associated with functions performed and risks assumed by the parties or transactions being compared. As under the resale price method, close physical similarity between products transferred in controlled and uncontrolled transactions is less important. Where there are differences that materially affect the cost

plus mark-ups earned in the controlled and uncontrolled transactions, adjustments should be made to account for such differences. In addition, appropriate adjustments should be made to the data used to ensure that the same types of costs are used in each case to ensure consistency.

### **3.3.2 Transactional profit methods**

When one of the three traditional transaction methods cannot be reliably applied alone or, exceptionally, cannot be applied at all, other approaches might be used to approximate arm's-length conditions. The OECD Guidelines refer to two transactional profit methods that examine the profits that arise from particular transactions among related enterprises. These two methods, the profit split method and the TNMM are the only profit methods that satisfy the arm's-length principle.

The OECD Guidelines state that profit arising from a controlled transaction can be a relevant indicator of whether the transaction was affected by conditions that differ from those that would have been made by independent enterprises in otherwise comparable circumstances. Thus, in those exceptional cases in which the complexities of real life business put practical difficulties in the way of the application of the traditional transaction methods and, provided all the safeguards set out in the OECD Guidelines are observed, application of the transactional profit methods may provide an approximation of transfer pricing in a manner consistent with the arm's-length principle. Furthermore, when other methods cannot be applied due to insufficient or unreliable data on uncontrolled transactions or other prohibitive factors, the OECD Guidelines and the Practice Note permit the use of Transactional Profits Methods.

#### **3.3.2.1 Profit Split Method**

The Profit Split method evaluates the arm's-length nature of the combined operating profit (or loss) resulting from one or more inter-company transactions, based on the relative value of each controlled party's contribution to the operating profit (or loss). The combined profit may be the total profit from the transactions or a residual profit intended to represent the profit that cannot readily be assigned to one of the parties, such as the profit arising from high-value, sometimes unique, intangibles. The contribution of each enterprise is based on a functional analysis of each enterprise, taking into account assets used and risks assumed. In addition, relative contributions must be valued to the extent possible by available reliable external market criteria, including profit split

percentages or returns observed among independent enterprises with comparable functions.

The OECD Guidelines and the Practice Note discuss two approaches, not necessarily exhaustive or mutually exclusive, for estimating the division of profits under the profit split method, namely the contribution analysis and residual analysis.

#### *Contribution Analysis*

Under a contribution analysis, the combined profits, which are the total profits from the controlled transactions, are divided between the related enterprises based upon the relative value of the functions performed by each enterprise, supplemented as much as possible by external market data that indicate how independent enterprises would have divided profits in similar circumstances. Determining the relative value of each party's contributions might be made by comparing the nature and degree of each party's contributions of different types, including, but not limited to, provision of services, development expenses incurred, and capital invested, and assigning a percentage based upon the relative comparison and external market data. Generally, operating profit is examined under this method, ensuring that both income and expenses are attributed to the relevant related enterprise on a consistent basis.

#### *Residual Analysis*

The residual analysis divides the combined profit from the controlled transactions in two stages. Firstly, each participant in the transaction is allocated sufficient profit to provide it with a basic return appropriate for the type of transactions in which it is engaged. This return is determined by reference to the market returns achieved for similar types of transactions by independent enterprises. In the second stage, any residual profit (or loss) is allocated among the parties based upon an analysis of the circumstances that might indicate how this residual would have been divided between independent enterprises. Indicators of the parties' contributions of intangible property and relative bargaining positions may be particularly useful in this context.

#### **3.3.2.2 Transactional Net Margin Method**

The TNMM examines the net profit margin (e.g. return on assets, operating income to sales, and possibly other measures of net profit) relative to an appropriate base (e.g. assets, sales, and costs) that a taxpayer realises from a controlled transaction. Thus, a TNMM operates in a manner similar to the CP and RP methods, and to be reliable it must be applied in a manner consistent with the application of the CP or RP methods. Specifically, the net margin of the taxpayer from the controlled transaction should ideally

be established by reference to the net margin that the same taxpayer earns in comparable uncontrolled transactions. Where this is not possible, the net margin that would have been earned in comparable transactions by an independent enterprise may serve as a guide.

Analysis under the TNMM should consider only the profits of the related enterprise that are attributable to particular controlled transactions. That is, it would be inappropriate to apply the TNMM on a company-wide basis if the company engages in a variety of different controlled transactions that cannot be appropriately compared on an aggregate basis with those of the independent enterprise. The related enterprise to which the TNMM is applied should be the enterprise for which reliable data on the most closely comparable transactions can be identified. This enterprise will generally be the enterprise that is the least complex of the enterprises involved in the controlled transaction and that does not own valuable intangible property or unique assets.

Multiple year data should be considered in the TNMM for both controlled and uncontrolled enterprises to the extent that their net margins are being compared, to take into account the effects on profits of product life cycles and short-term economic conditions. A range of results should also be taken into account to reduce the effects of differences between the controlled and uncontrolled entities.

### 3.4 International tax case law

In the absence of domestic case law on transfer pricing it may be useful to consider international cases that could also have application. In *GlaxoSmithKline vs. Canada Revenue Agency*, the appellant GlaxoSmithKline (“GSK”) lost an appeal in the Tax Court of Canada over a reassessment of its tax liability on supplier transactions in the early 1990s. The Tax Court found that the Canada Revenue Agency (“CRA”) was correct to seek further taxes from GSK for the years 1990 to 1993 in a dispute over the prices Glaxo Canada paid, as part of a supply contract, for the generic drug Ranitidine, which is used to make the branded product Zantac.

During the years under audit in Canada, Glaxo Canada purchased Ranitidine from Adechsa, a related party based in Switzerland. The Ranitidine purchased by Glaxo Canada from Adechsa was manufactured by a related-party manufacturer in Singapore. Glaxo Worldwide’s transfer pricing arrangements allowed the Singapore related party manufacturer to earn gross profits of about 90% on the sale of the drug to Adechsa. Adechsa was required to earn a minimum 4% profit (by agreement with the Swiss tax authorities), and Glaxo Canada earned a gross profit of approximately 60% on the sale of Zantac. In the audit period under review, generic manufacturers in Canada produced Ranitidine at a lower price than that which Glaxo Canada paid Adechsa.

It was argued by CRA that the costs of production should be benchmarked against those of the local producers of generic pharmaceutical products. Glaxo Canada argued that it was selling a branded medicine and therefore its costs were higher. The judge rejected a link between the supply contract with Adechsa and the licence agreement with Glaxo Canada’s parent. The method to evaluate the transfer price was also rejected by the court. The court held that the CUP method was appropriate and rejected the use of the TNMM which was put forward by Glaxo Canada.

Glaxo Canada also provided a set of comparables with European companies, which was also dismissed by the court. Using these European companies Glaxo Canada came up with a range of gross margins which was criticized by the court because it included insufficient data to accurately measure the profitability of the European licensees. The judge rejected Glaxo Canada's arguments that the outliers be discarded from the analysis, agreeing with the CRA that the highest observations in the range may in fact be the most comparable to those of Glaxo Canada.

Further guidance may be sought in *Roche Products Pty Limited v The Commissioner of Taxation* where a preliminary decision of significant interest to multinationals, particularly those in the pharmaceutical industry, was handed down on 2 April 2008 by Mr Justice Downes of the Administrative Appeals Tribunal ("AAT"). The Decision involved the determination of the transfer prices for pharmaceutical products acquired by Roche Products Pty Limited ("Roche Australia") from its parent company Roche Holdings Limited of Switzerland and other group companies (collectively, "Roche Basel").

In calculating the transfer price adjustments in the amended assessments, the Australian Tax Office ("ATO") used a TNMM. The ATO acknowledged that there was an absence of good comparables in the Australian market to support the transfer prices of product acquired by Roche Australia from its overseas group companies. In quantifying the adjustments in the amended assessments, the ATO considered the functions being performed by Roche Australia in respect of the resale of the products in Australia and sought to benchmark their profit against the profit earned by independent companies from similar activities. The ATO aggregated the returns from the various functional components to calculate an appropriate gross margin.

