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

ACTION 13: RE-EXAMINE TRANSFER PRICING DOCUMENTATION

1 BACKGROUND

In its 2013 Base Erosion and Profit Shifting (BEPS) Report,[1] the OECD noted that a key issue in the administration of transfer pricing rules is the asymmetry of information between taxpayers and tax administrations. This potentially undermines the administration of the arm's length principle and enhances opportunities for BEPS. The OECD further noted that:

- In many countries, tax administrations have little capability of developing a "big picture" view of a taxpayer's global value chain.
- There are divergences between approaches to transfer pricing documentation requirements which lead to significant administrative costs for businesses.
- It is important that adequate information about the relevant functions performed by other members of the MNE group in respect of intra-group services and other transactions is made available to the tax administration.[2]

2 OECD 2013 BEPS REPORT ON ACTION PLAN 13

On a domestic front, the OECD recommends that:

- Countries should develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business.
- The rules to be developed should include a requirement that MNEs provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template. [3]
- All actions to counter BEPS must be contemplated with actions that ensure certainty and predictability for business.

On an international front, the OECD planned to develop requirements for taxpayers to report income, taxes paid, and indicators of economic activity to governments according to a common country-by-country reporting template. In developing the country-by-country reporting template; the OECD noted that:

- A balance needs to be sought between the usefulness of the data to tax administrations for risk assessment and other purposes, and the compliance burdens placed on taxpayers.

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1 OECD" Action Plan on Base Erosion and Profit Shifting" (2013) at 22.
2 Ibid.
3 Ibid.

- There would be compliance related advantages if it were possible to limit the required information to data readily available to corporate management so that companies do not need to go through a time consuming and expensive process of constructing new data.[4]

3 OECD "DISCUSSION DRAFT ON TRANSFER PRICING DOCUMENTATION AND CBC REPORTING"

In January 2014, the OECD released a "Discussion Draft on Transfer Pricing Documentation and Country-by-Country Reporting", in which it was noted that when Chapter V of the OECD Transfer Pricing Guidelines[5] was adopted in 1995, tax administrations and taxpayers had less experience in creating and using transfer pricing documentation.[6] The Transfer Pricing Guidelines put an emphasis on the need for reasonableness in the documentation process from the perspective of both taxpayers and tax administrations, as well as on the desire for a greater level of cooperation between tax administrations and taxpayers in addressing documentation issues in order to avoid excessive documentation compliance burdens while at the same time providing for adequate information to apply the arm's length principle reliably. However, the previous language of Chapter V did not provide for a list of documents to be included in a transfer pricing documentation package nor did it provide clear guidance with respect to the link between the process for documenting transfer pricing, the administration of penalties and the burden of proof.[7]

Since then, many countries have adopted transfer pricing documentation rules. The proliferation of these rules, combined with a dramatic increase in the volume and complexity of international intra-group trade and the heightened scrutiny of transfer pricing issues by tax administrations, has resulted in a significant increase in

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4 Ibid.

5 OECD "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators" (1995) provide guidance on the application of the "arm's length principle", which is the international consensus on transfer pricing. The Guidelines were originally published in 1979 and were approved by the OECD Council in 1995. A limited update was made in 2009, primarily to reflect the adoption, in the 2008 update of the *Model Tax Convention,* of a new paragraph 5 of Article 25 dealing with arbitration, and of changes to the Commentary on Article 25 on mutual agreement procedures to resolve cross-border tax disputes. In the 2010 edition, Chapters I-III were substantially revised, with new guidance on: the selection of the most appropriate transfer pricing method to the circumstances of the case; the practical application of transactional profit methods (transactional net margin method and profit split method); and on the performance of comparability analyses. Furthermore, a new Chapter IX, on the transfer pricing aspects of business restructurings, was added. Consistency changes were made to the rest of the *Guidelines*. See http://www.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2010_tpg-2010-en accessed 16 may 2014.

6 OECD "Discussion Draft on Transfer Pricing Documentation and CbC Reporting" (30 January 2014) in para 2.

7 OECD "Discussion Draft on Transfer Pricing Documentation and CbC Reporting" in para 2; OECD/G20 Base Erosion and Profit Shifting Project Guidelines on Transfer Pricing Documentation and Country-by-Country Reporting Action 12: 2014 Deliverable (2014) at 13 (OECD/G20 2014 Report on Action Plan 13).

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compliance costs for taxpayers. Nevertheless, tax administrations often find transfer pricing documentation to be less than fully informative and not adequate for their tax enforcement and risk assessment needs. [8]

The OECD Discussion Draft on Transfer Pricing and Country-by-country reporting[9] came up with draft guidance that tax administrations ought to take into account when developing rules and procedures on documentation to be obtained from taxpayers in connection with a transfer pricing inquiry or risk assessment. It also came up with draft guidance to assist taxpayers in identifying documentation that would be most helpful in showing that their transactions satisfy the arm's length principle so as to resolve transfer pricing issues and facilitate tax examinations. The draft guidance went through a public consultation process conducted by the OECD. The finalised guidelines are now set out in the September 2014 Report on Action Plan 13 (discussed below).

