ANNEXURE 8

DAVIS TAX COMMITTEE: SECOND INTERIM REPORT ON BASE EROSION AND PROFIT SHIFTING (BEPS) IN SOUTH AFRICA*

SUMMARY OF DTC REPORT ON ACTIONS 8 TO 10: ALIGNING TRANSFER PRICING OUTCOMES WITH VALUE CREATION; AND 13: RE-EXAMINING TRANSFER PRICING DOCUMENTATION

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 tax laws, they may resort to tax planning in relation to transfer pricing, whereby they ensure that the profits arise in countries with lower tax rates.

The concepts of transfer pricing and "Illicit financial flows" are often confused and it is important to distinguish between these two concepts upfront. 'Transfer pricing' is, as indicated above, simply the price at which goods and services are transferred between connected parties. Provided the arrangements between the parties, and the consequent pricing, reflect what would arise between unconnected parties acting in their own interests (ie a price that would be negotiated arm's length), the transfer pricing is not illegal, and cannot be viewed as an 'illicit financial flow".

Global bodies[2] which advise Governments on tax policy-setting generally recommend the use of the arm's length principle in curbing transfer pricing. Paragraph 1 of Article 9 of the OECD MTC provides for the arm's length principle on the basis 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.

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[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] For example: Article 9(1) of the OECD and the UN Model Tax conventions.

The original commentary on Action 8 of the 2013 OECD Report on Base Erosion and Profit Shifting (BEPS)[3] noted 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 the income into low-tax environments. The final Report[4] notes that the perceived emphasis on *contractual* allocations of functions, assets and risks in the existing transfer pricing guidance can result in outcomes that don't correspond to actual value created by underlying economic activity. The Report (final), it states, thus seeks to clarify and strengthen the rules against this misalignment.

Therefore, the BEPS Action Plan require the guidance on the arm's length principle to be clarified and strengthened and, furthermore, if transfer pricing risks remain after clarifying and strengthening the guidance, the BEPS Action Plan foresees the possibility of introducing special measures either within or beyond the arm's length principle. [5]

It should be noted that the BEPS Action Plan rejects a radical switch to a formulary apportionment system ("Unitary approach") in resolving these transfer pricing problems. Rather, due to difficulties in developing such a method which would be suitable for universal adoption, it advocates building on the existing separate entity approach in terms of the arm's length principle.

That notwithstanding, the essence of the favoured approach should give rise to similar results to the what, it is advocated, the unitary approach should achieve due to the principle, set out in the proposed revised guidelines emanating from Actions 8-10, that profits arise where activities take place and value is created, and increased transparency of the results of the arm's length principle (as determined through the recommendations on documentation as indicated by Action 13, including country-by-country reporting).

Thus, although the allocation of an MNE's global profits will not be based on a 'formula', by using factors which quantify the actual geographical location of its activities, and applying the arm's length principle to those activities with the benefit of visibility of where all other activities take place, tax administrations like SARS will be able to secure tax on the income which reflects the true profits based on South African activities, risks and functions[6].

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

[4] OECD/G20 2015 Final Report on Actions 8-10.

[5] OECD/G20 2015 Final Report on Actions 8-10 at 9.

[6] View supported by SACTWU submission 18/8/2015 at 3/4.

The OECD's work on transfer pricing under the BEPS Action Plan focuses on four key areas:

- Action 8 deals with transfer pricing issues relating to transactions involving intangibles, since misallocation of the profits generated by valuable intangibles has significantly contributed to base erosion and profit shifting.
- Action 9 deals with the contractual allocation of risks, and the resulting allocation of profits to those risks, which may not correspond with the activities actually carried out. The guidelines set out under this Action effectively set out the underlying principles to be followed under the other OECD transfer pricing guidelines (e.g. Action 8), in order to achieve the arm's length principle.
  - Action 9 also addresses the level of returns to funding provided by a capital-rich MNE group member, where those returns do not correspond to the level of activity undertaken by the funding company.
- Action 10 focuses on other high-risk areas. These include:
  - the scope for addressing profit allocations resulting from transactions which are not commercially rational for the individual enterprises concerned (re-characterisation);
  - the scope for targeting the use of transfer pricing methods in a way which results in diverting profits from the most economically important activities of the MNE group, including a specific focus on the pricing of commodities; and
  - neutralising the use of certain types of payments between members of the MNE group (such as management fees and head office expenses) to erode the tax base in the absence of alignment with value creation.