Applying the TNMM resulted in the ATO issuing revised assessments which Roche Australia argued were excessive. In the Ethical Pharmaceutical Division, between 1996 and 2003, a number of products were sold by Roche Basel to independent wholesalers of generic pharmaceutical products in Australia, such as Alphapharm Pty Limited. Roche Australia used a CUP method to argue that the prices paid by Roche Australia for the product were comparable to the price paid by the Australian independent wholesalers. Roche Australia used the gross margin on the products for which it had a CUP as a benchmark of the gross margin of its other products for which it had no direct price comparison (non-CUP products). Roche Australia argued that because the gross margin on its CUP products approximated the gross margin on its non-CUP products, no adjustment to transfer prices in the Ethical Pharmaceutical Division was warranted.

In calculating the adjustments to the ethical pharmaceutical products, Mr Justice Downes concluded that an arm's length price for pharmaceuticals would have yielded Roche Australia a gross margin of at least 40 percent throughout its product range. His conclusion was based on the finding that the prices for the generic sales to Alphapharm Pty Limited were generally negotiated to yield a gross profit margin of 40 percent.

The court recommended "standing back and looking at the canvas" when looking at transfer prices arguing that just because a transfer price results in a loss does not necessarily mean that the transfer price is not arm's length. This was particularly important in relation to the Diagnostic Division, where the court was satisfied that the poor operating results of the division were a result of commercial factors, not transfer prices. In particular, the court was clearly concerned that one of the problems of TNMM is that in analysing the performance of a division or company "it inevitably attributes any loss to the pricing. After all it is certainly true that there are companies that make losses for reasons other than the prices for which they acquire their stock. The Australian operations for multinational companies are not necessarily excluded from this".

#### **3.4.1 Application to South African taxpayers**

Both cases serve as an important reminder to South African taxpayers of the importance of documenting contemporaneously the commercial reasons for pricing decisions in their transfer pricing analysis.

In the instance that the transfer price paid by a South African tax resident to a connected is increased then SARS may query whether the price paid by the South African resident is an arm's length charge. Based on the application of the CRA and Canadian Tax Court above, SARS may contend (in the instance of a comparable transaction existing) that the South African taxpayer could purchase alternative services/products from independent third parties at a lower price. SARS may also reject the transactional methods used to calculate the transfer prices between South African tax resident and their connected parties.

The approach of the court in the *Roche case* may also cause SARS some hesitation in immediately presuming that losses (or significant changes in profits) incurred by South African taxpayers with cross-border inter-company transactions are due to transfer pricing practices that are not arm's length.

## 4 The examination of tax planning structures

### 4.1 General overview

*“When examining the structure adopted by MNE’s, the term 'commissionaire' may be encountered.<sup>10</sup> Under this scenario a distributor has changes to a commissionaire structure and this is subsequently accompanied by a marked drop in profits earned by the company, namely the commissionaire. Very broadly a commissionaire is an undisclosed agent. It is important to bear this distinction in mind.”<sup>11</sup>*

While this report will continue to refer to the term 'commissionaire', one would treat any company that is acting as a commissionaire, as an undisclosed agent.

There are two important points to consider when looking at setting up a selling structure in SA which involves a commissionaire. Firstly in terms of section 31 of the Act, a true commissionaire arrangement is required to be at arm’s length in the SA. And, secondly, there may actually be more than one person who is taxable in the SA in respect of profits made from selling goods in SA.

This section discusses five stylised distribution models that have been employed by companies seeking to sell their products in foreign markets.<sup>12</sup> From a tax planning perspective, the choice of model should be driven both by commercial necessities as well as an understanding of the flexibility to shape certain parameters of the supply chain to achieve desired outcomes.

A range of sub-activities exists within the function of distribution, ranging from a commissionaire/commission agent type distribution activity to a full fledged distribution activity. The following examines potential distribution models that may be employed by a company when selling into the South African markets.

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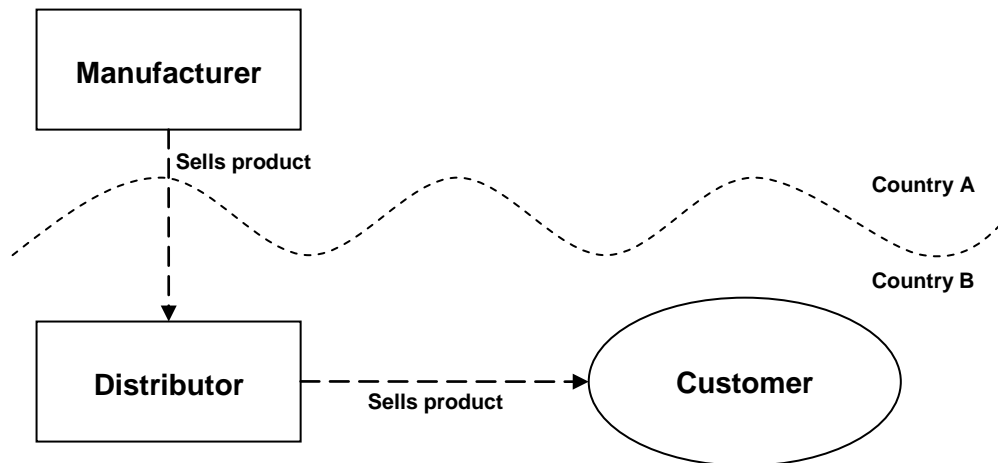
<sup>10</sup> Commissionaire, in the context of tax-planning structures is a French term, with no direct English translation.

<sup>11</sup> <http://www.hmrc.gov.uk/manuals/intmanual/INTM465040.htm>

<sup>12</sup> Michael Bacon, Jacky Coates, Thomas Herr and Michael Nelson, “Evolution of the distribution supply chain: tax considerations for US companies expanding in Europe”, Tax Planning International: Special Report (2008) pg:11

#### 4.1.1 Traditional ways of selling into SA

Most businesses in SA that sell finished goods, be it wholesale or retail, will do so by buying products, holding those products as stock, promoting and selling them to customers. A typical structure adopted in the past by a MNE may have looked something like this – a 'classical' buy/sell distributor



The distributor buys the products from the manufacturer and then sells them to third party customers. He will bear the risks associated with buying, holding and selling stock, such as:

- The risk of not selling;
- Stock obsolescence;
- Product returns and warranty (there may well be some recourse to the manufacturer, though);
- Bad debt risk of customers; and
- Foreign exchange risk (perhaps) of buying the goods.

A distributor will also incur the additional financial costs of carrying the stock. The distributor will also incur costs of getting the goods to the customers and promoting, marketing and selling the products. There may be associated activities such as after sales servicing.

The distributor may own important valuable marketing intangibles, such as brand names. It will expect to derive profits from exploiting these intangibles.