4 OECD SEPTEMBER 2014 REPORT ON ACTION PLAN 13

The September 2014 Report on Action Plan 13[10] notes that Chapter V of the Transfer Pricing Guidelines has been revised to provide for: [11]

- The objectives of transfer pricing documentation rules;[12]
- Revised standards for transfer pricing documentation and;
- A template for country-by-country reporting of income, earnings, taxes paid and certain measures of economic activity.

4.1 OBJECTIVES OF TRANSFER PRICING DOCUMENTATION REQUIREMENTS

In terms of the Transfer Pricing Documentation Guidelines, there are three objectives of transfer pricing documentation are:

4.1.1 To ensure Taxpayer's can assessment their compliance with the arm's length principle[13]

- This ensures that taxpayers give appropriate consideration to transfer pricing requirements in establishing prices and other conditions for transactions between associated enterprises and in reporting the income derived from such transactions in their tax returns.

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8 OECD "Discussion Draft on Transfer Pricing Documentation and CbC Reporting" in para 3; OECD/G20 2014 Report on Action Plan 13.

9 OECD "Discussion Draft on Transfer Pricing Documentation and CbC Reporting" in para 2.

10 OECD/G20 Base Erosion and Profit Shifting Project Guidelines on Transfer Pricing Documentation and Country-by-Country Reporting Action 12: 2014 Deliverable (2014) (OECD/G20 2014 Report on Action Plan 13).

11 OECD/G20 2014 Report on Action Plan 14

12 Ibid.

13 OECD/G20 2014 Report on Action Plan 15.

- By requiring taxpayers to articulate convincing, consistent and cogent transfer pricing positions, transfer pricing documentation can help to ensure that a culture of compliance is created. Well-prepared documentation will give tax administrations some assurance that the taxpayer has analysed the positions it reports on tax returns, has considered the available comparable data, and has reached consistent transfer pricing positions.
- This compliance objective may be supported in two important ways.
  - First, tax administrations can require that transfer pricing documentation requirements be satisfied on a contemporaneous basis. This would mean that the documentation would be prepared at the time of the transaction, or in any event, no later than the time of completing and filing the tax return for the fiscal year in which the transaction takes place.
  - The second way to encourage compliance is to establish transfer pricing penalty regimes in a manner intended to reward timely and accurate preparation of transfer pricing documentation and to create incentives for timely, careful consideration of the taxpayer's transfer pricing positions.
- Issues such as costs, time constraints, and competing demands for the attention of relevant personnel can sometimes undermine these objectives. The OECD recommends that it is therefore important for countries to keep documentation requirements reasonable and focused on material transactions in order to ensure mindful attention to the most important matters. [14]

4.1.2 To provide tax administrations with the information necessary to conduct an informed transfer pricing risk assessment [15]

Effective risk identification and assessment constitute an essential early stage in the process of selecting appropriate cases for transfer pricing audits or enquiries and in focusing such audits on the most important issues. Because tax administrations operate with limited resources, it is important for them to accurately evaluate, at the very outset of a possible audit, whether a taxpayer's transfer pricing arrangements warrant in-depth review and a commitment of significant tax enforcement resources.

Proper assessment of transfer pricing risk by the tax administration requires access to sufficient, relevant and reliable information at an early stage. While there are many sources of relevant information, transfer pricing documentation is one critical source of such information. The other tools and sources of information that can be used for identifying and evaluating transfer pricing risks of taxpayers and transactions, including:

- transfer pricing forms (to be filed with the annual tax return);
- transfer pricing mandatory questionnaires focusing on particular areas of risk;

[14] OECD/G20 2014 Report on Action Plan 15.
[15] Ibid.

- general transfer pricing documentation requirements identifying the supporting evidence necessary to demonstrate the taxpayer's compliance with the arm's length principle, and
- cooperative discussions between tax administrations and taxpayers. [16]

4.1.3 To provide tax administrations with useful information to employ in conducting an appropriately thorough transfer audit[17]

The OECD notes that transfer pricing audit cases tend to be fact intensive. They often involve difficult evaluations of the comparability of several transactions and markets. They can require detailed consideration of financial, factual and other industry information. The availability of adequate information from a variety of sources during the audit is critical to facilitating a tax administration's orderly examination of the taxpayer's controlled transactions with associated enterprises and enforcement of the applicable transfer pricing rules. In situations where a proper transfer pricing risk assessment suggests that a thorough transfer pricing audit is warranted, tax administration must have the ability to obtain, within a reasonable period, all of the relevant documents and information in the taxpayer's possession. This includes information regarding the taxpayer's operations and functions, relevant information on the operations, functions and financial results of associated enterprises with which the taxpayer has entered into controlled transactions, information regarding potential comparables, including internal comparables, and documents regarding the operations and financial results of potentially comparable uncontrolled transactions and unrelated parties. [18]