  The importance of the last two of these categories, for developing countries, has been highlighted in the Report.
- Action 13 re-examines transfer pricing documentation with a view to enhancing transparency for tax administrations by ensuring that they will be provided with adequate information to conduct transfer pricing risk assessments and examination. This is considered to be an essential part of tackling the BEPS problem. Action 13 thus introduces the country-by-country reporting standard.

In reviewing the above aspects of the OECD BEPS recommendations it is important to bear in mind the OECD's views on how they are to be implemented:[7] the country-by-country reporting standard, recommended in Action 13, is viewed as a minimum standard (ie all countries should commit to consistent application thereof). Actions 8-10 reinforce international standards to eliminate double taxation, in order to stop abuses and close BEPS opportunities.

[7] OECD/G20 BEPS Explanatory Statement.

The OECD's Report on Actions 8-10 contains detailed revised guidance which responds to the above issues and ensures that the transfer pricing rules secure outcomes that see operational profits allocated to the economic activities which generate them. The guidance in the Report takes the form of specific amendments to the Transfer Pricing Guidelines.[8]

The revised guidance[9] advocates analysing the contractual obligations between the parties against the actual transaction between the parties, and ensuring that the profits are allocated where value is created. It furthermore, guardedly, advocates the disregard of transactions that lack commercial rationality.

So, for example:

- Where a company contractually assumes risks over which it has no meaningful control or financial capacity to assume them, the risks and consequent rewards related thereto are to be allocated to the party who does.
- Similarly for intangibles, the income is to be allocated to the companies which perform important functions, control economically significant risks and contribute assets.
- A capital-rich company merely providing funds to a group company without assessing financial risk will be entitled only to a risk-free return, or less. Such "cash-boxes" will thus not be entitled to excessive profits.

As indicated above, the importance of the adoption of the recommendations made in Action 13 (documentation and transparency) in achieving the successful implementation of the arm's length principle for the intra group movement of goods and services, covered in Actions 8 to 10, globally, is emphasised.

Furthermore, the need for using dispute resolution procedures in the form of Mutual Agreement Procedures (also a minimum standard) and Advance Pricing Agreements (see DTC work on Action 14 and part 9 of this DTC Report), to ensure double taxation does not arise as a consequence of different transfer pricing results being determined by different tax authorities, is clear.

GENERAL ON TRANSFER PRICING IN SOUTH AFRICA

South Africa has transfer pricing legislation in section 31 of the Income Tax (Act 58 of 1962) (the ITA). As the OECD recommends, South Africa applies the arm's length principle to curb transfer pricing. The legislation focuses on cross-border transactions, operations, schemes, agreements or understandings that have been effected between, or undertaken for the benefit of, connected persons.

[8] OECD/G20 2015 Final Report on Actions 8-10 at 10.

[9] OECD/G20 2015 Final Report on Actions 8-10.

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,[10] which are also set out in SARS Practice Note 7.[11] This process is designed to combat the shifting of profits which should rightly be taxed in South Africa, to elsewhere.

Transfer pricing is a key focus area for SARS and an integral part of the Compliance Programme announced and reiterated by the Ministers of Finance (in office at various times).

It is not currently possible to reliably calculate the extent of base erosion and profit shifting as a result of transfer pricing schemes either globally or in South Africa (see OECD and DTC Reports on Action 11, respectively).

ANALYSIS OF ACTIONS 8 to 10 and 13

This detailed DTC Report attempts to follow a logical order when addressing the OECD Actions 8 to 10 and 13, by dealing first with Action 9, on the basis that it lays down the framework for the principles to be applied for ensuring that the outcomes are in line with value creation. Only thereafter are Actions 8 and10 covered and, finally, Action 13, as follows:

Part 1: General Principles for Transfer Pricing
Part 2: OECD Guidance for Applying the Arm's Length Principle;
Part 3: General on South African Transfer Pricing
Part 4: Action 9: Assure Transfer Pricing Outcomes are in Line with Value Creation with regard to Risks and Capital
Part 5: Action 8: Assure Transfer pricing outcomes are in line with value creation with regard to intangibles;
Part 6: Action 8: Updating the Guidance on Cost contribution arrangements;
Part 7: Action10: Ensure Transfer pricing outcomes are in line with value creation: Other high risk transactions.
Part 8: Action 10: Provide Protection against Common Types of Base Eroding Payments such as Management Fees and Head Office expenses- Low Value Added Intra Group Services; Commodity Transactions.
Part 9: Consideration of Advanced Pricing Agreements in the South African context.
Part 10: Action 13: Re-examine Transfer Pricing Documentation;

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

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

The detail of the discussion in each of these sections is not repeated in this summary, but should be referred to for the purposes of providing context to the recommendations made by the DTC, as set out below.