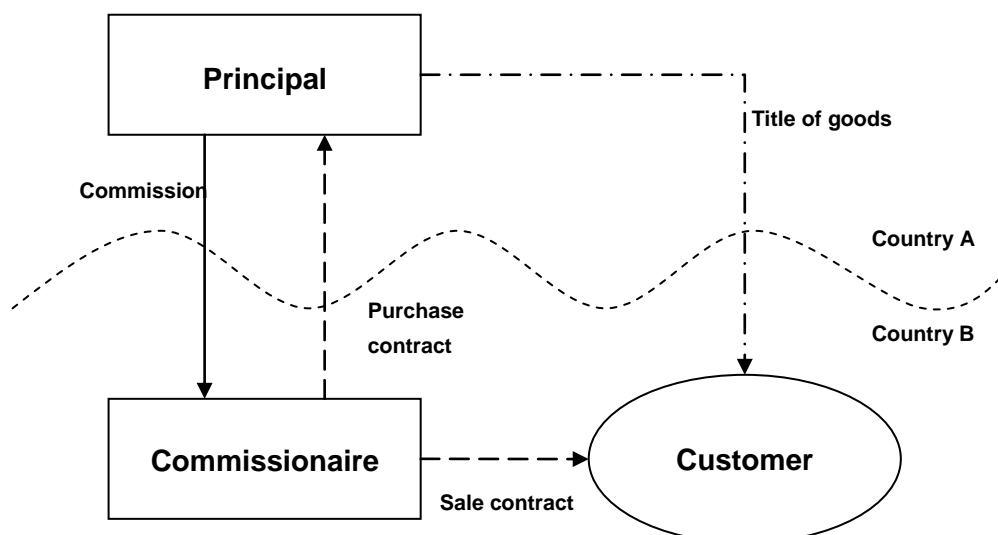
#### 4.1.2 Direct sale with the aid of a representative office

The representative office model may appeal to a company if the desire is to initially enter a foreign market without having to make a significant capital investment. Under the representative office model, a company would typically establish a representative office, in this instance in a low tax jurisdiction from where it will facilitate sales to its worldwide customers. The representative office may engage in marketing activities, including customer communication, but does not have the authority to enter into binding sales agreements with customers. The company would directly contract with and makes sales to customers.

Provided that the representative office does not constitute a permanent establishment (“PE”) there may be limited South African transfer pricing issues to consider. If it is treated as a branch of the foreign company, its activities would need to be analysed and the amount of profit allocable to those activities would need to be determined using transfer pricing principles. In many cases of limited branch activities, a simple cost plus reimbursement model may have the benefit of limited transfer pricing complexity.

#### 4.1.3 Commissionaire structure

At arm’s length, the lower the risk and activity, the lower the profit the distributor can expect to earn. This gave rise to a number of new structures for distributors with tax minimisation in mind, one of the most common of which was the commissionaire arrangement.



A commissionaire structure is one under which a foreign company establishes itself to serve as the principal for sales of goods into South Africa. As the principal the foreign company would be the manufacturer of the goods. An offshore entity (in this case the

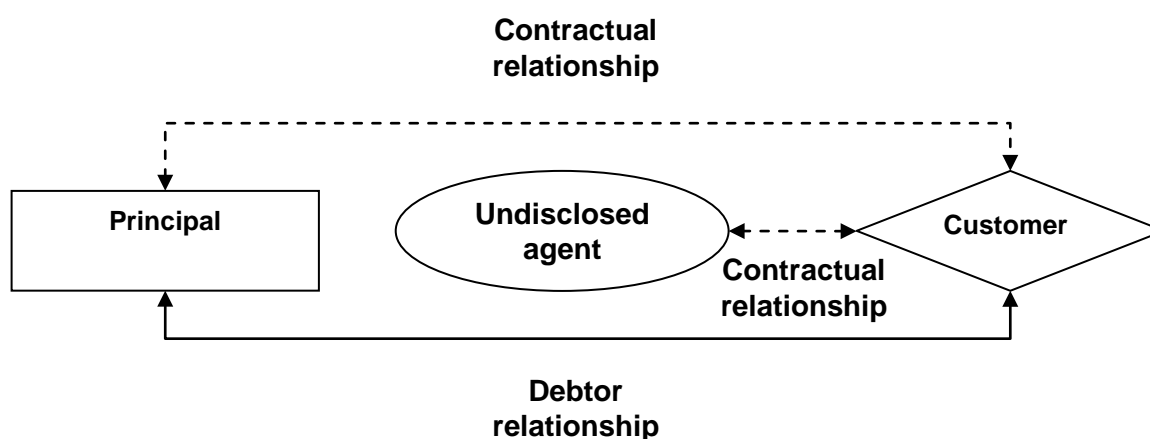
South African company), the commissionaire, is formed and acts in its own name but at the risk of, and on behalf of, foreign company, with respect to local country sales of the goods. The offshore entity, the agent, would not take title to the goods sold and is compensated with commissions for the sales that it makes.

The commissionaire legally does not take title to the goods. The compensation, the commissionaire receives is not from the margin it makes on the purchase and resale of the inventory, but rather the “commission” it gets from the principal. The commission is typically structured in one of two ways – either as a percentage of sales affected by the agent or as a reimbursement of the costs of the agent plus a profit mark-up. The latter is often preferred because it provides for a more predictable profit outcome. However, it also increases the risk that the agent may be viewed as a dependent agent and thus creates a PE for the principal. Thus, a percentage of sales compensation is often more advisable. To limit the risk exposure of the commissionaire, the commission percentage structure is often tapered to provide a higher relative compensation with lower sales and vice versa. This helps limit the downside of the commissionaire which will likely have certain fixed costs no matter what sales levels are achieved.

#### 4.1.4 Commission agent

The commission agent (also referred to as an undisclosed agency arrangement) will solicit sales on behalf of the principal. The commission agent agreement may state that either:

- the agent signs the sales contracts on behalf of the principal, thereby binding the principal; or
- the principal itself signs the contract, with the commission agent merely acting as an intermediary in the transaction.



The title to the goods passes directly from the principal to the third party customer in much the same way as for a commissionaire arrangement outlined above.

However, the main difference is that all sales invoicing is undertaken by the principal and not the commission agent. This reduces the sales invoicing by the agent by reducing the number of sales invoices issued compared with a commissionaire. In return for its sales function, the commission agent is remunerated by the principal, either on a commission basis or cost plus basis.

In SA, it is possible that a commissionaire is legally an undisclosed agent, with the potential to bind the principal. This is an important concept as it can have a bearing on whether the principal would be treated as trading in SA through a permanent establishment. This is discussed in greater detail in section 5.

#### **4.1.5 Stripped buy-sell subsidiary/distributor**

A stripped buy and sell subsidiary/distributor is characterised by the decreased functions and risks it bears as compared to a full-fledged distribution activity, and which normally yields lower profit levels as a result. Many of the functions will normally be centralised, for example, human resources, marketing, after-sales support etc. Inventory can be owned by the parent company in South Africa, until such time as a third party sale is made. The subsidiary will then purchase the goods from the parent, in South Africa, for immediate resale, allowing the subsidiary to minimise inventory holding costs. Whilst the subsidiary may assume credit risk on the sale, it could equally lay this off on another group company by means of a factoring or similar arrangement.

As with any intermediary, the subsidiary will make a gross profit on the difference between the sale price and the purchase price. However, if the functions of the subsidiary are reduced to the point that it performs similar functions to a commissionaire or commission agent, it should, in principle, earn an arm's length return similar to those structures.

#### **4.1.6 Full-fledged distributor**

A full-fledged distributor is a buy/sell entity that undertakes all of the sales and distribution functions and assumes associated risks typical of a distribution firm within the industry. Additionally, such entities may also hold strategic marketing responsibilities. A full-fledged distributor undertakes both operational and entrepreneurial functions relating to marketing, distribution and sales and therefore bears the risks associated with these activities. These risks include credit risk, inventory risk, market risk and marketing risk.

Full-fledged distributors perform numerous functions, using more assets and assuming more risks than a normal commission agent. One would therefore expect the distributor to earn a higher margin.

On the assumption that the foreign company has determined that the offshore jurisdiction is a commercially viable location for this part of its business and requires an in-country legal presence, it may deploy the buy/sell subsidiary model, in which a subsidiary is established that acts as the distributor. The SA distributor would purchase tangible goods produced by the foreign company and then sells those goods in its own name and on its own behalf to customers worldwide.

It is evident that MNE's expanding into new markets must integrate operational planning with income and transfer pricing planning, especially in the South African market. From that integration process, companies can effectively reduce the business and tax costs that may otherwise erode the benefits of operational planning, as well as reduce unexpected tax and transfer pricing risks. On a high-level basis, the models addressed above illustrate approaches that, if tailored properly, can facilitate the integration of operational planning with tax and transfer pricing planning.