In case that the documents and other information required for a transfer pricing audit are in the possession of members of the MNE group other than the local affiliate under examination, it is important that the tax administration is able to obtain directly or through information sharing, such as exchange of information mechanisms, information that extends beyond the country's borders.[19]

4.2 THE THREE-TIERED APPROACH TO TRANSFER PRICING DOCUMENTATION

In order to achieve the above three objectiveness of transfer pricing documentation requirements, the OECD recommends that countries should adopt a standardised approach to transfer pricing documentation by following a three-tiered structure consisting of:

16 OECD/G20 2014 Report on Action Plan 15.
17 OECD/G20 2014 Report on Action Plan 16.
18 Ibid.
19 Ibid.

(i) a master file containing standardised information relevant for all MNE group members;
(ii) a local file referring specifically to material transactions of the local taxpayer; and
(iii) a country-by-country report containing certain information relating to the global allocation of the MNE's income and taxes paid together with certain indicators of the location of economic activity within the MNE group.[20]

4.2.1 The Master file

The master file should provide an overview of the MNE group business, including the nature of its global business operations, its overall transfer pricing policies, and its global allocation of income and economic activity. The master file would be available to all relevant country tax administrations in order to assist tax administrations in evaluating the presence of significant transfer pricing risk.

- The master file is intended to provide a high-level overview in order to place the MNE group's transfer pricing practices in their global economic, legal, financial and tax context.
- It is not intended to require exhaustive listings of minutiae (*e.g*. a listing of every patent owned by members of the MNE group).
- The information required in the master file provides a "blueprint" of the MNE group and contains relevant information that can be grouped in five categories:
    a) the MNE group's organisational structure;
    b) a description of the MNE's business or businesses;
    c) the MNE's intangibles;
    d) the MNE's intercompany financial activities; and
    (e) the MNE's financial and tax positions.
- Taxpayers should present the information in the master file for the MNE as a whole. Care should be taken to assure that centralised group functions and transactions between business lines are properly described in the master file.[21]

4.2.2 The Local file

In contrast to the master file which provides a high-level overview. MNE are also expected to have a "local file" which provides more detailed information relating to specific intercompany transactions in each country they operate in; identifying relevant related party transactions, the amounts involved in those transactions, and the company's analysis of the transfer pricing determinations they have made with regard to those transactions.

[20] OECD/G20 2014 Report on Action Plan 17.
[21] OECD/G20 2014 Report on Action Plan 18.

- The information required in the local file supplements the master file and helps to meet the objective of assuring that the taxpayer has complied with the arm's length principle in its material transfer pricing positions affecting a specific jurisdiction.
- The local file focuses on information relevant to the transfer pricing analysis related to transactions taking place between a local country affiliate and associated enterprises in different countries and which are material in the context of the local country's tax system.
- Such information would include relevant financial information regarding those specific transactions, a comparability analysis, and the selection and application of the most appropriate transfer pricing method.[22]

4.2.3 The Country-by-Country report

The country-by-country report requires:

- Aggregate tax jurisdiction wide information relating to the global allocation of the income, the taxes paid, and certain indicators of the location of economic activity among tax jurisdictions in which the MNE group operates. In effect, the "country-by-country" report requires MNEs to:
    - report annually and for each tax jurisdiction in which they do business the amount of revenue, profit before income tax and income tax paid and accrued.
    - report their total employment, capital, retained earnings and tangible assets in each tax jurisdiction.
- The report also requires a listing of all the constituent entities for which financial information is reported, including the tax jurisdiction of incorporation, where different from the tax jurisdiction of residence, as well as the nature of the main business activities carried out by that constituent entity. In effect, MNEs are required to:
    - identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities each entity engages in. [23]

The country-by-country report will be helpful for:

- high-level transfer pricing risk assessment purposes;
- It may also be used by tax administrations in evaluating other BEPS related risks and where appropriate for economic and statistical analysis. [24]

However, the information in the country-by-country report should:

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22 OECD/G20 2014 Report on Action Plan 19.
23 Ibid.
24 Ibid.

- not be used as a substitute for a detailed transfer pricing analysis of individual transactions and prices based on a full functional analysis and a full comparability analysis.
- The information in the country-by-country report on its own does not constitute conclusive evidence that transfer prices are or are not appropriate.
- It should not be used by tax administrations to propose transfer pricing adjustments based on a global formulary apportionment of income. [25]

Annex III to Chapter V of these Guidelines contains a model template for the country-by-country report together with its accompanying instructions.

Taken together, these three documents (master file, local file and country-by-country report) will:

- require taxpayers to articulate consistent transfer pricing positions,
- provide tax administrations with useful information to assess transfer pricing risks,
- make determinations about where audit resources can most effectively be deployed, and,
- in the event audits are called for, provide information to commence and target audit enquiries.