PER PARTS 3 and 4: UPGRADING SOUTH AFRICA'S TRANSFER PRICING RULES, IN GENERAL and ACTION 9: ASSURE TRANSFER PRICING OUTCOMES ARE IN LINE WITH VALUE CREATION WITH REGARD TO RISKS AND CAPITAL:

Based on the general discussion on the current legislative position in South Africa, set out in part 3 of the detailed DTC Report, and the discussion in part 4: Action 9: Assure Transfer Pricing Outcomes are in Line with Value Creation with regard to Risks and Capital the DTC recommends that:

- although the OECD report on Actions 8 to10 indicates that further work is still to follow, based on the DTC's analysis of the recommended changes to be made to the Transfer Pricing Guidelines as a consequence of the Action 8 to10 OECD Report, and in line with the recommendations on the OECD Action 13 Report, in order to reduce the incidence of income not being taxed in South Africa when the risks, functions and values actually take place here, South Africa adopts all the OECD recommendations pertaining to transfer pricing rules and documentation.
- the South African legislators ensure that section 31 of the ITA refers to the OECD guidelines, on the basis that it is obligatory to apply these guidelines for companies that are part of a group that falls above the threshold (EU750mn) requiring country-by-country reporting, but also recommended for smaller companies. Thus, as part of the mandatory application for groups above the threshold, it is recommended that all the documentation requirements should also be compulsory in terms of the legislation. This will ensure global consistency of application and documentation for such groups, as is recommended by the OECD, and foster a system on which foreign investors can rely (in line with the National Development Plan).
- at least one legally Binding General Ruling (BGR), as provided for in section 89 of the Tax Administration Act, 2011, be enacted on section 31. Without departing from the OECD Transfer Pricing Guidelines, the suggested General Ruling should include a set of principles reflecting the South African reality eg to define the method for converting the threshold amount to SA Rands.
- when taxpayers perform benchmarking studies to arrive at an arm's length price, due to the absence of local comparable data, it only be mandatory to take to make adjustments to the results as a consequence of location savings advantages/disadvantages, following the issue of guidance by SARS/

Treasury in the BGR, as to how to make the specific adjustments for South Africa's specific circumstances.[12]

- for the purposes of providing certainty to inbound investors where loans are not significant, the BGR defines a safe harbour e.g specified debt to equity ratio (or refers to the calculation set out in section 23M of the ITA), together with an interest rate (e.g. prime +2% - or in line with prevailing EXCON requirements) for inbound loans not exceeding, say, R100mn. In this manner inbound investors will not need to spend significant amounts on professional fees to determine an arm's length amount for loans below the pre-defined limit. .
- the implementation of an Advanced Pricing Agreement (APA) regime, which would also provide certainty for investors. In order to introduce the option for APAs to be obtained in South Africa, SARS will be need to be given the resources to build an APA unit.
- SARS ensures 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 to audit the results.[13]

To reiterate the last point, above, the adoption of the recommendations set out above, however, requires "sufficient transfer pricing resources at SARS to provide the guidance and to audit the results".[14]

The DTC, however, cautions that, although the objective of the transfer pricing rules, proposed by the OECD, is to secure the taxation of the profits of MNE's in those countries where the functions, risks, and value lie, South Africa could be a net loser in the equation if it fails to successfully lure MNE's to the country, due to other unattractive non-tax practices and policies.

PER PART 5: ACTION 8: ASSURE TRANSFER PRICING OUTCOMES ARE IN LINE WITH VALUE CREATION WITH REGARD TO INTANGIBLES;

Based on the discussion in Part 5, on Action 8: Assure Transfer pricing outcomes are in line with value creation with regard to intangibles, which focuses on determining the location of income and costs in the locations where the development, enhancement, maintenance, protection and exploitation of intangibles are capable of and actually take place, the DTC recommends that:

- South Africa adopts the principles set out in the OECD Action 8 Report in order to align with its trading partners' methodologies relating to intangibles, but that like the OECD, it reserves its rights to review and refine the methodology over time, as it becomes clear whether it satisfies the correct allocation of profits principle.

