ADDESSING BASE EROSION AND PROFIT SHIFTING IN SOUTH AFRICA
DAVIS TAX COMMITTEE INTERIM REPORT

ACTION 8: ASSURE TRANSFER PRICING OUTCOMES ARE IN LINE WITH VALUE CREATION WITH REGARD TO INTANGIBLES

1 GENERAL ON TRANSFER PRICING

The term "transfer pricing" describes the process by which related entities set prices at which they transfer goods or services between each other.[1] When multinational companies operate in different countries, where they are subject to different laws,[2] they may resort to fictitious transfer pricing whereby they manipulate profits so that they appear lower in a country with higher tax rates and yet higher in a country with lower tax rates.[3] The OECD recommends the use of the arm's length principle in curbing transfer pricing. Paragraph 1 of Article 9 of the OECD MTC provides that when conditions are made or imposed between two associated enterprises in their commercial or financial relations which differ from those which would have been 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.

Action Plan 8 of the 2013 OECD Report on Base Erosion and Profit Shifting (BEPS)[4] notes that although, in many instances, the existing transfer pricing rules, based on the arm's length principle, effectively and efficiently allocate the income of multinationals among taxing jurisdictions, in other instances multinationals have been able to use and/or misapply those rules to separate income from the economic activities that produce income and to shift it into low-tax environments. This most often results from:

- transfers of intangibles and other mobile assets for less than full value;
- the over-capitalisation of lowly taxed group companies, and;
- contractual allocations of risk to low-tax environments in transactions that would be unlikely to occur between unrelated parties.

It should be noted that the OECD BEPS Action Plan rejects a radical switch to a formulary apportionment system in resolving these transfer pricing problems. Rather, it advocates building on the existing separate entity approach in terms of the arm's length principle.

---

1 South African Revenue Services Practice Note No. 7 'Section 31 of the Income Tax Act, 1962: *Determination of Taxable Income of Certain Persons from International Taxation: Transfer Pricing* (6 Aug 1999) in par 2.1.

2 BJ Arnold & MJ McIntyre *International Tax Primer* (2002) at 54; JE Bischel, R Feinschreiber *Fundamentals of International Taxation* 2nd ed (1985) at 27.

3 A Ginsberg *International Tax Havens* 2nd ed (1997) at 20.

4 OECD *Action Plan on Base Erosion and Profit Shifting* (2013) at 20.

2 TRANSFER PRICING OF INTANGIBLES

With regard to transfer pricing of intangibles, it is worth noting that the current tax regimes were developed in economies largely concerned with the exchange of physical products made and sold in physical locations. Trends in the international tax environment such as globalisation of business, increased tax competition among countries for tax revenues, and a growing proportion of company assets that are made up of intangible assets or intellectual property (IP) such as: patent, brand names, trademarks, copyrights and know how; have transformed the tax landscape.[5] IP is often a key component of any group-wide restructuring within a multi-national enterprise (MNE) in order to achieve overall tax savings. Such exercises are sometimes referred to as supply chain optimisation exercises. In the context of BEPS, IP is particularly relevant because of the overall significance of IP in the transfer pricing context. This is demonstrated by cases such as the Canadian case of *Canada v GlaxoSmithKline Inc,*[6] and the Australian case of *Commissioner of Taxation v SNF (Australia) Pty Ltd.*[7]

Profit shifting which involves the use of IP has two important characteristics: Firstly, it is a driver of value creation in multinational firms. Secondly, because IP is highly mobile, it plays an important role in international profit shifting. It is no surprise that most of the companies currently accused of avoiding taxes have IP intensive business models[8] involved in intra-company allocation of IP.[9] This is because cross-border transfer of IP often attracts high taxes. Furthermore, the deductions that various countries allow in respect of expenditure on research and development (R&D) or on the acquisition of IP may differ greatly.[10]

In order to avoid such high taxes, taxpayers often take advantage of the fact that IP is intangible in nature and it can be easily moved from country to country through the use of planned licensing structures.[11] A taxpayer can, for instance, establish a licensing and patent holding company suitably located offshore to acquire, exploit, license or sublicense IP rights for its foreign subsidiaries in other countries.[12] Profits can then be effectively shifted from the foreign subsidiary to the offshore patent

---

5 PWC "Paying Taxes: The Global Picture" (2014) at 19.

6 2012 SCC.

7 [2011] FCAFC 74

8 C Fuest, C Spengel, K Finke; JH Heckemeyer; H Nusser "Discussion Paper No. 13-078 on "Profit shifting and 'aggressive' tax planning by multinational firms: Issues and options for reform" (2013) at 1.

9 M Dischinger & N Riedel "Corporate taxes and the location of intangible assets within multinational firms" (2011) *Journal of Public Economics* at 691-707.

10 E Tomsett "Treaty Shopping and Debt/equity Ratios in the United Kingdom" *Bulletin for international Fiscal Documentation* (March 1990) at 43.

11 WH Diamond & DB Diamond *Tax Havens of the World* at INTRO /2.

12 P Roper & J Ware *Offshore Pitfalls* (2000) at 9; L Olivier & M Honiball *International Tax: A South African Perspective* (2011) at 557.

owning company which may end up paying little or no tax on the royalties received.[13] Fees derived by the licensing and patent holding company from the exploitation of the intellectual property will be either exempt from tax or subject to a low tax rate in the tax-haven jurisdiction.[14] Licensing and patent holding companies can also be used to avoid high withholding taxes that are usually charged on royalties flowing from the country in which they are derived.[15] In most cases, high withholding taxes can be reduced when countries enter into double taxation treaties.[16] In order to benefit from the reduced withholding taxes that treaty countries enjoy, a royalty conduit company can be established in a low-tax jurisdiction. The royalty conduit company can then be used to own licence rights which it sublicenses to a second licensing company that is located in a territory with a favourable network of double-taxation treaties. The second licensing company will usually be responsible for the exploitation of the licensing rights from which it would earn only a small margin on the royalties (which would be subject to local corporate income tax) and the balance would be paid to the ultimate licensor. Setting up a royalty conduit company in one of the treaty countries can result in income being shifted from those countries by taking advantage of the tax concessions the treaty offers.[17] The Netherlands is an example of a country which has been utilised for establishing sublicensing companies with the aid of such structures.[18] Large international firms with extensive intra-firm trade and high R&D generally make use of tax havens to avoid taxes.[19]

Figure 6 below illustrates how the patent rights of R&D activities produced at the Headquarters of the multi-national enterprise (the figure uses California as an example) are owned by the empty shell company (Ireland is used as an example in the figure). The figure shows that the subsidiaries of the multi-national enterprise pay a fee for the use of the patents. Aggressive tax planning then takes two forms: firstly, profit shifting from California to Ireland and secondly, base erosion in the subsidiaries (when the fee paid is excessive compared to the value of the patent).