This information should make it easier for tax administrations to identify whether companies have engaged in transfer pricing and other practices that have the effect of artificially shifting substantial amounts of income into tax-advantaged environments. The countries participating in the BEPS Project agree that these new reporting provisions, and the transparency they will encourage, will contribute to the objective of understanding, controlling, and tackling BEPS behaviours.

- The specific content of the various documents reflects an effort to balance tax administration information needs, concerns about inappropriate use of the information, and the compliance costs and burdens imposed on business.
- Some countries would strike that balance in a different way by requiring reporting in the country-by-country report of additional transactional data (beyond that available in the master file and local file for transactions of entities operating in their jurisdictions) regarding related party interest payments, royalty payments and especially related party service fees. Countries expressing this view are primarily those from emerging markets (Argentina, Brazil, China, Colombia, India, Mexico, South Africa, and Turkey) who state they need such information so as to perform risk assessment and who find it challenging to obtain information on the global operations of an MNE group headquartered elsewhere.
- Other countries expressed support for the way in which the balance has been struck in this document. Taking all these views into account, it is mandated that countries participating in the BEPS project will carefully review the

[25] OECD/G20 2014 Report on Action Plan 21.

implementation of these new standards and will reassess no later than the end of 2020 whether modifications to the content of these reports should be made to require reporting of additional or different data.

4.3 COMPLIANCE ISSUES

4.3.1 Contemporaneous documentation

The OECD recommends that:

- Each taxpayer should endeavour to determine transfer prices for tax purposes are in accordance with the arm's length principle, based upon information reasonably available at the time of the transaction.
- Taxpayers should not be expected to incur disproportionately high costs and burdens in producing documentation.
- Tax administrations should balance requests for documentation against the expected cost and administrative burden to the taxpayer.
- Where a taxpayer reasonably demonstrates, having regard to the principles of these Guidelines, that either no comparable data exists or that the cost of locating the comparable data would be disproportionately high relative to the amounts at issue, the taxpayer should not be required to incur costs in searching for such data. [26]

4.3.2 Time frame

The OECD notes that:

- Practices regarding the timing of the preparation of the documentation differ among countries.
- These differences in the time requirements for providing information can add to taxpayers' difficulties in setting priorities and in providing the right information to the tax administrations at the right time.
- The OECD recommends that:
  - With regard to the local file, the best practice is to require that this file be finalised no later than the due date for the filing of the tax return for the fiscal year in question.
  - The master file should be reviewed and, if necessary, updated by the tax return due date for the ultimate parent of the MNE group. In countries pursuing policies of auditing transactions as they occur under cooperative compliance programmes, it may be necessary for certain information to be provided in advance of the filing of the tax return.
  - With regard to the country-by-country report, it is recognised that in some instances final statutory financial statements and other financial information that may be relevant for the country-by-country data may not be finalised until after the due date for tax returns in some countries for a given fiscal year. Under the given circumstances, the date for

[26] OECD/G20 2014 Report on Action Plan 20.

completion of the country-by-country report described may be extended to one year following the last day of the fiscal year of the ultimate parent of the MNE group. [27]

4.3.3 Materiality

Not all transactions that occur between associated enterprises are sufficiently material to require full documentation in the local file. The OECD recommends that:

- Individual country transfer pricing documentation requirements based on Annex II to Chapter V of The OECD Transfer Pricing Guidelines should include specific materiality thresholds that take into account the size and the nature of the local economy, the importance of the MNE group in that economy, and the size and nature of local operating entities, in addition to the overall size and nature of the MNE group.
- Measures of materiality may be considered in relative terms (*e.g*. transactions not exceeding a percentage of revenue or a percentage of cost measure) or in absolute amount terms (*e.g*. transactions not exceeding a certain fixed amount).
- Individual countries should establish their own materiality standards for local file purposes, based on local conditions. The materiality standards should be objective standards that are commonly understood and accepted in commercial practice.
- In order not to impose on taxpayers costs and burdens disproportionate to their circumstances, it is recommended to not require SMEs to produce the amount of documentation that might be expected from larger enterprises. However, SMEs should be obliged to provide information and documents about their material cross-border transactions upon a specific request of the tax administration in the course of a tax examination or for transfer pricing risk assessment purposes.
- The country-by-country report should include all tax jurisdictions in which the MNE group has an entity resident for tax purposes, regardless of the size of business operations in that tax jurisdiction. [28]

4.3.4 Retention of documents

The OECD recommends that:

- Taxpayers should not be obliged to retain documents beyond a reasonable period consistent with the requirements of domestic law at either the parent company or local entity level.
- However, at times materials and information required in the documentation package (master file, local file and country-by-country report) may be relevant to a transfer pricing enquiry for a subsequent year that is not time barred, for

[27] OECD/G20 2014 Report on Action Plan 20.
[28] OECD/G20 2014 Report on Action Plan 21.

example where taxpayers voluntarily keep such records in relation to long-term contracts, or to determine whether comparability standards relating to the application of a transfer pricing method in that subsequent year are satisfied.