## 5 The examination of potential income tax and transfer pricing issue post-restructuring

### 5.1 Permanent establishment and transfer pricing

Commissionaire (and undisclosed agent) structures have been used extensively as a way of forming low risk, low-margin sales companies, especially in Europe. In theory, such agents should be able to have lower risks and profits than distribution operations as they lack the inventory and accounts receivable risk incurred by fully-fledged distributors.

Tax authorities (and potentially SARS) may challenge the ongoing transfer pricing of taxpayers using commissionaire structures in two ways<sup>13</sup>:

- by challenging the transfer pricing, arguing that the commissionaire is not receiving an arm's-length remuneration; and
- by arguing that the commissionaire is a PE of the principal.

The concept of a permanent establishment ("PE") is of material relevance in determining whether South Africa will seek to impose tax under its domestic legislation on interest and capital gains on a non-resident. It is further of importance where that non-resident is tax resident in a jurisdiction that has concluded a double tax agreement ("DTA") with South Africa. In such circumstances the concept of a permanent establishment determines, *inter alia*, which jurisdiction has taxing rights in respect of any income derived by the non-resident from a South African source.

Tax inspectors commonly argue in this respect that in fact the commissionaire does more than provide services. Tax inspectors may point to the high value of the marketing activities performed or the importance of the client relationship in the value chain.

This argument typically is not directly motivated by the amount of the transfer-pricing remuneration. In general, this point is raised when the commissionaire is not considered independent from its principal, for example under circumstances where the commissionaire only has one principal and/or when its remuneration is guaranteed. The commissionaire conundrum is that the steps taken to make the commissionaire a relatively risk-free entity entitled to only a limited return may increase the risk of being treated as a PE, while steps taken to reduce the risk of being treated as a PE may increase transfer-pricing exposure.

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<sup>13</sup> Luquet & Llinares "The remuneration of the commissionaire" [www.internationaltaxreview.com](http://www.internationaltaxreview.com) pg: 60

For example, multinational groups may consider establishing a remuneration system based on a sales-based commission to mitigate the risk of the characterization of a commissionaire as a PE. However, setting a commission driven off of sales may lead to unusual profit results (including the possibility of an operating loss) that may lead to serious transfer-pricing issues.

Conversely, steps that reduce transfer pricing risk (for example, setting transfer prices in a way such that they always fall within an arm's-length range or paying a commission which is calculated on the basis of selling general and administration costs plus a mark-up on selling general and administration costs) may increase PE concerns. If the commissionaire earns a virtually guaranteed profit with little if any risk, tax authorities may choose to view the commissionaire as an agent of the principal, and therefore try to tax a portion of the principal's profits as well.

### **5.1.1 Arm's length remuneration**

Furthermore, the OECD issued a revised discussion draft in August 2004 on the Attribution of Profits to Permanent Establishments – Part 1 (General Considerations) (In the discussion draft the OECD very clearly stated the dilemma presented above, that is, that if the commissionaire is determined to be merely a dependent agent of the non-resident principal the entity will be deemed to be a PE and profits will be attributed to the PE (and taxed by the local country) accordingly. While the discussion draft is simply a first step in the development of guidelines on the recommended tax consequences of the PE it is clear that the commissionaire arrangement is one of the structures the OECD had in mind when addressing the issue. Clearly, then, the balancing process described below is not likely to get easier as the OECD moves forward. (See, for example, discussion draft paragraphs 271 and 282). Balancing the transfer pricing and PE risks associated with commissionaires involves balancing the following factors:

- On what basis can the commission be defined? Driving payments off of sales rather than costs may reduce PE risk, but could potentially complicate the management of profit levels in company. This issue can be addressed by adding various features to the basic model. For example, it is possible to define a remuneration based on sales with thresholds, or to define a commission based on sales with a minimum fixed amount<sup>14</sup>; and
- Which OECD methods can be used? As specific transactional comparables are often difficult to find, most transfer-pricing analyses fall back on other OECD methods. As

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<sup>14</sup> Ibid pg: 61-62

gross margin-based methods (cost plus or resale minus) are generally not applicable since they require comparability criteria that are hard to match, this generally results in the use of the transactional net margin method TNMM.

- What profit-level indicator (“PLI”) can be used to define or test the arm’s-length nature of the commission? There are a number of PLIs that could be used in this setting. As discussed above, in general pricing is driven off of sales, and perhaps the most popular PLI is the operating margin, as for buy-sell distributors. The commission is then determined on the basis of budgeted sales such that it leaves the commissionaire with the corresponding operating margin. The remuneration may then be adjusted for the risks that the commissionaire does not assume.

### 5.1.2 Transfer pricing exposure

A critical issue in business restructurings relates to the allocation of risks between related parties in an article 9 context and in particular the interpretation and application of paragraphs 1.26 and 1.27 of the OECD Guidelines. Theoretically, in the open market, the assumption of increased risk must also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which risks are actually realised.

Paragraph 1.26 of the OECD Guidelines states that:

*“it may be considered whether a purported allocation of risk is consistent with the economic substance of the transaction”.*

Whilst paragraph 1.27 of the OECD Guidelines notes that:

*“An additional factor to consider in examining the economic substance of a purported risk allocation is the consequence of such an allocation in arm's length transactions. In arm's length dealings it generally makes sense for parties to be allocated a greater share of those risks over which they have relatively more control”.*

It is evident therefore that risk allocation and risk transfers are a significant factor in many business restructurings and can lead to complex disputes as to the assessment of their effects on the profit potential of associated enterprises. In a profit-making context, disputes have arisen as to whether restructurings may abusively shift profits out of the country of the restructured entity; in a loss making context, disputes can arise as to where losses should be attributed.

It must be noted that in any selling operation, the most important function and area of risk is the marketing and selling of the goods. This is recognised by distributors, as sales

personnel are usually much better rewarded than people carrying out other functions, such as chasing debts or ordering the products. Without the means to sell the goods, without the relationship with the customers, without the experience and strategy to attract new customers – the rest of the activities of the whole selling operation are unlikely to generate significant profit.

As previously noted in paragraph 2.3.3 the issue of risk allocation is dealt with in the case of *DSG Retail Ltd and others v HMRC*.

The case concerned the sale of extended warranties in Dixons shops (“Dixons, Currys, PC World”). Sales were made both of insurance products insured by Cornhill and 95 percent reinsured with the Dixons group’s Isle of Man insurance company (“DISL”) and of service contracts sold by a third party (“ASL”), the risk on which was all insured with DISL. Administration and repairs were carried out by another Dixons UK company, MSDL.

Under neither structure was there any transaction directly between members of the Dixons group. Customers bought the insurance or service contract in store from a Dixons UK group company acting as the sales agent of either Cornhill or ASL. The sales agent deducted an upfront sales commission and passed the balance of the money to Cornhill or ASL. Cornhill paid MSDL an upfront administration fee and reinsured 95 percent of the risk with DISL for which it received ceding commission. ASL also paid the administration fee to MSDL, and insured 100 percent of its risk with DISL. In both structures, DISL ultimately met all claims. Also in both structures, once the policies were off risk (usually just over five years after they had been sold), a profit commission was paid by DISL up to Cornhill or ASL and on to the sales agent.

There was no disagreement between HMRC and Dixons over the remuneration of either ASL or MSDL. The primary issue was the reinsurance/insurance premiums paid to DISL, and whether ‘provision’ (per Schedule 28AA) had been made or imposed by means of a series of transactions.