[12] Per recommendation by Deloitte 26 July 2015 at 7.

[13] Per SACTWU submission 18 August 2015 at 4.

[14] Per SACTWU submission 18 August 2015 at 4.

- Greater transparency of the exchange control rules be considered.[15] The exchange control legal and regulatory framework that exists between the SARB and the delegated powers of the Authorised Dealers (and the DTI) results in the rules relating to the import, export and the use of intellectual property not being readily available, and not being consistently applied, to persons wishing to apply them properly.
- OECD's BEPS Action 8, which requires countries to enact legislation to prevent transfer pricing using 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. In addition, South African CFC rules exclude intangibles from the CFC exemption benefits, section 23I of the ITA is an anti-avoidance provision which prohibits the claiming of an income tax deduction in respect of "tainted IP", and the "beneficial ownership" requirement in the royalty article (12) of DTAs can also be applied to deny the reduced withholding tax treaty rate if the recipient lacks substance. This can be further reinforced by cross boarder reporting rules on intangibles.
- any future developments of EXCON rules for IP (and specifically any liberalisation of these rules) be carefully considered from a transfer pricing point of view. As indicated above, 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 Ideally EXCON policy development in this area should be informed by tax (and specifically transfer pricing) considerations.
- care 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. It may for instance be advisable to revisit South Africa's R&D tax incentive to ensure that it is comparable to that in South Africa's trading partners.
- as a separate but related point, Government considers the attractiveness of South Africa as a destination for intangible related activity and consequent intangible related returns. The Key factors that influence South Africa's attractiveness as:
    - The effective tax rate of the South African operations (considering all tax factors);
    - The certainty of tax treatment;
    - The availability of local skills; and
    - The ability of foreign skills to sustainably migrate to South Africa. On this point current immigration laws and their application do not promote the attraction of highly skill individuals to South Africa. The impact of this can be to limit the case for greater intangible returns to SA. [16]

[15] PWC "Comments on DTC BEPS First Interim Report" (30 march 2015) at 23.

[16] PWC "Comments on DTC BEPS First Interim Report" (30 march 2015) at 23.

PER PART 6: ACTION 8: UPDATING THE GUIDANCE ON COST CONTRIBUTION ARRANGEMENTS

Set out in the OECD Transfer Pricing Guidelines there are various methods which are considered to be acceptable for determining the arm's length principle. One of these, which is, at times, used when different group companies are involved in contributing to the same transaction e.g. in particular, the development of IP, is the cost contribution method. Guidelines of how this method may be applied more effectively are set out in Action 8. Based on the discussion on such cost contribution arrangements, on part 6 of the DTC's detailed report, the DTC recommends that:

- notwithstanding that CCA's may be rarely seen in the South African context, as such arrangements arise offshore and may include South African entities, South Africa adopts the proposed guidelines for CCA's and ensures that it has sufficient exchange of information agreements in place to be able to derive the information that it requires should the taxpayer not be forthcoming.
- in line with the other recommendations, this recommendation again requires that SARS has the necessary resources and training to evaluate CCAs and obtain the necessary information.

PER PART 7: ACTION10: ENSURE TRANSFER PRICING OUTCOMES ARE IN LINE WITH VALUE CREATION: OTHER HIGH RISK TRANSACTIONS

TRANSACTIONAL PROFIT SPLIT METHOD (TPSM)

As indicated above, set out in the OECD Transfer Pricing Guidelines there are various methods which are considered to be acceptable for determining the arm's length principle. Another one of these, which it was felt required clarification, is the Transactional Profit Split Method (TPSM), which may be used in the context of global value chain, but which is often considered a method of last resort ie when no other 'one-sided' method appears to provide a suitable result e.g. in highly integrated operations, due to the complexities around applying it. Based in the discussion on this method, in part 7 of te DTC Report the DTC recommends that:

- South Africa does not attempt to issue its own guidelines regarding the TPSM, but waits for the outcome of the OECD work still to be performed.
- the absence of local South African comparables should not be considered the determinant that the TPSM is the most appropriate method. The availability of all data should first be assessed. Failure to do so will lead to all countries that have no data adopting the TPSM, which will potentially give rise to corresponding double taxation and transfer pricing disputes risks.[17] This could potentially detriment inward investment to South Africa.