- Tax administrations should bear in mind the difficulties in locating documents for prior years and should restrict such requests to instances where they have good reason in connection with the transaction under examination for reviewing the documents in question.
- The way that documentation is stored - whether in paper, electronic form, or in any other system - should be at the discretion of the taxpayer provided that relevant information can promptly be made available to the tax administration in the form specified by the local country rules and practices. [29]

4.3.5 Frequency of documentation updates

- The OECD recommends that transfer pricing documentation be periodically reviewed in order to determine whether functional and economic analyses are still accurate and relevant; and to confirm the validity of the applied transfer pricing methodology.
- In general, the master file, the local file and the country-by-country report should be reviewed and updated annually.
- In order to simplify compliance burdens on taxpayers, tax administrations may determine, as long as the operating conditions remain unchanged, that the searches in databases for comparables supporting part of the local file be updated every 3 years rather than annually.
- Financial data for the comparables should nonetheless be updated every year in order to apply the arm's length principle reliably. [30]

4.3.6 Language

The OECD recommends that:

- The language in which transfer pricing documentation should be submitted should be established under local laws.
- Countries are encouraged to permit filing of transfer pricing documentation in commonly used languages where it will not compromise the usefulness of the documents.
- Where tax administrations believe that translation of documents is necessary, they should make specific requests for translation and provide sufficient time to make such translation as comfortable a burden as possible. [31]

4.3.7 Penalties

The OECD notes that:

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29 OECD/G20 2014 Report on Action Plan 22.
30 OECD/G20 2014 Report on Action Plan 23.
31 Ibid.

- Many countries have documentation-related penalties to ensure efficient operation of transfer pricing documentation requirements.
- These penalties are designed to make non-compliance more costly than compliance.
- Penalty regimes are governed by the laws of each individual country.
- Documentation-related penalties imposed for failure to comply with transfer pricing documentation requirements or failure to timely submit required information are usually civil (or administrative) monetary penalties.
- The OECD recommends that:
    - Care should be taken not to impose a documentation-related penalty on a taxpayer for failing to submit data to which the MNE group did not have access. However, a decision not to impose documentation-related penalties does not mean that adjustments cannot be made to income where prices are not consistent with the arm's length principle.
    - An assertion by a local entity that other group members are responsible for transfer pricing compliance is not a sufficient reason for that entity to fail to provide required documentation, nor should such an assertion prevent the imposition penalties for failure to comply with documentation rules where the necessary information is not forthcoming.
    - Another way for countries to encourage taxpayers to fulfil transfer pricing documentation requirements is by designing compliance incentives. For example, where the documentation meets the requirements and is timely submitted, the taxpayer could be exempted from tax penalties or subject to a lower penalty rate if a transfer pricing adjustment is made and sustained, notwithstanding the provision of documentation.[32]

4.3.8 Confidentiality

The OECD recommends that:

- Tax administrations should take all reasonable steps to ensure that there is no public disclosure of confidential information (trade secrets, scientific secrets, *etc.*) and other commercially sensitive information contained in the documentation package (master file, local file and country-by-country report).
- Tax administrations should also assure taxpayers that the information presented in transfer pricing documentation will remain confidential.
- In cases where disclosure is required in public court proceedings or judicial decisions, every effort should be made to ensure that confidentiality is maintained and that information is disclosed only to the extent needed.[33]

4.3.9 Other issues

[32] OECD/G20 2014 Report on Action Plan 23.
[33] OECD/G20 2014 Report on Action Plan 24.

Local/regional comparables: The OECD recommends that:

- The requirement to use the most reliable information will usually, but not always, require the use of local comparables over the use of regional comparables where such local comparables are reasonably available.
- The use of regional comparables in transfer pricing documentation prepared for countries in the same geographic region in situations where appropriate local comparables are available will not, in some cases, comport with the obligation to rely on the most reliable information.
- While the simplification benefits of limiting the number of comparable searches a company is required to undertake are obvious, and materiality and compliance costs are relevant factors to consider, a desire for simplifying compliance processes should not go so far as to undermine compliance with the requirement to use the most reliable available information. [34]

Certifying of documentation: The OECD notes that:

- It is not recommended, particularly at the stage of transfer pricing risk assessment, to require that the transfer pricing documentation should be certified by an outside auditor or other third party.
- Mandatory use of consulting firms to prepare transfer pricing documentation is not recommended. [35]

4.3.10 Implementation and Review

- The OECD notes that it is essential that the new guidance in this Chapter V of the Transfer Pricing Guidelines, and particularly the new country-by-country report, be implemented effectively and consistently.
- The OECD is of the view that taxpayers should deliver the local file directly to tax administrations in the relevant local jurisdiction.
- There are, however, different views about the filing process for the master file and the country-by-country report, and consequently about the mechanisms by which the information is to be made available to tax administrations in all relevant countries.[36]