Certain key principles can be distilled from the decision:

- The relative bargaining powers of the parties is a key factor. The Dixons UK group was found to have far more power than DISL;
- Profit is to be allocated in the light of the scarcity of the contribution offered by each party. In other words, it is important to consider the availability of economic alternatives; and
- The assumption of risk is critical. The Commissioners discussed DISL’s risk profile at some length, and concluded that loss ratios had become stable and predictable, the implication being that DISL did not face very great risk. It is not clear how precisely this feeds into their decision; but certainly the Commissioners point out that Cornhill

would not have agreed to the 1993 reduction of its margin had foreseen major changes in the loss ratios; and seems likely that the conclusion on DISL'S risk fed at least intuitively into the findings that DISL was making 'too much' and that other insurers would have been prepared to take on the book.

In the event that SARS attack's a company's transfer prices SARS may, in terms of section 31(2)(c)(ii) of the Act, adjust the taxable income of the South African company to reflect an arm's length price for the services rendered (or goods purchases) by the company. The following tax consequences would therefore arise for the commissionaire:

- the adjusted amount will be included in the determination of taxable income i.e. taxable income would increase;
- the adjusted amount will be deemed to be a dividend which will be subject to Secondary Tax on Companies ("STC");
- interest will be levied on the tax and STC that may be due; and
- penalties may be levied on the amount.

## 5.2 Permanent establishment and the OECD Model Tax Convention

The OECD Model stipulates that a country may only tax so much of the profits of foreign company as are attributable to a PE of that company in South Africa.

The question therefore arises whether a principal-agent supply model implemented by a foreign company (post-restructuring) would create a PE in South Africa by virtue the activities of its commission agent or commissionaire structure in South Africa. This also assumes that the foreign company is situated in country that has entered into a DTA with South Africa.

### 5.2.1 Fixed place of business

According to Article 5 of the OECD Model, where a non-resident carries on its business, wholly or partly through a fixed place of business in South Africa this could give rise to a PE in South Africa. A fixed place of business includes, *inter alia*, a place of management, a branch or an office. It follows by implication that in order for a company to have a PE in South Africa, the following conditions must be met:

- it must have a place of business in South Africa – i.e. business premises;
- the place of business must be fixed in terms of location and duration; and
- the place of business must be used to carry on, wholly or partly, the business of the non-resident.

### 5.2.2 Exclusions<sup>15</sup>

However, even where the above-mentioned general requirements of a PE are met, there are certain activities that are specifically excluded from constituting a PE even if carried on through a fixed place of business as referred to above. In particular, the following activities are specifically excluded from creating a PE in terms of the OECD Model:

- the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to an enterprise;
- the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or irregular delivery;

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<sup>15</sup> The OECD Model Commentary on Double Taxation Agreements (2005) pg: 85 - 110

- the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise; and
- the maintenance of a fixed place of business solely for purpose of activities which have a preparatory or auxiliary character for the enterprise, such as advertising or scientific research.

### 5.2.3 Dependent agents creating PE exposure

Article 5 of the OECD MODEL states that a PE means a fixed place of business through which the business of the enterprise is wholly or partly carried on. In the instance of an agent having no employees in South Africa nor conducting any aspect of their business from a fixed place in South Africa then it would appear that there would be *prima facie* evidence of the non-existence of a PE. However if the greater extent of the foreign company's presence in South Africa is through the administrative services performed by the commissionaire or commission agent are the marketing and selling services (in so far as these are rendered in South Africa) what therefore needs to be considered is whether a PE for the foreign company could be created through these activities in South Africa.

Furthermore, where an enterprise operates through a party other than employees (or people taking instructions from the enterprise in a similar role as an employee) the specific provisions in the DTA dealing with the position of independent and dependent agents requires consideration.

### 5.2.4 Independent Agent

The OECD Model provides that an enterprise should be treated as having a PE in a State if that enterprise is represented by a person/company acting in the other Contracting State, if such person has, and habitually exercises, an authority to conclude contracts in the name of and on behalf of the enterprise. However, where an enterprise carries on business in South Africa through a broker, general commission agent or any other agent of an independent status, the agent will not constitute a PE in that state, provided the agent is acting in the ordinary course of its business.

Essentially, an agent will not constitute a PE of the MNE on whose behalf it acts if:

- it is independent of the enterprise both legally and economically;

- the activities of the enterprise are carried on by the agent in the ordinary course of its business; and
- it does not have the authority to bind the entity contractually.

In determining whether a commissionaire is independent of its foreign parent from a legal point of view, regard should be had to the extent of the obligations, which they have in relation to the foreign parent. Where the commission agent's commercial activities are subject to detailed instructions or to comprehensive control by the foreign parent, the commissionaire cannot be regarded as being legally independent of the foreign parent. Another important criterion would be whether any entrepreneurial risk is borne by the commission agent.

In terms of the OECD Model Commentary on Double Taxation Agreements, an agent will be regarded as being economically independent only to the extent that it carries on comprehensive economic activities of its own. Where an agent carries on activities exclusively on behalf of its principal, then the agent will be regarded as being economically dependent on the principal as its entire income base will be dependent on the principal.

A further requirement that the agent must carry on the activities in the ordinary course of its business is relevant in the determination of the independent status of the agent. In this regard, an agent cannot be said to be acting within the ordinary course of its business if such persons perform activities, which economically belong to the sphere of the principal rather than to that of the agent's business operations. This would be the situation where the agent acts outside the scope of its own trade. A criterion indicating such ordinary course of business can also be assessed by looking at which party bears the entrepreneurial risk in respect of the transaction.

Taking the above three aspects into account it would appear that the commissionaire should not be seen to be economically or legally dependent on the foreign parent. This should be evidenced the fact that it assumes all entrepreneurial risk in relation to its business, the services are rendered within the ordinary course of its business and that the commercial activities of the commissionaire are not subject to detailed instruction or comprehensive control by the foreign parent.

### **5.2.5 Dependent Agent**

A dependent agent can only create a PE for a foreign parent in South Africa if it has the authority to conclude contracts on behalf of the foreign parent in South Africa and such contracts are concluded on a regular basis.

The question whether such an agent has the authority to conclude contracts must be decided not only with reference to law but must also take into account the actual behaviour of the contracting parties.

Additionally, where an agent has the authority to negotiate contracts up to the point where they are only finalised and signed off by the principle, the agent will still be considered as having concluded the contract (based on substance over form). The principle would need to apply its mind to each situation and take the ultimate decision and the mere “rubber stamping” of an agreement by the principle will also lead to the conclusion that the agent in fact concluded the agreement.

In other words, where an agent has the authority to negotiate contracts with third parties up to the point where they are only finalised and signed by the principal, the agent will still be regarded as having concluded the contract. Furthermore, where mass contracts are processed using a standard format and are merely signed by the principal without evidence of the principal applying its mind to each situation, the agent will be deemed to have taken the ultimate decision and will therefore be regarded as having the authority to conclude the contracts. Where, however, it is evident that genuine input is required from the principal then the agent will not be regarded as having concluded the contract by merely soliciting an order.<sup>16</sup>

### **5.2.6 Conclusion of potential PE exposure**

Accordingly, to the extent that a commission agent does not have the authority to conclude, or negotiate in substance all the elements of a contract that would bind a foreign parent (or connected party), then their activities (even if they are considered to be dependent agents of the foreign parent) should not give rise to a PE for the foreign parent in South Africa. In the event that the commission agent has and regularly does exercise the authority to bind the foreign parent this would lead to an exposure.

The expenses incurred in earning the income of the PE, including in certain cases head office allocation, may be taken into account in determining the profit to be attributed to the PE. The OECD Model Commentary states that the profits to be attributed to a PE are those which a PE would have made “if, instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market.” The OECD Model goes on to say that, “in the great majority of cases, trading accounts of the PE will be used by the taxation authorities concerned to ascertain the profit properly attributable to that PE”. The authorities will then adjust the

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<sup>16</sup> *Klaus Vogel* Klaus Vogel on Double Taxation Conventions Third Edition (1997) pg: 331

accounts if necessary to ensure that they comply with the arm's length principles and that they reflect the real economic functions and risks of the head office and its PE. The expenses incurred in earning the income of the PE, including in certain cases head office allocation, may be taken into account in determining the profit to be attributed to the PE.<sup>17</sup>

In the instance that a foreign company would wish to leave as little profit as possible in South Africa then an agent remuneration structure should be implemented. A caveat would be to ensure that the agent is remunerated on an arm's length basis to mitigate against the agent being characterised as a PE.