---

13 A Rappako *Base Company Taxation* (1989) at 194; C Doggart "Tax Havens and Their Uses" *The Economist Publication* (1990) Special Report No 1191 at 36-37.

14 B Arnold *The Taxation of Foreign Controlled Corporations: An International Comparison* (1986) at 121.

15 B Spitz & G Clarke *Offshore Service* (March 2002) Issue 66 at LEX/26.

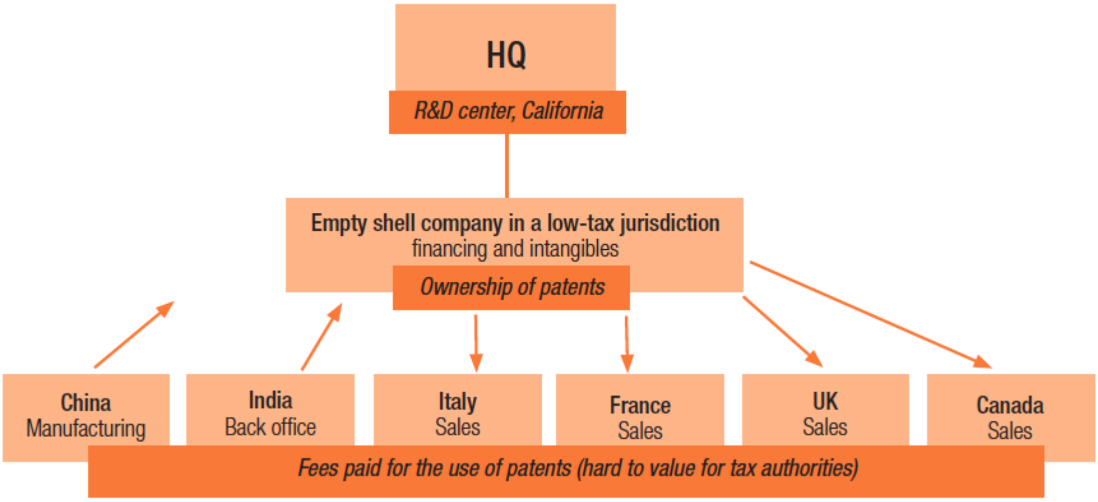
16 Tomsett at 48-49.

17 Spitz & Clarke at 94.

18 Ginsberg at 50; Doggart at 36-37; Tomsett at 48-49.

19 MA Desai, CF Foley, JR Hines "The demand for tax haven operations" (2006) *Journal of Public Economics* at 513-531.

FIGURE 6: INTANGIBLES



3 PROMINENT SCHEMES FOR IP PROFIT SHIFTING

Although multinationals do not all use exactly the same techniques for shifting income via licensing, the strategies they apply follow similar patterns. The following discussion presents two prominent IP-based tax planning strategies and identifies the central flaws and loopholes in national and international tax law rendering these tax avoidance strategies possible. [20]

3.1 The “Double Irish Dutch Sandwich”

A prominent IP tax planning scheme which Google (based in the USA) and other e-commerce businesses have been using to reduce their tax liability is the “Double Irish Dutch Sandwich” scheme. As its name implies, the “Double Irish Dutch Sandwich” involves two companies incorporated in Ireland; the one an IP-Holding and the other an Operating Company. Then one other Conduit Company incorporated in the Netherlands.[21] In this structure the IP-Holding Company (using the USA as a typical example) is a direct subsidiary of a USA Parent Company and the single owner of the Irish Operating Company and the Dutch Conduit Company. The IP-Holding Company would usually be managed and controlled in a low tax jurisdiction such as Bermuda and would therefore considered resident in Bermuda for Irish tax purposes. The US, on the contrary, treats the company as an Irish

20 C Fuest, Clemens; Spengel, Christoph; Finke, Katharina; Heckemeyer, Jost H.; Nusser, Hannah, Discussion Paper No. 13-078 on “Profit shifting and 'aggressive' tax planning by multinational firms: Issues and options for reform” (2013) at 3.

21 ED Kleinbard “Stateless Income” (2011) *Florida Tax Review* at 707-714; J Sandell “The Double Irish and the Dutch Sandwich: How Some U.S. Companies Are Flummoxing the Tax Code” (2012) *Tax Notes International* at 867-878.

corporation because tax residency is based on jurisdiction of incorporation according to US tax law. [22] The tax consequences of this structure are as follows:

(a) This structure often results in low tax payment on the initial IP transfer:

To achieve this result, the US Parent Company first has to transfer the rights to use its IP outside the US to the IP-Holding Company. As transferring the full-fledged intangible would trigger taxation of hidden reserves and future income generated by the intangible according to the US super royalty rule, the IP-Holding Company typically makes a buy-in payment and concludes a cost-sharing agreement on the future modification and enhancement of the IP with the US Parent Company. Consequently, the IP-Holding owns the non-US IP rights developed under the cost-sharing agreement and therefore no periodic licence payments have to be made to the US Parent Company. Determining the arm´s length price for the buy-in payment is usually very difficult as the intangible is only partially developed at the time of transfer and risk is associated with future earnings. Hence, multinationals have considerable leeway in determining the price and are often able to avoid high exit taxes. [23]

(b) The structure results in almost no taxation in the country of final consumption:

The Irish Operating Company exploits the IP and usually earns high revenues. In Google´s case the Operating Company provides advertising services and acts as the contractual partner of all non-US customers. Hence, no physical presence is created in the country of final consumption and the profits cannot be taxed there. Functions in the customers' residence states like the delivery of products or marketing activities are usually assigned to low-risk group companies. These group service providers work on a cost-plus basis, keeping the tax base in the country of final consumption low. [24]