5 INTERNATIONAL CONCERNS

- In its September 2014 report on Action 13, the OECD stresses the need to consider business's compliance costs. Despite the transfer pricing documentation guidance provided by the OECD; costs and confidentiality are still the top concerns that taxpayers have with regard to the master file, local file and country-by-country reporting. From a client perspective, compliance with the reporting template represents an absolutely massive investment in

[34] OECD/G20 2014 Report on Action Plan 25.
[35] Ibid.
[36] Ibid.

terms of human resources and systems capability enhancements. [37] Confidentially is also a major concern because some tax authorities don't have confidentiality provisions under their local laws. Some taxpayers prefer that this type of information should be shared under the exchange of information provisions under treaty networks in order to maintain confidentiality of taxpayer information.[38]

- The OECD has also been called upon to consider whether the information sharing system should be structured in a way that it excludes delivery of information to countries where adequate provisions do not exist to protect the confidentiality of competitively sensitive data and how this might be accomplished.
- Concerns have been raised regarding the currencies in which information should be presented in the country by country template. It is not clear whether the information should be reported in the functional currencies of each individual entity or if it should be translated into a single consistently used currency (functional currency of the ultimate parent), or some combination.
- Concerns have also been raised regarding whether the taxes paid in each country should be reported on a cash or accrual basis. Governments would ordinarily be most interested in cash taxes paid in a given year, or alternatively cash taxes paid with respect to the income reported in a given year, for risk assessment purposes. While tax accruals would perhaps align better with accrual based financial statement income (assuming income from statutory financials is ultimately what is reported), there could be a question as to whether reporting tax accruals as opposed to cash tax paid would introduce distortions related to deferred tax accounting, tax provisions and other accrual accounting issues. The difficulty with such an approach is that some companies in an MNE Group may not be obliged to file a tax return in any country and may not be obliged to report some portion or all of their financial statement income on a tax return in any country.

6 TRANSFER PRICING DOCUMENTATION IN SOUTH AFRICA

South African Revenue Services (SARS) Practice Note 7 which was issued on 6 August 1999 contains quite detailed but rather unclear “documentation guidelines”.[39] Submitting transfer pricing documentation is not compulsory in South Africa. SARS Practice Note 7 states that SARS documentation guidelines “broadly follow Chapter V of the OECD Guidelines”. [40]

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37 DA Glenn, Tax Analysts “Costs and Confidentiality Are Biggest Concerns With OECD Discussion Draft, Practitioners Say” 18 February 2014; DD Stewart and DL Glenn “BEPS Project on Track to Meet 2014 Deadlines, OECD's Saint-Amans Says” Tax Analyst 24 January 2014.

38 DA Glenn, Tax Analysts “Costs and Confidentiality Are Biggest Concerns With OECD Discussion Draft, Practitioners Say” 18 February 2014.

39 SARS Practice Note 7 in para 10.3.

40 Ibid.

However the version of the OECD Guidelines which was applicable when SARS Practice Note 7 was issued was the "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" as issued by the OECD in July 1995 being a revision of the 1979 guidelines. Additional Chapters to these Guidelines have been issued since 1995, including Intra-group Services (1996), Intangible Property (1996) and Cost Contribution Arrangements (1997). Revised Transfer Pricing Guidelines were issued in 2009 (with relatively minor changes) and more material revisions were published by the OECD in 2010 transfer pricing guidelines. In light of the OECD BEPS Action Plan 13, Chapter V of the Transfer Pricing Guidelines has also been revised to provide for transfer pricing documentation rules as discussed above.

Recommendations for South Africa

- The OECD's view that one of the purposes of transfer pricing documentation guidelines is to ensure that taxpayer's can assessment their compliance with the arm's length principle, is consistent with the fundamental change that was made to South Africa's transfer pricing provisions in section 31 of the Income Tax Act for tax years starting from 1 April 2012. More specifically, whereas transfer pricing adjustments previously could only be made by SARS (in terms of a discretion), the amended version of section 31 provides in section 31(2), that a taxpayer must itself make any transfer pricing adjustments that might be required in the calculation of its taxable income. This places a significantly greater onus on taxpayers. Thus under the revised version of section 31(2), an onus is placed on each taxpayer with foreign related party transactions to "confirm the arm's length nature of its financial results at the time of filing its tax return". This onus exists, regardless of whether or not the taxpayer has transfer pricing documentation.