The SARS has indicated that it will apply transfer pricing principles based on the OECD guidelines.<sup>18</sup> In the case that the foreign parent is deemed to have a PE in South Africa then the foreign parent or connected party would be subject to a rate of tax applicable to that of a branch at 33%.

## 5.3 Exit charges

### 5.3.1 Background

Taxing authorities have assumed exit charges in the case of business restructurings within a multinational group as the "fair" or arm's length response to future earnings lost. Simply put, if a revenue stream dries up, it will almost automatically be assumed transferred and assumed that this transfer would have generated a buyout fee in an arm's length situation that ought to be taxed. In theory, one can certainly assume that if anything is being transferred cross-border which has value (i.e. generates a certain or highly likely revenue stream for a certain period of time) the transferor would only be willing to do so for good reason, and the receipt of a purchase price for the transfer of such "asset" would seem to be one possible good reason.

The (legal) basis for taxation used by the revenue authorities in situations like this is the arm's length standard: this standard requires an *analysis* whether *unrelated companies* doing business in a similar fashion and under similar conditions would have agreed to pay an exit charge.

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<sup>17</sup> Klaus Vogel Klaus Vogel on Double Taxation Conventions Third Edition (1997) pg: 436

<sup>18</sup> The OECD Report on the Attribution of Profits to Permanent Establishments (2006) pg: 12

### 5.3.2 The concept of an exit charge

In the instance of full risk distributors becoming stripped distributors or limited risk distributors become (or fully fledged manufacturers becoming contract manufacturers) with all risk and related rewards being allocated to strategically-located principal group entities, many tax authorities may feel cheated out of their “rightful” revenues base.

So in the instance of a South African business being restructured, local tax authorities, SARS, may argue that an arm’s-length compensation is payable to the restructured entity for any value transferred to a foreign-related party.

This statement is however contentious as a 2007 Australian Discussion Draft paper on Restructuring addressed the issue of business restructuring already in detail and acknowledged that, “*The arm’s length principle does not require that a converted or stripped entity receive compensation in every business restructuring situation*” but built on a “benefit” notion to determine whether compensation would be justified. This discussion seems to acknowledge that the restructuring can allocate benefits to the restructured (stripped) entity yet this is no reason for a prima facie entitlement to compensation.<sup>19</sup>

Globally this compensation is referred to as an exit charge. Unless otherwise indicated, the term exit charge is used to refer to both the aggregate compensation payable for any value transferred to related parties, and the value that may be associated with the unbundled components of anything transferred to related parties. An exit charge can be distinguished from payments to a related company for goods or services that a company provides. Where an exit charge is required, one or more foreign- related parties may need to make the payment (that is, exit charges usually imply acquisition payments by the other party to the transaction).

### 5.3.3 Examples of situations that may give rise to an exit charge

It is commonplace for business entities to restructure as the markets in which they operate change, as new technology renders production processes obsolete or too expensive or as business models become outdated and are replaced. MNEs are subject to the same commercial pressures and more. For example, MNEs restructure their various businesses for a variety of reasons, including:

- To rationalize business operations post-merger or acquisition;

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<sup>19</sup> Issued by the Australian Taxation office in May 2007

- To provide more centralized control and management of manufacturing, research and distribution activities;
- To provide increased operational efficiencies; and
- To reduce costs.

It is commonplace that an exit charge may be required when key intellectual property is transferred from the original location where it was developed and exploited to a centralized entrepreneurial entity. This commonly occurs when an MNE group decides to centralize the hitherto dispersed intellectual property in the form of product and process patents in a dedicated IP company. It is then likely that the (related) buyer should pay compensation to the (related) seller if the asset or business is valuable.<sup>20</sup>

However, tax authorities – especially in developed countries that have an active transfer-pricing audit programme – are increasingly expecting payments from a much broader range of corporate restructuring. Typical examples would include:

- The transformation of a full-function, full-risk distributor into a limited-risk distributor or commissionaire: to streamline operations and reduce costs, MNEs may transfer certain functions and risks from a (fully fledged) distribution company to a centralized distribution entity. The reduced function/risk entity may continue in business as a consignment distributor, sales agent or commissionaire; or the
- Conversion of a full-function, full-risk manufacturer into a limited-risk manufacturer: to streamline operations and reduce costs, MNEs may transfer certain functions and risks from a (fully fledged) manufacturing company to a centralized entrepreneurial entity with the reduced full-risk entity continuing as a limited risk or contract manufacturer.

The same question arises in all of the above examples: whether the entity that reduces its functions/risks or is being shut down is entitled to a payment for the business that has been transferred to the other entity.

### **5.3.4 South African tax implications attendant upon the disposal transaction**

#### **5.3.4.1 *The Law***

In the instance of a business restructuring a company that is a tax resident in South Africa would be subject to CGT on any net capital gain realised on the disposal of any

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<sup>20</sup> Monique van Herksen, Clive Jie-A-Joen and Marco Wallart, "Business Restructurings: the latest tax trap?", *Tax Planning International Transfer Pricing BNA* (2009) pg: 25

assets (refer paragraph 2(1)(a) of the Eighth Schedule to the Act). Accordingly the pertinent CGT provisions contained in the Eighth Schedule to the Act would find application on the disposal.

Paragraph 38 of the Eighth Schedule states that where a person disposes of an asset to a connected person for no consideration, or for a consideration which does not reflect an arm's length price, the person disposing of that asset must be treated as having disposed of that asset for an amount equal to the market value of that asset as at the date of that disposal.

CGT applies to the "disposal" of an "asset" on or after 1 October 2001. A capital gain on the disposal of an asset subsequent to 1 October 2001 arises when the proceeds from the sale of an asset are in excess of the base cost, whereas a capital loss will typically arise when the base cost exceeds the proceeds. The base cost of an asset disposed of after 1 October 2001 will depend on whether the asset was acquired before or on/after 1 October 2001.

Companies have to include 50% of the net capital gain realised by the company in its taxable income by virtue of the provisions of paragraph 10 of the Eighth Schedule to the Act read together with section 26A of the Act. Companies, with a statutory income tax rate of 28%, are thus subject to CGT at an effective tax rate of 14% (50% of capital gain x 28%) on any net capital gain realised during a particular year of assessment. Therefore, in terms of the Eighth Schedule to the Act, a capital gain or loss will be calculated with reference to the following formula:

$$\text{Proceeds} - \text{Base cost} = \text{Capital Gain} / (\text{Loss})$$

#### **5.3.4.2 Disposal of an asset**

A "disposal" is defined for CGT purposes in paragraph 11 of the Eighth Schedule to the Act to include, *inter alia*:

*"any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset and includes –*

*the sale, donation, expropriation, conversion, grant, cession, exchange or any other alienation or transfer of ownership of an asset; ..."*(Own emphasis added)

An "asset" is defined for CGT purposes in paragraph 1 of the Eighth Schedule to the Act to include –

“(a) *property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and*

(b) *a right or interest of whatever nature to or in such property;”*

In terms of the above definition it is be my contention that SARS would ground their views on CGT (exit charges) based on an analysis of the “rights” of the South African entity to preserve future profits without taking into account the options available to the counterparty to the transaction. These views, coupled with a willingness to assert contractual arrangements aligned with them, have led to inconsistent positions on the part of different tax authorities, which makes it difficult for taxpayers to comply with such conflicting expectations and which potentially subject taxpayers to double tax.