(c) The structure allows reduced tax on high royalty payments at the level of the Operating Company:

Basically, the profits from customer sales earned by the Operating Company are subject to tax in Ireland. However, the tax base of the Operating Company is close to zero because it pays high tax-deductible royalties for the use of the IP held by the IP-Holding Company. As Ireland has only recently introduced transfer pricing rules and these rules do not apply to contracts and terms agreed on before July 2010, most companies using the "Double Irish Dutch Sandwich" are able to erode the tax base in Ireland by paying very high royalty payments. [25]

(d) Interposition of Dutch Conduit Company results in no withholding taxes on royalties leaving the European Union:

This is achieved because; the royalties are not paid directly to the IP-Holding Company but are passed through a Conduit Company in the Netherlands, which sublicenses the IP. The Dutch Conduit Company does not perform any economic activity. It is interposed because the IP-Holding Company is a Bermuda resident for

---

22 Fuest et al at 4.

23 Fuest *et al* at 5.

24 Ibid.

25 Fuest *et al* at 6.

Irish tax purposes and Ireland levies withholding tax on royalty payments to Bermuda. By channelling the royalties through the Dutch Conduit Company, withholding taxes can be completely circumvented as royalties paid from Ireland to the Netherlands are tax-free under the EU Interest and Royalties Directive and the Netherlands does not impose withholding tax on any royalty payments, irrespective of the residence state of the receiving company. The tax liability of the Conduit Company in the Netherlands consists only of a small fee payable for the use of the Dutch tax system. [26]

(e) IP-Holding Company is not taxed in Ireland and in Bermuda:

The IP-Holding Company is neither subject to tax in Ireland nor in Bermuda since Ireland considers the company a non-resident and Bermuda does not impose income tax on corporations. Hence, the profits earned in the European Union leave the European Union virtually untaxed. [27]

(f) US CFC rules are circumvented:

The United States also does not tax the non-US income as long as it is not redistributed as dividends or qualified as Subpart F income. To avoid the latter, the Irish Operating Company and the Dutch Conduit Company file a check-the-box election with the consequence that both Irish subsidiaries and the Dutch Conduit Company are treated as one single Irish corporation and their incomes are combined for US tax purposes. The royalty payments between the companies thus are disregarded and only revenues from transactions with customers, which due to exceptions included in the Subpart F provisions typically do not constitute Subpart F income, are considered from a US perspective. [28]

3.2 The IP-Holding Structure Using an IP Box Regime

Another example of how IP-Holdings can be used to minimise taxes is the possibility to transfer the IP to an IP-Holding Company resident in a European country that offers a special IP Box Regime, like for example Luxembourg, Belgium or the United Kingdom. The Operating Company can generally be resident in any EU Member State. However, locating it in a country that does not strictly apply the arm´s length principle facilitates increasing the amount of profits shifted. As in the case of the "Double Irish Dutch Sandwich", the structure requires that no CFC rules in the residence country of the Parent Company apply and that the IP can be transferred without triggering high exit taxes.[29] The following are the tax consequences of the IP-Holding structure

(a) Avoidance of withholding tax on royalties due to the EU Interest and Royalties Directive:

[26] Ibid.
[27] Ibid.
[28] Ibid.
[29] Fuest *et al* at 7.

The Operating Company pays royalties directly to the IP-Holding Company. No conduit company needs to be interposed to avoid withholding tax as the IP-Holding Company is located in an EU Member State and therefore the Interest and Royalties Directive applies. [30]

(b) Low taxation of the royalties at the level of the IP-Holding Company:

The royalties are not completely untaxed at the level of the IP-Holding Company. However, as IP Box Regimes either exempt a large share of royalty income from taxation or offer reduced tax rates for such income, the tax liability of the IP-Holding Company is very low. [31]

The tax planning structures described above reveal substantial flaws in the existing national and international tax systems that result in a waiver of residence taxation due to:

- no or ineffective CFC rules;
- a conflicting definition of tax residence in different countries;
- low general tax rates, and;
- special tax regimes such as IP Boxes.

The structures result in no or little source taxation due to:

- the non-existence of withholding taxes on royalties both within the European Union and with respect to third countries;
- difficulties in the valuation of IP and relating royalty payments, and;
- the absence of the taxable presence of multinationals doing business via the internet in customers' residence countries. [32]

4 OECD WORK ON TRANSFER PRICING OF INTANGIBLES

Transfer pricing issues pertaining to intangibles have long been identified by the OECD as a key area of concern to governments and taxpayers, due to insufficient international guidance, in particular on the definition, identification and valuation of intangibles for transfer pricing purposes. [33] Transfer pricing of intangibles is particularly challenging for the OECD's "preferred" transaction pricing method based on the arm's length principle. Since intangibles are unique in nature, and hence in value, there is no market benchmark against which to conduct an objective comparability analysis. That is why the OECD Transfer Pricing Guidelines for Multinational Enterprises, revised in 2010, allow for the tax treatment of intangibles to depart from the market-based arm's length principle and to use the "profit split method". The profit split method measures the combined profits of the two multinational enterprises entities involved in the transfer and then split the profits between the two based on allocation keys – sales, staff and investment.

[30] Fuest *et al* at 8.
[31] Ibid.
[32] Ibid.
[33] OECD "Revised Discussion Draft on Transfer Pricing Aspects of Intangibles" (30 July 2013) in para 35.

4.1 OECD 2013 BEPS REPORT: RECOMMENDATIONS ON TRANSFER PRICING OF INTANGIBLES

The 2013 the OECD BEPS Report[34] recommends that countries should develop rules to prevent BEPS that result from moving intangibles among MNE group members by:

- adopting a broad and clearly delineated definition of intangibles;
- ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation;
- developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and
- updating the guidance on cost contribution arrangements.