- Since the current transfer pricing documentation guidelines, as contained in SARS Practice Note 7 (PN 7), are not that clear and are based on the 1995 OECD Guidelines, it is recommended that SARS revises PN 7 to be in line with the OECD revised Transfer Pricing Documentation Guidelines in Chapter V. For several years there have been indications from SARS and Treasury that an updated transfer pricing Interpretation Note is imminent. SARS PN Note 7 is now 15 years old and has not been changed to keep pace with developments at the OECD. As mentioned above, currently preparing transfer pricing documentation is not compulsory in South Africa. It is recommended that documentation requirements should be introduced in line with the above discussed OECD Guidelines. Consequently, the OECD's recommendation that countries should adopt a standardised approach to transfer pricing documentation that follows a three-tiered structure consisting of a master file, a local file and country-by-country reporting should be adopted in South Africa. This approach will encourage a consistent approach to transfer pricing

documentation in different countries which will help contain the cost of global transfer pricing documentation.

- SARS PN 7 also makes references to certain provisions of the Income Tax Act which have been repealed and now form part of the Tax Administration Act 28 of 2011 (examples are provisions dealing with record keeping requirements and penalty provisions). It is therefore imperative that an updated Interpretation Note be prioritized.

- It should be noted that with regard to Country-by country reporting, South Africa along with other emerging economies are of the view that the country-by-country report should require additional transactional data (beyond that available in the master file and local file for transactions of entities operating in their jurisdictions) regarding related party interest payments, royalty payments and especially related party service fees. Such information would be needed to perform risk assessments where it is found challenging to obtain information on the global operations of an MNE group headquartered elsewhere. The OECD plans to take these views into consideration and review the implementation thereof no later than end of 2020. It is therefore recommended that South Africa monitors the OECD's final recommendations in this regard and then implement the same.

- It is recommended that preparing a master file, local file and country-by-country reporting should be compulsory for large Multinational businesses. A recommended threshold is businesses over R1 billion group turnover. As the OECD recommends, with regard to compliance matter under the heading "materiality", disproportionate and costly documentation requirements should not imposed on SMEs. SMEs should not be required to produce the same amount of documentation that might be expected from larger enterprises. However, SMEs should be obliged to provide information and documents about their material cross-border transactions upon a specific request of the tax administration in the course of a tax examination or for transfer pricing risk assessment purposes.

- Furthermore on the matter of materiality, the OECD recommends that individual country transfer pricing documentation requirements should be based on Annex II to Chapter V of The OECD Transfer Pricing Guidelines and should include specific materiality thresholds that take into account the size and the nature of the local economy, the importance of the MNE group in that economy, and the size and nature of local operating entities, in addition to the overall size and nature of the MNE group. The OECD recommends that individual countries should establish their own materiality standards for local file purposes, based on local conditions. The materiality standards should be objective standards that are commonly understood and accepted in

commercial practice. In this regard, it is important that when SARS updates its PN 7 in line with the OECD transfer pricing documentation guidelines, it should provide taxpayers with much more specific guidance on what information is actually required instead of the current rather vague information in the Addendum to SARS PN 2.

- With respect to the compliance matter under the heading "confidentiality", the OECD recommends that tax administrations should take all reasonable steps to ensure that there is no public disclosure of confidential information (trade secrets, scientific secrets, *etc.*) and other commercially sensitive information contained in the documentation package (master file, local file and country-by-country report). In this regard, there are various provisions in the Tax Administration Act which deal with confidentiality. These include sections 21, 56 and Chapter 6 of the Tax Administration Act. Confidentiality is therefore this is an important element of South Africa's income tax system. It is however important that these provisions are strengthened in line with the OECD recommendations.

- With regard to compliance matters under the heading of "contemporaneous documentation" the OECD recommends that taxpayers should not be expected to incur disproportionately high costs and burdens in producing documentation. SARS should balance requests for documentation against the expected cost and administrative burden to the taxpayer of creating it. This guidance is directly in line with the "Addendum to SARS PN 7: Submission of Transfer Pricing Policy Document", where it is explicitly stated that:
    - "SARS acknowledges that the preparation of transfer pricing documentation is time-consuming and expensive. The important general rule is that it is not expected of taxpayers to go to such lengths that the compliance costs related to the preparation of documentation are disproportionate to the nature, scope and complexity of the international agreements entered into between the taxpayers and connected persons. Furthermore, where a taxpayer has provided full details of the international agreements that it has entered into with connected parties, the absence of formal transfer pricing documentation will not be regarded as non-disclosure. Taxpayers choosing not to prepare documentation must, however, realise that they are at risk and that it may be more difficult to discharge the onus of proving that an arm's length price has been established."
    - This additional guidance therefore continues to be relevant. The cautionary note in the last sentence is more strongly applicable than ever – in view of the greater onus which is now placed on taxpayers in relation to transfer pricing.

- With respect to the compliance matter relating to “time frames” the OECD notes that practices regarding the timing of the preparation of the documentation differ among countries. The OECD however recommends that the local file should be finalised no later than the due date for the filing of the tax return for the fiscal year in question. The master file should be updated by the tax return due date for the ultimate parent of the MNE group. And that the country-by-country report, should be submitted when the final statutory financial statements and other financial information are finalised, which may be after the due date for tax returns for a given fiscal year. In view of these OECD recommendations, it is important that SARS clarifies what its expectations are with respect to each of the three reports.