On the basis of the above definition, it is evident that the loss of an income-generating activity would constitute a “disposal” of an “asset”, as defined for CGT purposes. In order to calculate the capital gain or loss attendant upon this disposal, the base cost and proceeds in relation to the assets disposed of, need to be determined.

#### **5.3.4.3 Base cost of the function**

For purposes of completeness I will assume that the income-generating activity represents a “post valuation date asset” as the expenditure incurred in respect of these assets were all incurred subsequent to 1 October 2001.

The base cost of a post valuation date asset is generally limited to the amount of expenditure actually incurred by the taxpayer in acquiring or creating the asset. In this regard, paragraph 20 of the Eighth Schedule to the Act provides that the base cost of an asset acquired by a person is the sum of, *inter alia*:

- expenditure actually incurred in respect of the cost of acquisition or creation of that asset;
- expenditure actually incurred in respect of the valuation of the asset for purposes of determining a capital gain or capital loss in respect of the asset;
- expenditure directly related to the acquisition or disposal of the asset, including, *inter alia*:
  - remuneration of a surveyor, valuer, auctioneer, accountant, broker, agent, consultant or legal advisor in respect of services rendered;
  - transfer costs;

- stamp duty, transfer duty or similar duty; or
- the costs of advertising to find a seller or a buyer.

Accordingly, to the extent that the restructured has incurred any of the abovementioned expenditure, such expenditure may be included in the base cost of the asset.

#### **5.3.4.4 Proceeds**

Paragraph 35 of the Eighth Schedule to the Act determines what will qualify as “proceeds” for CGT purposes. Briefly, in terms of paragraph 35 of the Eighth Schedule to the Act, proceeds from the disposal of an asset include, *inter alia* –

“(1) ... *the amount received by or accrued to, or which is treated as having been received by, or accrued to or in favour of a person in respect of that disposal ...*”

Further, in terms of paragraph 35(3) of the Eighth Schedule to the Act, the proceeds from the disposal of an asset must be reduced, *inter alia*, by any amount of the proceeds that must be or was included in the gross income of that person or that must be or was taken into account when determining the taxable income of that person before the inclusion of any taxable capital gain.

## 5.4 Effective management

### 5.4.1 General principles

South Africa has adopted a residence basis of taxation, in terms of which residents are taxable on their worldwide income. According to section 1 of the Act the definition of a resident includes:

*“[Any] person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic ....”*

Therefore, in the absence of the application of a DTA, which may provide otherwise, a subsidiary incorporated and resident in South Africa, is subject to tax in South Africa on its worldwide income.

#### *Importance of “effective management”*

South Africa taxes residents on a world-wide basis and non-residents on income that is from a South African source or deemed source. Accordingly, it is important to ascertain whether a taxpayer is a resident for tax purposes or not.

For purposes of the Act, a “resident” is defined in section 1 of the Act to mean in the case of a person other than a natural person, a person which is incorporated, established, or formed in the Republic or which has its place of effective management in the Republic.

Thus, a company is considered to be a South African resident company for tax purposes if it is incorporated, established or formed in the Republic, or if it has its place of effective management in the Republic. If the principal in a commissionaire structure would be incorporated, established or formed outside of South Africa, it would only fall within the definition of “resident” for the purposes of the Act if it were to be effectively managed in South Africa.

#### *Place of “effective management”*

In the instance of the executive management team of the principal being based in South Africa where the critical management decisions and the day-to-day business activities are co-ordinated, a risk is raised the principal being effectively managed from South Africa.

There is no universal meaning of the term effective management. The term tends to differ somewhat depending upon the jurisdiction under review and source consulted. It is further evident that even internationally there are different interpretations, depending on whether the particular jurisdiction favours the continental or the non-continental interpretation.<sup>21</sup>

SARS has published its interpretation of the term in an interpretation note, Interpretation Note No. 6 (“Interpretation Note 6”), which tends to follow the non-continental interpretation. There are also the views of the OECD.

Notwithstanding the various views on this subject, it is my contention that the only manner in which the principal could obtain certainty about their residence status would be to satisfy both the international and SARS view of effective management.

Furthermore, satisfying both the international and SARS view of effective management should result in certainty in the event of any challenge by SARS. On that basis there should only be one place of effective management, thus the place where decisions are ultimately taken and implemented should correspond. It should also be borne in mind that determining where a company is effectively managed is an ongoing test and it is based on facts and evidence.

In this regard, the place of residence of the directors of the principal could be an important indication of the place where more important management decisions are taken and/or carried out as opposed to day-to-day administrative management. Therefore, international guidelines place the emphasis on the place where the “important” decisions of the company are taken, and not necessarily the place where such decisions are implemented.<sup>22</sup>

#### *Consequences of being effectively managed in South Africa*

The importance of ensuring that the effective management of the principal is outside of South Africa, crucial to ensuring successful implementation of the restructure. For this reason I highlight the most pertinent matters that may be affected by the place of effective management of principal, as follows:

- Firstly if principal is effectively managed in South Africa and there exists a DTA between South Africa and the foreign jurisdiction, the DTA may, in terms of a tie-breaker clause, grant South Africa the taxing rights. In addition, the principal would

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<sup>21</sup> Michael Honiball & Lynette Olivier International Tax, A South African Perspective (2008) pg: 65

<sup>22</sup> Michael Honiball & Lynette Olivier International Tax, A South African Perspective (2008) pg: 66-67

become subject to STC on any dividends that it declares, however it may qualify for the section 64B(5)(f) STC exemption, in certain instances;

- If the principal is effectively managed outside SA, it would be a CFC in relation to South African entity and its income will either be attributable to the South African entity or it will be exempt, depending on whether one of the exemptions will apply. It is only when one of the exemptions apply that the tax benefits of effectively managing the company in a tax friendly foreign jurisdiction, will materialise;
- The dividend streams from the African subsidiaries would, however, be exempt from income tax in terms of section 10(1)(k)(ii)(dd) of the Act, (if the required 20%+ equity shareholding by the recipient company is in place at the time of declaration of the dividend) irrespective of where the principal is effectively managed;
- It is essential have assumed that a valid FBE be established, which will enable the principal to be excluded from South Africa's CFC rules (subject to certain restrictions). If this is not the case, a full attribution of the net income of the principal would need to be made in the hands of commissionaire, thus eliminating many of the tax advantages of setting up such a structure from a tax advantageous position (in other words, the income of the principal will also be taxed in South Africa); and
- in the instance that the principal receives passive income (such as royalties and interest income) in excess of 10% of the income attributable to the principal, then even though a valid BE may be found to exist in the relevant offshore jurisdiction, section 9D (9) (b) (iii) of the Act will regard passive income not to be excluded as FBE income to the extent that such income exceeds 10% of the *total income and capital gains* of the principal

In this regard, to the extent that such passive income exceeds 10% of the total income or capital gains of the principal, that amount will not be excluded as BE income and will thus have to be attributed in the hands of South African entity and subject to South African tax.

The above assumption will not be applicable if offshore foreign subsidiaries will be able to access their local respective financial markets for funding of their local operations (thus not having a need to have funding advanced to the principal by the South African entity i.e. the commissionaire), if no significant dividend flows will be paid to the principal (by entities in which shareholdings of not less than 20% are held), in the instance that no royalties will be paid to the principal (provided that it would not hold any of the intellectual property developed by the MNE in South Africa) and finally if the principal will largely

receive significant management fees from its offshore investments. Furthermore the following must be considered;

- However, even if the principal does not qualify under the FBE exclusion contained in section 9D(9)(b) of the Act, dividend income received should not be included in the net income of the CFC, if any, and therefore not attributed to the South African resident if the CFC holds 20% or more of the equity shares in the company paying the dividend;
- Section 9D (9) (f) of the Act states that section 9D does not apply to any portion of the net income of a CFC to the extent that it is attributable to any foreign dividend declared or deemed to be declared to the CFC by any other company from income which has been or will be included in the income of the resident in terms of section 9D. This exclusion prevents double taxation of the same income;
- To the extent that South African entity will be required to attribute an amount equal to the net income of the CFC in its income, the South African entity will be able to rely on the provisions of section 6quat of the Act, which could minimise the incidence of double taxation. Section 6quat, *inter alia*, allows a South African resident to claim a rebate against its South African income tax liability in respect of foreign taxes paid on amounts included in terms of section 9D of the Act.