Pre-dating the 2013 OECD BEPS report, on 6 June 2012 the OECD published a "Discussion Draft on Transfer Pricing Aspects of Intangibles".[35] This was followed on 19 July 2013 by the "Revised Discussion Draft on the Transfer Pricing Aspects of Intangibles"[36] which culminated in the September 2014 Report on Transfer Pricing Aspects of Intangibles"[37] which provides guidance on determining arm's length conditions for transactions that involve the use or transfer of intangibles.

4.2 THE SEPTEMBER 2014 OECD REPORT ON TRANSFER PRICING OF INTANGIBLES

The OECD September 2014 report in the transfer pricing of intangibles refers to the to the final revisions to Chapters I, II and VI of the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) which have been developed in connection with Action 8 of the OECD 2013 *Action Plan on Base Erosion and Profit Shifting*. The changes to the Transfer Pricing Guidelines as discussed below:

- clarify the definition of intangibles;
- provide guidance on identifying transactions involving intangibles,
- provide supplemental guidance for determining arm's length conditions for transactions involving intangibles;
- final modifications to the guidance on the transfer pricing treatment of local market features and corporate synergies.[38]

4.2.1 Transfer pricing guidelines for intangibles

[34] OECD *Action Plan on Base Erosion and Profit Shifting* (2013) at 20.
[35] Ibid.
[36] Ibid.
[37] OECD/G20 Base Erosion and Profit Shifting Project Guidelines on Transfer Pricing Aspects of Intangibles Action 8: 2014 Deliverable (2014) (OECD/G20 2014 Report on Action 8)
[38] OECD/G20 2014 Report on Action 8 at 9.

Chapter VI of the 2010 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations has been revised to provide guidance specially tailored to determining arm's length conditions for transactions that involve the use or transfer of intangibles. In the Guidelines, the OECD notes that Article 9 of the OECD Model Tax Convention is concerned with the conditions of transactions between associated enterprises, not with assigning particular labels to such transactions. Consequently, the key consideration when a transaction conveys economic value from one associated enterprise to another, is whether that benefit derives from tangible property, intangibles, services or other items or activities.[39]

The OECD notes that as is the case with other transfer pricing matters, the analysis of cases involving the use or transfer of intangibles should begin with a thorough comparability analysis, including a functional analysis. That functional analysis should identify the functions performed, assets used, and risks assumed by each relevant member of the MNE group.[40] In cases involving the use or transfer of intangibles, it is especially important to ground the comparability and functional analysis on an understanding of the MNE's global business and the manner in which intangibles are used by the MNE to add or create value across the entire supply chain. The OECD recommends that in order to determine arm's length conditions for the use or transfer of intangibles it is important to consider as part of the comparability and functional analysis:

(i) the identification of specific intangibles;
(ii) the legal ownership of intangibles;
(iii) the contributions of MNE group members to their development, enhancement, maintenance, protection and exploitation; and
(iv) the nature of the controlled transactions involving intangibles including the manner in which such transactions contribute to the creation of value.[41]

On that foundation, it is then necessary to consider the remuneration that would be paid between independent parties in transactions involving intangibles.

4.2.2 Identifying intangibles

The OECD notes that difficulties can arise in a transfer pricing analysis as a result of definitions of the term intangible that are either too narrow or too broad. If an overly narrow definition of the term intangible is applied, either taxpayers or governments may argue that certain items fall outside the definition and may therefore be transferred or used without separate compensation, even though such use or transfer would give rise to compensation in transactions between independent enterprises. If too broad a definition is applied, either taxpayers or governments may argue that the use or transfer of an item in transactions between associated

39 OECD/G20 2014 Report on Action 8 at 27.
40 OECD/G20 2014 Report on Action 8 at 28.
41 Ibid.

enterprises should require compensation in circumstances where no such compensation would be provided in transactions between independent enterprises.[42]

In the Transfer Pricing Guidelines, the word "intangible" is intended to address:

- something which is not a physical asset or a financial asset,
- which is capable of being owned or controlled for use in commercial activities,
- whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.[43]

For an item to considered an intangible:

- it need not be an intangible for accounting purposes;
- it need not be an intangible for general tax or treaty withholding tax purposes;
- it need not be legally protected (e.g. goodwill is not protected in some countries); and
- it need not be separately transferable (e.g. goodwill does not move separately).[44]

In a transfer pricing analysis of a matter involving intangibles, it is important to identify the relevant intangibles with specificity. The functional analysis should identify the relevant intangibles at issue, the manner in which they contribute to the creation of value in the transactions under review, and the manner in which they interact with other intangibles, with tangible assets and with business operations to create value. A thorough functional analysis, including an analysis of the importance of identified relevant intangibles in the MNE's global business, should support the determination of arm's length conditions.[45]

4.2.3 Categories of intangibles

The OECD gives the following examples of items often considered as intangibles. These examples are not intended to be comprehensive or to provide a complete listing of items that may constitute intangibles.

(a) Patents

- A patent is a legal instrument that grants an exclusive right to its owner to use a given invention for a limited period of time within a specific geography. A patent may relate to a physical object or to a process.[46]

(b) Know-how and trade secrets

- Know-how and trade secrets are proprietary information or knowledge that assist or improve a commercial activity. They generally consist of undisclosed information of an industrial, commercial or scientific nature arising from previous experience, which has practical application in the operation of an

42 OECD/G20 2014 Report on Action 8 at 28.
43 OECD/G20 2014 Report on Action 8 at 28-29.
44 OECD/G20 2014 Report on Action 8 at 29.
45 OECD/G20 2014 Report on Action 8 at 30.
46 OECD/G20 2014 Report on Action 8 at 33.

enterprise. Know-how and trade secrets may relate to manufacturing, marketing, research and development, or any other commercial activity.[47]

(c) Trademarks, trade names and brands

- A trademark is a unique name, symbol, logo or picture that the owner may use to distinguish its products and services from those of other entities. The registered owner of a trademark may exclude others from using the trademark in a manner that would create confusion in the marketplace.
- A trade name (often but not always the name of an enterprise) may have the same force of market penetration as a trademark and may indeed be registered in some specific form as a trademark.
- The term "brand" is sometimes used interchangeably with the terms "trademark" and "trade name." In other contexts a brand is thought of as a trademark or trade name imbued with social and commercial significance.[48]