[17] Deloittes submission to DTC July 2015 at 6.

- the South African Regulators consider the need for publication of data by South African companies, or for SARS and/or Stats SA to issue information, based on data available to them, that may be suitably be used for South African comparability purposes. Such data is common in the rest of the World, and is what the currently available databases[18] are based upon.

PER PART 8: ACTION 10: PROVIDE PROTECTION AGAINST COMMON TYPES OF BASE ERODING PAYMENTS SUCH AS MANAGEMENT FEES AND HEAD OFFICE EXPENSES - LOW VALUE ADDED INTRA GROUP SERVICES; COMMODITY TRANSACTIONS

LOW VALUE ADDED SERVICES

A major BEPS concern among many developing countries in which MNE enterprises operate, including South Africa and other African countries, is that these enterprises claim deductions for various head office expenses such as management, technical and service fees, often leaving little or no profit in the paying country. Based on the discussion on this issue in part 8 the DTC recommends that:

- in line with other countries, and to ensure the success of the simplified approach, South Africa adopts the simplified approach for low value added services, as defined. This approach is based on the actual cost of the services (with a pre-determined suitable allocation key) plus a standard mark-up, recommended to be 5%, as proposed by the OECD, but also implements a suitable threshold for the amount of such services, to which this method can be applied . The level of this threshold to be evaluated once the further OECD work is complete.
- SARB be approached to align with this approach.
- in line with the Minister of Finance's 2016 Budget Speech, the services withholding tax be scrapped.

COMMODITIES

Developing countries, including South Africa, have identified commodities as of critical importance to them insofar as BEPS challenges are concerned. Action 10 recommends the application of comparable uncontrolled price (CUP) method for pricing such transactions for transfer pricing purposes and advises that this may be determined using quoted prices with suitable comparability adjustments. Based on the discussion in Part 8 of the DTC Report, the DTC recommends that:

- South Africa follows the OECD Guidelines on Commodities, including the additional guidelines, set out in Actions 8-10, with particular reference to

[18] Eg Bureau van Dijk's Amadeus; Thompson Reuters; Royaltysource; Lexisnexis; Onesource; (all commonly used by taxpayers and tax authorities globally).

quoted prices[19] and dates on which to apply these, as well as necessary adjustments, taking into account the comparability factors mentioned in the report (and others), and uses these as the basis on which to establish a benchmark price. Such a price should be one that results in an appropriate level of profit for the affiliate based on its activities in the country, and taking into account the value it creates for the MNE as a whole. This includes the benefits of providing a source of supply combined with the management of stocks and of ultimate delivery, and access to raw materials which is a type of location-specific advantage;

- SARS consults with Industry to understand the "quoted price" data, its origins and how MNE's actually price the sale of commodities through the value chain, as well as South Africa's location in the context of key markets, the transport logistics and demurrage risks in order to determine the situations when it might be appropriate to apply the "deemed pricing date";[20]
- SARS issues guidance on the nature of adjustments that would be expected to be made to the quoted price, from a South Africa specific perspective, and only make such adjustments mandatory once such guidance has been issued;
- South African considers the implementation of Advanced Pricing Agreements to ensure certainty for both taxpayers and SARS.
- SARS has the resources to apply these Guidelines, in particular, to facilitate the timely conclusion of APA/MAP procedures with respect to commodity transactions to ensure non-double taxation. In addition, the SARS resources are sufficiently trained.

PER PART 9: CONSIDERATION OF ADVANCE PRICING AGREEMENTS IN THE SOUTH AFRICAN CONTEXT

There are various types of Advance Pricing Agreements (APAs) which may be reached between taxpayers and their own revenue authorities and, potentially, also another revenue authority where the other side of a transaction takes place. Such agreements generally increase certainty for taxpayers and tax authorities regarding the transfer pricing amounts of a particular transaction, and thereby encourage trade. Based on the discussion in part 9, the DTC recommends that

- SARS considers putting in place an APA regime in South Africa, subject to it ensuring it has adequate resources.

(It will be noted that this recommendation appears in other parts of this Report as it supports other areas discussed).

[19] The EFF's submission to the Davis Tax Committee supports the recommendation of the application of the quoted price (Sixth method) in South Africa at 31 and 39.

[20] Deloittes submission to DTC: 26 July 2015 at 5.