#### **5.4.2 Practical guidelines to minimise exposure**

The place of effective management of the principal would be determined based on each entity's specific activities and is likely to be the place where key management and commercial decisions necessary for the conduct of the business activities are made as well as the place where these decisions are implemented.

Each company should therefore take into account the factors/steps below to give weight in evidencing that it is effectively managed offshore:

##### *Legalistic implementation*

- A definitive decision should be taken as to where the subsidiary is to be effectively managed and this decision should be recorded in writing and could be evidenced in the following manner:
- the Articles of Association should preferably state that the foreign company is engaged in conducting its main business in that relevant overseas country and what the role of directors is in this regard; and

- The Articles of Association should state that the directors wish to establish meetings of the *board of directors / executive committee* as the forum through which the company is effectively managed.
- The place of effective management being overseas should be obvious at all times. In this regard, the directors' resolutions should be drafted, signed and kept overseas. The minutes of the board meetings/executive committee should reflect that these meetings occur overseas and the details contained in the minutes of such meetings should assist in illustrating that strategic management decisions are actually taken at such meetings and not merely ratified there.
- A majority of non-South Africans should be appointed to the board of directors. However, it is important that they are skilled directors who are empowered to take and implement important business decisions overseas (i.e. they should have real authority and be actively and sufficiently involved in the business transactions and affairs of such companies so as to be in a position to make the important business decisions for such companies).
- The directors resident in South Africa should have split roles for services rendered for overseas subsidiaries. These could be achieved through the appointment of these individuals as directors or through the use of dual employment contracts. In instances where South African resident employees of parent companies perform low level back office functions on behalf of foreign companies, such services should be performed under a separate service level agreement signed with the specific company.
- The key is ensuring that when outside of the country of incorporation of the foreign subsidiary, these individuals do not act in terms of their foreign appointments by such company. For example, a foreign employee should not perform work on behalf of these latter entities while in South Africa, unless such work is in terms of an agreed service level agreement and relates to low-level activities.

#### *Practical implementation*

- All board meetings should be held outside of South Africa (preferably where the subsidiary is incorporated). It is important that the directors resident in South Africa actually travel to attend the meeting. In this regard, the individual passports of the directors resident in South Africa and the minutes of the board meeting/ executive committee meetings should attest to the number of visits made overseas for the meetings.

- The passing of resolutions in writing signed by all the directors (e.g. by way of round robin) or by holding meetings via teleconference or video conference is not recommended, as it would water down an argument of effective management being located in a specific location.
- It is important that strategic and key decisions are made at these board meetings which should not be convened merely to rubber-stamp the decisions that have already been made. The content of the minutes of the board meetings should reflect that there was active participation and deliberations by all the directors (both by the South Africans and non-South Africans) before the decisions were taken as opposed to merely ratifying them in the country of incorporation. Such strategic and key decisions should then be implemented overseas, preferably by an employee of the company.
- The board members should be actively involved in the running of the company. They should not be “men of straw” who merely “rubber stamp” the decision of the shareholder. It is therefore important that the board members have the necessary skill and ability to run the company;
- Where the authority of the board of directors of the overseas subsidiaries has been delegated to the executive committee, the place where the executive committee of such subsidiary convenes to make decisions on important business affairs should be overseas. In this regard, it is important that the meeting of such committee takes place with sufficient regularity to enable effective management of the business and written records should be kept. We note, however, that the delegation to the executive committee is in many instances only necessary in limited circumstance, for example, where the subsidiary does not have any employees.
- All the decisions taken by the directors of the overseas subsidiaries or executive committee should be implemented overseas, preferably in the country of incorporation. Practically, it is advisable to appoint a senior executive/director who is resident or will reside overseas to attend to the implementation of all the decisions taken by the board or executive committee while overseas. This senior executive should preferably form part of the executive committee (should it be necessary to put one in place). It is also important that the senior executive is not a “man of straw” and is therefore not also a director of numerous other group companies.
- Where possible, the place of residence of the executive committee members/directors of the overseas subsidiaries should be located outside South Africa;

- The shareholders should, where possible, during their annual general meetings make key decisions relating to the overseas subsidiaries outside of South Africa. The shareholder should not assume the overall management of the subsidiary, rather this should be left to the board of directors of the subsidiaries.

It must be reiterated that the test relating to effective management is an ongoing test. Care must therefore be taken on a regular basis to determine where the effective management of the principal.

### **Conclusion**

*The place of effective management of the principal would typically be determined with reference to the place where the “real” board of directors or executive management (as opposed to appointed “straw men”) actually make/take decisions on important business affairs of the company as opposed to the place where they are formally resolved (“rubber stamped”).*

## **6 Conclusion**

### **6.1 Summary of findings in respect of the research problem**

#### **6.1.1 Transfer pricing issues pertaining to restructures**

Business restructurings involve the reallocation of functions, assets, and/or risks with associated profit/loss potential between connected parties. Restructurings can also involve the termination or substantial renegotiation of existing arrangements. There are important questions about the application of the arm's length principle and the OECD Guidelines to the restructuring itself, in particular the circumstances in which at arm's length the restructured entity would receive compensation for the transfer of functions, assets and/or risks, and/or an indemnification for the termination or substantial renegotiation of the existing arrangements.

#### **6.1.2 Income tax issues pertaining to restructures**

##### *Permanent establishment*

Non-residents are subject to tax in South Africa only in respect of income derived from an actual or deemed source in South Africa. Therefore, whether a non-resident is liable for tax in South Africa will depend on whether income of a South African source or deemed source has been received by or accrued to the non-resident.

South Africa will seek to impose tax under its domestic legislation on interest and capital gains on a non-resident. It is further of importance where that non-resident is tax resident in a DTA country. In such circumstances the concept of a permanent establishment determines which jurisdiction has taxing rights in respect of any income derived by the non-resident from a South African source

The PE argument typically is not directly motivated by the amount of the transfer-pricing remuneration. In general, this point is raised when the agent is not considered independent from its principal, for example under circumstances where the agent only has one principal and/or when its remuneration is guaranteed. The agent issue is that the steps taken to make the agent a relatively risk-free entity entitled to only a limited return may increase the risk of being treated as a PE, while steps taken to reduce the risk of being treated as a PE may increase transfer-pricing exposure. In this instance a foreign company may consider establishing a remuneration system based on a sales-based commission to mitigate the risk of the characterisation of an agent as a PE. However,

setting a commission driven off of sales may lead to unusual profit results (including the possibility of an operating loss) that may lead to serious transfer-pricing issues.

#### *Exit charges*

The application of exit charges (or CGT in the case of South African tax) or some form of buy-out compensation may be automatically demanded by SARS in case of business restructuring citing authority to do so under the OECD TP Restructures document. However, this determination warrants ample consideration as to whether the application is to be consistent with the arm's length principle as outlined in section 31 of the Act.

#### *Effective management*

To facilitate a successful restructuring, in this case a commissionaire distribution structure, that may be set up with the principal in a foreign jurisdiction and must be effectively managed from that jurisdiction. It is of the utmost importance to ensure that "effective management" of the principal is retained offshore to maintain the benefits of such a distribution structure to prevent the principal being deemed to be a South African tax resident.

## **6.2 Potential areas of future research**

Changes in supply chain structure have important implications for VAT and Customs. By way of example the "standard" treatment of taxing imports and zero rating of exports would be difficult to apply to the more complicated distribution arrangements which have been developed as part of business restructuring.

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