(d) Rights under contracts and government licences

- Government licences and concessions may be important to a particular business and can cover a wide range of business relationships. They may include, among others, a government grant of rights to exploit specific natural resources or public goods (*e.g.* a licence of bandwidth spectrum), or to carry on a specific business activity. However, government licences and concessions should be distinguished from company registration obligations that are preconditions for doing business in a particular jurisdiction.
- Rights under contracts may also be important to a particular business and can cover a wide range of business relationships. They may include, among others, contracts with suppliers and key customers, and agreements to make available the services of one or more employees.[49]

(e) Licences and similar limited rights in intangibles

- Limited rights in intangibles are commonly transferred by means of a licence or other similar contractual arrangement, whether written, oral or implied. Such licensed rights may be limited as to field of use, term of use, geography or in other ways.[50]

(f) Goodwill and ongoing concern value

- Depending on the context, the term goodwill can be used to refer to a number of different concepts. In some accounting and business valuation contexts, goodwill reflects the difference between the aggregate value of an operating business and the sum of the values of all separately identifiable tangible and intangible assets. Alternatively, goodwill is sometimes described as a representation of the future economic benefits associated with business assets that are not individually identified and separately recognised. In still other contexts goodwill is referred to as the expectation of future trade from existing customers.

---

[47] OECD/G20 2014 Report on Action 8 at 33.
[48] OECD/G20 2014 Report on Action 8 at 34.
[49] OECD/G20 2014 Report on Action 8 at 34-35.
[50] OECD/G20 2014 Report on Action 8 at 35.

- The term ongoing concern value is sometimes referred to as the value of the assembled assets of an operating business over and above the sum of the separate values of the individual assets. It is generally recognised that goodwill and ongoing concern value cannot be segregated or transferred separately from other business assets.[51]

4.2.4 Allocating the return attributable to an intangible

The OECD's views with respect to the allocation of the return attributable to an intangible are still in the interim drafts and are not yet fully agreed upon by the countries involved. The OECD hopes these will be finalised in 2015 in connection with other related BEPS work.[52] The OECD interim draft guidance in this regard notes that: Both taxpayers and tax authorities have struggled with the question of how to correctly allocate the return "attributable to an intangible". The OECD provides that legal ownership is the starting point of the analysis, but legal ownership alone does not convey a right to ultimately retain all the income attributable to intangibles. Although the legal owner of an intangible may initially be entitled to receive the proceeds from exploitation or transfer of the intangible, other members of the MNE group may have performed functions, contributed assets or assumed risks that contribute to the value of the intangible, for which they must be compensated under the arm's length principle by allocating to them their part of the return attributable to the intangible. The compensation can constitute all or a large share of the returns attributable to intangibles.[53]

The guidance above reflects a shift away from the concept of legal ownership of intangibles toward a more functional approach that concentrates on which entity develops, enhances, maintains and protects the intangibles. The entity may have those functions performed by independent or associated enterprises, provided it controls the functions. But an entity that simply funds the acquisition or development of intangibles should only be entitled to a risk-adjusted rate of anticipated return on its invested capital.[54]

4.2.5 Distinguishing intangibles from location savings and other local market features

The OECD further explains that an intangible has to be distinguished from market conditions or other circumstances that are not capable of being owned or controlled by a single enterprise. For example location savings and other local market features.

---

51 OECD/G20 2014 Report on Action 8 at 35.

52 OECD/G20 Base Erosion and Profits Shifting Project: Guidance on Transfer pricing Aspects of Intangibles – Action 8: 2014 Deliverable" (2014) at 10.

53 OECD "Revised Discussion Draft on Transfer Pricing Aspects of Intangibles" in para 65.

54 A Cinnamon "How the BEPS Action Plan Could Affect Existing Group Structures" *Tax Analyst* 12 November 2013.

These market conditions are comparability factors which may affect the determination of an arm's length price for a particular transaction and should be taken into account in a comparability analysis. They are, however, not intangibles for the purposes of Chapter VI of the OECD Transfer Pricing Guidelines.[55] Difficult issues can arise in evaluating differences between geographic markets and in determining appropriate comparability adjustments. Such issues may arise in connection with the consideration of cost savings attributable to operating in a particular market. Such savings are sometimes referred to as **location savings**. In other situations comparability issues can arise in connection with the consideration of local market advantages or disadvantages that may not be directly related to location savings.[56] In determining how location savings are to be shared between two or more associated enterprises, the OECD recommends that it is necessary to consider:

(i) whether location savings exist;
(ii) the amount of any location savings;
(iii) the extent to which location savings are either retained by a member or members of the MNE group or are passed on to independent customers or suppliers; and
(iv) where location savings are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate any retained net location savings.[57]

(a) Other local market features

- Features of the local market in which business operations occur may affect the arm's length price with respect to transactions between associated enterprises. While some such features may give rise to location savings, others may give rise to comparability concerns not directly related to such savings. For example, the comparability and functional analysis conducted in connection with a particular matter may be affected by the relevant characteristics of the geographic market in which products are manufactured or sold. Such include: the purchasing power and product preferences of households in that market; whether the market is expanding or contracting; the degree of competition in the market; and other similar factors which may affect the prices and margins that can be realised in the market. The OECD recommends that appropriate comparability adjustments should be made to account for such factors where reliable adjustments that will improve comparability can be identified.[58] Local market features are not intangibles.

(b) Assembled workforce

- Some businesses are successful in assembling a uniquely qualified or experienced cadre of employees. The existence of such an employee group

55 OECD/G20 2014 Report on Action 8 at 13.
56 Ibid.
57 Ibid.
58 OECD/G20 2014 Report on Action 8 at 14.

may affect the arm's length price for services provided by the employee group or the efficiency with which services are provided or goods produced by the enterprise. Such factors should ordinarily be taken into account in a transfer pricing comparability analysis. Where it is possible to determine the benefits or detriments of a unique assembled workforce *visà-vis* the workforce of enterprises engaging in potentially comparable transactions, comparability adjustments may be made to reflect the impact of the assembled workforce on arm's length prices for goods or services.[59] The assembled work force is not an intangible.