PER PART 10: ACTION 13: RE-EXAMINE TRANSFER PRICING DOCUMENTATION

That taxpayers supply sufficient documentation to enable Revenue authorities to determine how business operate globally and where transfer pricing risks may arise is considered a critical aspect of the work performed by the OECD team working on the Action Plan.

Action 13 sets out revised guidance for transfer pricing documentation in order to achieve this objective, together with examples of how such documentation, which takes the form of: 1. Master File setting out an overall picture of the group's operations; 2. A country file setting out the detailed functions and risks taking place in each country that the global group operations; and 3. A country by country report providing, in template format, detailed numerical information on what and where the MNE's people, assets, income and costs arise, for the purposes of facilitating risk assessment by each Revenue authority which will receive it (on an automatic exchange of information basis).

Based on the discussion on Action 13, and the fact that this is considered to be a Minimum Standard, the DTC recommends that:

- ➢ preparing a master file, local file and country-by-country reporting be compulsory for large Multinational businesses ie legislated via reference to the OECD Guidelines in section 31. In line with the OECD Guidelines, MNE groups with annual consolidated group revenue in the immediately preceding fiscal year of €750 million (converted at year end) could be considered to be large MNEs.
- ➢ a Binding General Ruling (see under general notes above) be issued setting out *inter alia* how the conversion be performed locally eg based on SARS average rates for the year.
- ➢ as the OECD recommends, with regard to compliance matters under the heading "materiality", disproportionate and costly documentation requirements should not imposed on SMEs (groups with consolidated turnover less than the defined threshold (currently EU750)). SMEs should not be required to produce the same amount of documentation that might be expected from larger enterprises. Such documentation could be recommended but not obligatory, leaving the amount of transfer pricing documentation produced to support the pricing to the relevant SME group. However, SMEs could be obliged to provide information about their material cross-border transactions in their tax returns to facilitate risk assessment (as is presently the case), and upon a specific request of the tax administration in the course of a tax examination or for further transfer pricing risk assessment purposes. It is however important that definition of material transactions be clarified.
- ➢ SARS revises PN 7 to be in line with the OECD revised Transfer Pricing Documentation Guidelines in Chapter V and recommended for companies that

are part of smaller groups.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 could be adopted in South Africa, as a recommendation even for groups of companies with turnover below the OECD threshold.

- although with regard to country-by country reporting, South Africa, along with other emerging economies, is 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 in order to perform risk assessments where it is found challenging to obtain information on the global operations of an MNE group headquartered elsewhere, since the OECD plans to take these views into consideration and review the implementation thereof no later than end of 2020, South Africa monitors the OECD's final recommendations in this regard and then implements them, but remains in line with the prevailing OECD guidelines at any particular time. This will ensure consistency of treatment of companies in groups globally. Furthermore, as the country-by country report is designed to provide information for risk assessment only the relevant authority (e.g. SARS) would still be in a position to ask for detailed information regarding any particular transaction paid/received by the local company.

- for the purposes of providing certainty to inbound investors where loans are not significant, the revised PN7 defines a safe harbour eg debt to equity ratio (or in line with s23M), together with interest rate (eg prime +2% - or in line with prevailing EXCON requirements) for inbound loans not exceeding, say, R100mn. In this manner inbound investors will obtain the certainty they need regarding loan requirements without having to expend significant amounts to determine an arm's length amount for loans below the pre-defined limit.
- the various provisions in the Tax Administration Act which deal with confidentiality, which include sections 21, 56 and Chapter 6 of the Tax Administration Act be strengthened in line with the OECD recommendations. 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).
- SARS clarifies what its expectations are with respect to the timing of submission of each of the three reports, in line with the OECD recommendations. 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.

- clear guidance should be issued on *which* group company has the legal obligation to retain what transfer pricing documentation. In this respect a distinction should be made between in-bound and outbound groups. [21] 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, other than as recommended here, 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.
- SARS considers including guidance in the recommended update to the Practice Note 7 and the BGR with regard to the requirement of 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 adhere to these recommendations.
- Clarity be provided in in the legislation or the revised PN 7/BGR that the secondary adjustment mechanism results in a tax equivalent to the 15% withholding tax with no DTA relief available.
- SARS considers coming up with additional measures to encourage compliance. 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 continues to reinforce and expand its highly skilled transfer pricing team, including 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.