- With regard to the compliance matter under the heading “retention of documents”, the OECD recommends that taxpayers should not be obliged to retain documents beyond a reasonable period consistent with the requirements of domestic law at either the parent company or local entity level. In South Africa, the rules in relation to retention of documents are contained in Chapter 4 of the Tax Administration Act 28 of 2011, particularly sections 29 to 32 which deal with “returns and records”. It is thus probably not necessary for SARS to provide additional detail as regards retention of documents except to the extent that it is considered necessary to have rules which are specific to transfer pricing documentation.

- With regard to the compliance matter under the heading “frequency of documentation updates” the OECD recommends that transfer pricing documentation be periodically reviewed in order to determine whether functional and economic analyses are still accurate and relevant and to confirm the validity of the applied transfer pricing methodology. Furthermore that the master file, the local file and the country-by-country report should be reviewed and updated annually. And that database searches for comparables be updated every 3 years. It is recommended that SARS should consider including the above guidance in the recommended update to the Practice Note 7.

- As regard the compliance matter under the heading “penalties” the OECD acknowledges that countries normally have documentation-related penalties imposed for failure to comply with transfer pricing documentation requirements or failure to timely submit required information are usually civil (or administrative) monetary penalties. It however quotations that care should be taken not to impose a documentation-related penalty on a taxpayer for failing to submit data to which the MNE group did not have access. In the South African context, with effect from 1 April 2012, the onus to make transfer pricing adjustments has been shifted to taxpayers. Therefore the general penalty regime applicable in terms of the Tax Administration Act applies to

transfer pricing matters as well – specifically in circumstances where a taxpayer fails to make an appropriate transfer pricing adjustment. In this regard it is appropriate to refer to Chapters 15 and 16 of the Tax Administration Act. However, an unresolved issue in South Africa's tax law is the issue of secondary adjustments. Current legislation states that a transfer pricing adjustment by a taxpayer results in a deemed loan to the foreign related party section 31(3) of the Income Tax Act. This has resulted in considerable uncertainty and inconvenience for taxpayers. Because of this, the Budget Documentation associated with the 2014 Budget Speech of the Minister of Finance stated the following:

- Applying the secondary adjustment in the form of a deemed loan is an administrative burden, both for the taxpayer and SARS. The accounting treatment of the deemed loan's repayment and interest is difficult, because there is no legal obligation to repay the loan. It is recommended that the transfer pricing provision be amended to state that the secondary adjustment is deemed to be a dividend or capital contribution depending on the facts and circumstances.

The proposed abolition of the deemed loan mechanism is to be welcomed – for the reasons stated in the Budget Speech. However, it is difficult to understand the reasoning behind suggesting that the secondary adjustment may, in certain circumstances (presumably where the foreign counter-party is a subsidiary rather than a shareholder) be treated as a capital contribution. More specifically, how such treatment will result in a benefit to the South African Fiscus is not clear. It is suggested that the secondary adjustment should take into account the fact that, regardless of the relationship between the South Africa taxpayer and the counter-party, a transfer pricing adjustment is triggered as a result of economic value being transferred from South Africa for no, or inadequate, consideration. This transfer of economic value results in depletion in the asset base of the South African taxpayer; and a resultant potential loss of future taxable income for the Fiscus. For this reason it is suggested that transfer pricing adjustments are economically similar to outbound payments of dividends to foreign related parties since they represent a distribution of value from South Africa to the foreign company. Therefore the secondary adjustment mechanism should result in a tax equivalent to the proposed 15% withholding tax. For example, a tax similar to the old secondary tax on companies (STC) would be appropriate. Because it would be a tax levied on the South African company rather than on the foreign related party, no DTA relief would be available.

- Apart from imposing penalties on taxpayers, the OECD recommends that another way for countries to encourage taxpayers to fulfil transfer pricing documentation requirements is by designing compliance incentives. For example, where the documentation meets the requirements and is timely submitted, the taxpayer could be exempted from tax penalties or subject to a

lower penalty rate if a transfer pricing adjustment is made and sustained, notwithstanding the provision of documentation. SARS should consider coming up with such an incentive programme to encourage compliance.

- With regard to the compliance matters under the heading “other issues”, the OECD recommends that use the most reliable information which is usually local comparables over the use of regional comparables where such local comparables are reasonably available. In this regard, it is important that SARS builds a database of comparable information. In this respect:
    - SARS needs to establish a highly skilled transfer pricing team to include not only lawyers and accountants but also business analysts and economists, to ensure an understanding of commercial operations. This will require that measures are taken to identify, employ and retain skilled personnel especially in the regions.
    - Information required from corporates via the IT14 submissions needs to be improved so that timely decisions can be made on the tax assessment of companies.
    - The collection and sharing of data should be extended to include other holders of vital information such as exchange control information about capital outflows collected by the South African Reserve Bank.