(c) MNE group synergies

- Comparability issues, and the need for comparability adjustments, can also arise because of the existence of MNE group synergies. In some circumstances, MNE groups and the associated enterprises that comprise such groups may benefit from interactions or synergies amongst group members that would not generally be available to similarly situated independent enterprises. Such group synergies can arise, for example, as a result of combined purchasing power or economies of scale, combined and integrated computer and communication systems, integrated management, elimination of duplication, increased borrowing capacity, and numerous similar factors. Such group synergies are often favourable to the group as a whole and therefore may heighten the aggregate profits earned by group members, depending on whether expected cost savings are, in fact, realised, and on competitive conditions.[60] Group synergies may have an effect on the determination of arm's length conditions for controlled transactions and should be addressed for transfer pricing purposes as comparability factors. As they are not owned or controlled by an enterprise, they are not intangibles.[61]

(d) Market specific characteristics

- Specific characteristics of a given market may affect the arm's length conditions of transactions in that market. For example, the high purchasing power of households in a particular market may affect the prices paid for certain luxury consumer goods. Similarly, low prevailing labour costs, proximity to markets, favourable weather conditions and the like may affect the prices paid for specific goods and services in a particular market. Such market specific characteristics are not capable, however, of being owned or controlled, and are therefore not intangibles and should be taken into account in a transfer pricing analysis through the required comparability analysis.[62]

4.2.6 Relevance of this Chapter V of the Transfer Pricing Guidelines for other tax purposes

59 OECD/G20 2014 Report on Action 8 at 17.
60 OECD/G20 2014 Report on Action 8 at 13.
61 OECD/G20 2014 Report on Action 8 at 18.
62 OECD/G20 2014 Report on Action 8 at 37.

The guidance contained in Chapter V of the OECD Transfer Pricing Guidelines is intended to address transfer pricing matters exclusively. It is not intended to have relevance for other tax purposes. Moreover, the manner in which a transaction is characterised for transfer pricing purposes has no relevance to the question of whether a particular payment constitutes a royalty or may be subjected to withholding tax under Article 12 of the OECD MTC. The concept of intangibles for transfer pricing purposes and the definition of royalties for purposes of Article 12 are two different notions that do not need to be aligned. The guidance in this Chapter V is also not relevant to recognition of income, capitalisation of intangible development costs, amortisation, or similar matters.

4.2.7 Interaction between the Report on Action Plan 8 and Action Plans 9 and 10

The OECD clarifies that guidance contained in the September 2014 report on intangibles represents the first instalment of the transfer pricing work mandated by the BEPS Action Plan. The BEPS Action Plan address a number of transfer pricing issues: Action Plan 8 deals with Intangibles; Action Plan 9 deal with risks and capital and Action Plan 10 deals with other high-risk transactions. The OECD notes that the second phase of the work, addressing Action plans 9 and 10, is to be completed in 2015. Inevitably, some transfer pricing issues relating to intangibles are closely related to issues that are to be addressed during 2015 under the Action Plan. Most notably, strong interactions exist between the work on ownership of intangibles under Action 8 and the work on risk, re-characterisation of transactions, and hard to value intangibles. Because of those interactions the OECD notes that it is challenging to finalise guidance in one area without also addressing other issues in an integrated manner. Therefore, the OECD decided not to finalise the work on some sections of Action Plan 8 for the September 2014 deadline.

It is the intention of the countries involved in the BEPS project to complete these sections of the revised intangibles guidance during 2015 in conjunction with the BEPS work on risk, re-characterisation and hard to value intangibles. This 2015 BEPS work will likely include revisions to portions of Chapters I, II, VI, VIII, and IX of the Guidelines and will include finalising the relevant interim section on Action Plan 8. In completing the 2015 BEPS transfer pricing work, issues will be addressed in an integrated manner in order to provide coherent and consistent transfer pricing guidance across issues that involve intangibles and those that do not. Work on these transfer pricing measures will be co-ordinated with other BEPS work on:

- the deductibility of interest,
- the permanent establishment definition,
- controlled foreign company (CFC) rules,
- digital economy issues, and work on dispute resolution.

The OECD hopes that this will ensure a coherent set of rules that will effectively address transfer pricing concerns related to BEPS.[63]

5 GENERAL ON TRANSFER PRICING IN SOUTH AFRICA

South Africa has transfer pricing legislation in section 31 of the Income Tax Act. As the OECD recommends, South Africa applies the arm's length principle to curb transfer pricing. The legislation focusses on cross-border transactions, operations, schemes, agreements or understandings that have been effected between, or undertaken for the benefit of, connected persons. If the terms or conditions made or imposed by the connected persons differ from the terms and conditions that would have otherwise existed between independent persons acting at arm's length, and the difference confers a South African tax benefit on one of the parties, the taxable income of the parties that have benefitted must be calculated as if the terms and conditions had been at arm's length. To determine an arm's length price South Africa makes use of the methods set out in the OECD Transfer Pricing Guidelines,[64] which are also set out in SARS Practice Note 7.[65]

Transfer pricing is a key focus area for SARS and an integral part of the Compliance Programme announced by the Minister of Finance. The Programme aims to protect the depletion of the tax base as a result of base erosion and profit shifting. It is impossible to reliably calculate the extent of base erosion and profit shifting as a result of transfer pricing schemes. In an effort to achieve some sense of the magnitude of the transfer pricing BEPS challenge, SARS had consultations with the South African Reserve Bank to get an indication of the numbers of payments directed offshore. The Reserve Bank indicated that tracking the import and export of physical goods through formal trade channels was not particularly challenging, as major risks were classified and value of goods was disclosed. Conversely, non-goods trade, such as services, royalties, and licence fees, because they are intangible, do not necessarily follow easily defined or clear transaction lines. There is a level of ambiguity present in the nature of these transactions as well as the values associated with it. In this ambiguous domain, non goods transactions are rife and pricing mechanisms overly complex, with multiple layers attached to them.

Recommendations on transfer pricing in general

- The legislators should ensure that section 31 of the Income Tax Act refers to the OECD guidelines. This is stated in SARS Practice Note 7, but SARS Practice Notes are not legally binding. At least one legally binding General Ruling, as provided for in section 89 of the Tax Administration Act, 2011, should be enacted on section 31.