[21] PWC "Comments on DTC BEPS First Interim Report" (30 march 2015) at 23.

- SARS improves Information required from corporates via the ITR14 submissions so that timely decisions can be made on the risk assessment of companies, and any consequent queries and adjustments, especially SME's that are not compelled to compile country by country reporting information. The guidance provided by SARS in the Tax Return Guide in respect of the relevant information is often unclear and needs significant improvement. In addition, the Tax Return Guide is updated once in a while, however, taxpayers are not notified of these updates, which may result in a taxpayer completing transfer pricing related disclosure following specific guidance, but at the time the tax return is submitted via e-filing, the guidance (or even the question in the tax return) may have changed without the taxpayer being sufficiently notified of this.[22]
- the collection and sharing of data be extended to include other holders of vital information such as exchange control information about capital outflows collected by the South African Reserve Bank.
- care be taken to ensure that even when SARS builds a data base, taxpayers such as financial institutions can still make use of non-publically available data so that they are able to defend their positions against these comparables, since with respect to financial institutions, financial data available to SARS usually includes publically available and non-publically available data. This will also minimise the uncertainties for taxpayers with respect to updating their data and other administrative issues surrounding data keeping.[23]
- the use of safe harbour rules, which can be easily applied and documented be considered.

[22] SAICA "Comment on DTC 1st Interim BEPS Report" (31 March 2015) para 26.

[23] Comments submitted to the DTC by the Banking Association South Africa (BASA) on the "DTC First Interim Report on BEPS Action Plan 1" (25 March 2015) at 2.

DTC REPORT ON ACTIONS 8 TO 10: ALlGNING TRANSFER PRICING OUTCOMES WITH VALUE CREATION; AND 13: RE-EXAMINING TRANSFER PRICING DOCUMENTATION

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1 GENERAL ON TRANSFER PRICING

"Over several decades and in step with the globalisation of the economy, world-wide intra-group trade has grown exponentially"[1] This together with differing tax rates adopted by countries who guard their sovereign rights to determine their own tax regimes, has encouraged multinational companies to get involved in transfer pricing planning schemes.

The term "transfer pricing" describes the process by which related entities set prices at which they transfer goods or services between each other.[2] When multinational companies operate in different countries, where they are subject to different tax laws, they may resort to structuring their affairs in order to achieve a transfer pricing outcome whereby profits are lower in a country with higher tax rates and yet higher in a country with lower tax rates.[3]

Global bodies [4] which advise Governments on tax policy setting generally recommend 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.

The 2013 OECD Report on Base Erosion and Profit Shifting (BEPS)[5] noted that although, in many instances, the arm's length principle has effectively and efficiently allocated the income of multinationals among taxing jurisdictions, and although it has proven useful as a practical and balanced standard for tax administrations and taxpayers to evaluate transfer prices between associated enterprises, and to prevent double taxation, 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" the income into low-tax environments.

[*] DTC BEPS Sub-committee: Prof Annet Wanyana Oguttu, Chair DTC BEPS Subcommittee (University of South Africa - LLD in Tax Law; LLM with Specialisation in Tax Law, LLB, H Dip in International Tax Law); Prof Thabo Legwaila, DTC BEPS Sub-Committee member (University of Johannesburg - LLD,) and Ms Deborah Tickle, DTC BEPS Sub-Committee member (Director International and Corporate Tax Managing Partner KPMG).

[1] OECD/G20 2015 Final Report on Actions 8-10 at 9.

[2] 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.

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

[4] For example the OECD and the UN Model Tax conventions.

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

With the arm's length principle's perceived emphasis on contractual allocations of functions, assets and risks, the existing guidance on the application of the principle has also proven vulnerable to manipulation. This manipulation can lead to outcomes which do not correspond to the value created through the underlying economic activity carried out by the members of an MNE group.[6]

Therefore, the BEPS Action Plan requires the guidance on the arm's length principle to be clarified and strengthened and, furthermore, if transfer pricing risks remain after clarifying and strengthening the guidance, the BEPS Action Plan foresees the possibility of introducing special measures either within or beyond the arm's length principle. [7]

The OECD's work on transfer pricing under the BEPS Action Plan focuses on four key areas.