[63] OECD/G20 2014 Report on Action 8 at 11.

[64] OECD *Transfer Pricing for Multinational Enterprises and Administrations* (July 2010).

[65] SARS Practice Note No. 7 in par 9.1.2 - 9.1.3.

- Without departing from the OECD Transfer Pricing Guidelines, the suggested General Ruling should include a set of principles reflecting the South African reality.
- SARS should ensure that the enforcement capacity of its transfer pricing unit is adequate. It should also ensure that there is sufficient transfer pricing training and capacity building in its transfer pricing unit.

6 ADDRESSING TRANSFER PRICING OF INTANGIBLES IN SOUTH AFRICA

South Africa's transfer pricing rules in relation to intangibles exist in close conjunction with the Exchange Control (EXCON) rules. For this reason, in assessing the potential impact of BEPS in relation to IP in the South African context, it is necessary to reflect on the relevant exchange control rules. In this section we concentrate on:

- the transfer pricing implications associated with foreign owned IP which is licensed to South African related parties, and;
- the transfer pricing implications associated with South African owned IP which is made available to foreign related parties.

6.1 Transfer pricing implications associated with foreign owned IP licensed to South African related parties

(a) Exchange Control Rules

Royalties payable by a South African resident entity to a foreign related party require prior EXCON approval. Royalties are divided into 2 categories, namely: Royalties associated with a process of manufacture; and other royalties.

- As regards the first category (royalties associated with a process of manufacture), the South African Reserve Bank (SARB) has delegated its authority to the Department of Trade and Industry (DTI). This means that applications for approval of such royalties are required to be submitted to the DTI. In practice the DTI generally restricts the royalty rate to 6% of the turnover of the South African licensee. Royalties in excess of this threshold can be motivated and approved on an exceptional basis. However, in practice royalties exceeding 8% are rarely approved.
- As regards other royalties, applications for approval are required to be submitted to the SARB itself. The SARB is less inflexible than the DTI as regards the royalty rate. However in practice royalties of much higher rates are sometimes approved. Parties applying for approval are generally required to submit an opinion from an independent transfer pricing specialist that the proposed royalty is acceptable for South African transfer pricing purposes. Also, there is a considerable onus placed on local office bearers, who are required to confirm that the SA company has received and benefited from, the IP in question.

A further key point that is discussed fully below, is that South Africa's EXCON rules generally prohibit the transfer of South African owned IP to a foreign related party. This greatly inhibits the potential, in the South Africa environment, for transactions involving transfers of intangibles or rights in intangibles as described in the OECD's Guidelines on the Transfer pricing of intangibles.

(b) Implications of the exchange control restrictions

The EXCON/DTI restrictions mean that, in practice, South Africa often permits a lower royalty rate in respect of manufacturing royalties than the rates which are considered to be arm's length in global transfer pricing studies of MNE's. Also, royalties are only approved by the DTI to the extent that the DTI is persuaded that the South African licensee receives, and benefits from, the IP rights in question. One of the main possible strategies for BEPS is to transfer valuable IP to a low tax (or tax free-jurisdiction) so as to ensure a flow of royalty income to that jurisdiction. However the potential for such a strategy – as regards South Africa owned IP – is extremely limited. As is discussed fully below, there are punitive tax consequences for payments of royalties by South African taxpayers which previously used to own the relevant IP. Against this background the following points can be made in relation to South Africa owned IP within a MNE:

- Base erosion often arises in a business restructuring arrangement, as a result of the relocation of IP to a lower tax jurisdiction. However, in the current regulatory arrangement, there appears to be more limited scope for this type of strategy in the South African environment than in other countries which do not have exchange control rules.
- It should be acknowledged that there are still strategies which can be employed to externalise value associated with South African IP. This can for example, be done via sub-license arrangements, in terms of which the South Africa entity retains a steadily diminishing interest in "old" IP whereas "new" IP is developed outside South Africa (or owned outside South Africa). However, the validity – including the substance – of such strategies must still be demonstrated by the South African taxpayer. Thus this matter is not of primary concern in the South African environment. However, the tax and TP implications of any future liberalisations of the EXCON rules should be carefully considered since the EXCON rules act as an effective means of blocking many of the BEPS strategies which exist in the global tax planning community.

6.2 Transfer pricing implications associated with South African owned IP which is made available to foreign related parties

As already noted, the BEPS concern in relation to South Africa owned IP is the possibility that MNEs may relocate IP to lower tax jurisdictions. However, below are two main constraining factors in the South African environment which make such a strategy unlikely.

(a) Exchange Control Rules

South Africa's EXCON rules prohibit the export of IP (except with approval from the SARB – which is only granted in exceptional circumstances). This is a significant constraining factor as regards supply chain optimisation exercises involving South African based multi-nationals. South African based owners of IP, which make the IP available to foreign related parties, are also required to charge an appropriate royalty for the IP. Failure to do so amounts to an export of capital.

It should be noted that regulatory restrictions in the area of IP are not confined to South Africa but occur across Africa. For example, Nigeria prohibits payment of royalties other than for manufacture. Therefore a South African based enterprise with Nigerian operations (e.g. a retailer) cannot extract the value of the right to trade under the brand in Nigeria. Therefore policy development in this area should ideally be done in conjunction with policy discussions in other major African economies.

(b) Section 23I of the Income Tax Act

Section 23I of the Income Tax Act No. 58 of 1962 is an anti-avoidance provision which prohibits the claiming of an income tax deduction in respect of "tainted IP" as defined, which essentially refers to IP which was previously owned by a "connected person" in relation to the licensee. Therefore, even if it were possible to obtain EXCON approval to export IP from South Africa, any subsequent licensing back of that IP to a South African group company would have adverse tax implications.

7 SIGNIFICANCE OF PEOPLE FUNCTIONS IN RELATION TO IP

One of the key OECD BEPS concerns in relation to the transfer pricing of intangibles is to "align profits with value creation". In the context of IP, the significance of this concern is demonstrated by the following common scenario:

- Normally there would be a group initiative to develop IP (or to relocate and centrally house an ongoing IP development process)
- The selection of a location for this initiative is made primarily on the basis of a low tax – or tax free – jurisdiction.
- The legal entity (IPCo) which is formed to house this initiative has minimal (if any) fulltime employees.
- IPCo is capitalized to fund the development of IP (typically on a contract Research and Development - R&D – in terms of which the R&D work is remunerated on a cost plus basis).
- The royalty streams associated with any IP which is successfully developed flows to IPCo and is either tax free or taxed at a very favourable rate.

Historically the validity of such an arrangement has been argued by pointing out that IPCo bears the risk in the IP development process. More specifically, that IPCo pays for the R&D process regardless of whether that results in commercially exploitable IP. Further that IPCo may also bear additional risks such as the risk of legal claims by licensees or creditor risk. However the increased international focus on people functions questions whether this assumption of risk is sufficient to justify receipt by IPCo of the full royalty income. The suggestion is that, in determining where the royalty income should go, regard should be had to the location where "important people functions" are performed. In the context of IP development, a key significant factor that should be taken into account is the location of the people who created the IP.

At this point it is not clear exactly how, if the R&D activity is to be remunerated by means of more than a cost plus remuneration such remuneration should be determined. It must be emphasised that the risking of the capital associated with the IP development process is by no means an insignificant factor. Therefore, even if it is considered that other functions require more than just a cost plus remuneration, the entity which risks the capital should continue to share in a significant portion of the royalty income. One possibility would be some form of profit split arrangement.

Also of relevance would be the people functions associated with the following aspects:

- The strategic decision making process involving the IP development and commercialization.
- Legal registration and protection of the IP.

The following elements (amongst others) would also be relevant as regards contract R&D activities conducted in South Africa:

- The extent to which such R&D is supervised or directed from outside the country on an ongoing basis.
- Does the R&D activity form part of a global contract R&D arrangement with a strong central strategic focus? If the South African entity is the sole contract R&D service provider, this might provide a greater indication of possible artificiality.
- As regards the overall strategic function of the group, to what extent is this outside South Africa? If it is only the IP related functionality which is represented as sitting outside South Africa (with the balance of the strategy being driven in SA), this might also be an indicator of lack of substance.

8 DOUBLE TAXATION AGREEMENTS

One of the factors which creates potential for tax avoidance within MNE's is the flow streams of royalty income to low tax jurisdictions. In the South African context, this strategy would be of limited benefit for countries with which South Africa does not have a DTA as such royalties would be subject to withholding tax at 15% in terms of

Part IVA of the Income Tax Act. For countries with South Africa has a DTC, the withholding tax is normally relieved in terms of article 12 of the treaties based on the OECD MTC. However DTAs generally only provide relief from withholding taxes on royalties to the extent that the recipient of the royalties is the "beneficial owner" of the relevant IP. In practice, such an owner is required to have a certain degree of substance and activity in relation to IP in order to be regarded as the beneficial owner of that IP for DTA relief. For example, in the 2012 Canadian case of *Velcro Canada vs The Queen,*[66] the court considered the issue of beneficial ownership by reference to four elements that must be considered in determining the whether the recipient is the beneficial owner: possession, use, risk and control. It would therefore be relevant to take into account this – and other – international tax guidance on the issue of beneficial ownership.

10 CONCLUSION AND RECOMMENDATIONS ON TRANSFER PRICING OF INTANGIBLES FOR SOUTH AFRICA

- The OECD's BEPS Action Plan 8, which requires countries to enact legislation to prevent transfer pricing of intangibles, may not require major legislative attention in South Africa at this stage, since current exchange controls restrict the outbound movement of intangibles and royalty payments. This is unlike some other countries where taxpayers have greater freedom as regards excessive payments of royalties or relocation of IP.
  - South African developed IP cannot be readily exported without Exchange Control or the Department of Trade and Industry (DTI) approval and royalty rates are often capped. Therefore any future developments of EXCON rules for IP (and specifically any liberalisation of these rules) should be carefully considered from a transfer pricing point of view. Ideally EXCON policy development in this area should be informed by tax (and specifically transfer pricing) considerations.
  - South African CFC rules exclude intangibles from the CFC exemption benefits.
  - Section 31 of the Income Tax Act – or even the general anti-avoidance provision – can also be applied to challenge the limited remuneration of a South African entity involved in the development process.
  - Section 23I of the Income Tax Act is an anti-avoidance provision which prohibits the claiming of an income tax deduction in respect of "tainted IP".
  - The "beneficial ownership" in terms of the royalty article 12 of DTAs can also be applied to deny the reduced withholding tax treaty rate if the recipient lacks substance.
- Despite the above measures, the potential undervaluation of local intangibles in determining profit splits is a potential concern for South Africa.

[66] 2012 TCC 273.

- There could also be concerns as regards contract R&D arrangements which are highly artificial or lacking in substance. However, from an EXCON point of view, it would be possible to argue that any resultant IP is South African owned IP (or partly owned in South Africa). This would render any transfer of the resultant IP an EXCON transgression. SARS could also invoke the transfer pricing provisions under section 31 of the Income Tax Act – or even the general anti-avoidance provision under sections 80A-80L to challenge the limited remuneration of the South African entity involved in the development process.
- To reinforce the above provisions, it may be necessary in the future to enact provisions in the Income Tax Act to address any schemes that could be developed regarding transfer pricing of intangibles. A hypothetical example could be if a South Africa company develops a product, then it writes off the expenditure as a tax deduction in South Africa, and then it registers the IP in a tax haven and charges the local branch a fee for the use of the IP.
- To address challenges relating to the transfer pricing of intangibles, South African should align its laws and practices with the OECD Guidelines on the transfer pricing of intangibles discussed above.
- When legislative provisions are enacted, the following are some uncertainties and risks that need to be addressed:
    - If a low tax entity is the legal owner of intangibles and bears the costs of developing the intangibles, but does not perform any of the important functions, what profits should be attributed in terms of the arm’s length principle?
    - How is the transfer of intangibles with highly uncertain values going to be priced?
- Care should be taken, when developing tax legislation on transferring of intangibles, to ensure that the legislation is not so restrictive that it limits South Africa’s ambitions to be a global player in the development of IP.