- Action 8 deals with transfer pricing issues relating to transactions involving intangibles, since misallocation of the profits generated by valuable intangibles has contributed to base erosion and profit shifting.
- Action 9 deals with the contractual allocation of risks, and the resulting allocation of profits to those risks, which may not correspond with the activities actually carried out. The guidelines set out under this Action effectively set out the underlying principles to be followed under the other OECD guidelines (e.g. Action 8), in order to achieve the arm's length principle.
  - Action 9 also addresses the level of returns to funding provided by a capital-rich MNE group member, where those returns do not correspond to the level of activity undertaken by the funding company.
- Action 10 focuses on other high-risk areas. These include:
  - the scope for addressing profit allocations resulting from transactions which are not commercially rational for the individual enterprises concerned (re-characterisation);
  - the scope for targeting the use of transfer pricing methods in a way which results in diverting profits from the most economically important activities of the MNE group; and
  - neutralising the use of certain types of payments between members of the MNE group (such as management fees and head office expenses) to erode the tax base in the absence of alignment with value creation.
- Action 13 re-examines transfer pricing documentation with a view to enhancing transparency for tax administrations by ensuring that they will be provided with adequate information to conduct transfer pricing risk assessments and examination. This is considered to be an essential part of tackling the BEPS problem. Action 13 thus introduces the country by country reporting standard.

[6] OECD/G20 2015 Final Report on Actions 8-10 at 9.

[7] OECD/G20 2015 Final Report on Actions 8-10 at 9.

In reviewing the above aspects of the OECD BEPS recommendations it is important to bear in mind the OECD's views on how they are to be implemented:[8] the country by country reporting standard, recommended in Action 13, is viewed as a minimum standard (ie all countries should commit to consistent application thereof). Actions 8-10 reinforce international standards to eliminate double taxation, in order to stop abuses and close BEPS opportunities.

The OECD's Report on Actions 8-10 contains detailed revised guidance which responds to the above issues and ensures that the transfer pricing rules secure outcomes that see operational profits allocated to the economic activities which generate them. The guidance in the Report takes the form of specific amendments to the Transfer Pricing Guidelines.[9]

The guidance on Actions 8-10 is linked in a holistic way with other Actions, in particular:

- interest deductibility rules in Action 4 - with regard to capital-rich entities.
- preventing treaty abuse in Action 6.
- CFC rules under Action 3.
- Since transfer pricing analysis depends on access to relevant information, access to the transfer pricing documentation under Action 13 is relevant and, since these aspects (analysis and documentation) are so intrinsically linked the discussion on the re-examination of transfer pricing documentation is included in this report.
- Since transfer pricing depends on a facts and circumstances analysis and can involve subjective interpretations of these facts and circumstances, in order to address the risk of double taxation, the work under Action 14 to improve the effectiveness of dispute resolution mechanisms includes a new minimum standard providing for access to the Mutual Agreement Procedure of Article 25 of the Model Tax Convention for all transfer pricing cases.

The OECD Final Report on Actions 8-10 also contains guidance on transactions involving commodities as well as on low value-adding intra-group services. These two areas were identified by developing countries as being of critical importance to them since they create additional transfer pricing BEPS challenges for developing countries. Guidance on these matters in Action 8-10 will be supplemented with further work mandated by the G20 Development Working Group, which will provide knowledge, best practices, and tools for developing countries to use to price commodity transactions for transfer pricing purposes and to prevent the erosion of their tax bases through common types of base eroding payments. [10]

[8] OECD/G20 BEPS Explanatory Statement.

[9] OECD/G20 2015 Final Report on Actions 8-10 at 10.

[10] OECD/G20 2015 Final Report on Actions 8-10 at 11.

In a nutshell, the work under Actions 8-10 of the BEPS Action Plan will ensure that transfer pricing outcomes better align with value creation of the MNE group. Moreover, the holistic nature of the BEPS Action Plan will ensure that the role of capital-rich, low-functioning entities in BEPS planning will become less relevant. As a consequence, the goals set by the BEPS Action Plan in relation to the development of transfer pricing rules have been achieved without the need to develop special measures outside the arm's length principle.

Commentators, like Chorvat[11], have proposed, especially in relation to intangibles, the use of financial/economic models as a way to allocate profits among related parties. She suggests the use of models such as the "Capital Asset Pricing Model" which allocates value based on capital and risk. Chorvat[12] argues that such a model allows for the allocation of profits among related parties based on the risk assumed. She notes that this would better comprehend corporate behaviour, aid in alleviating the shortcomings of the traditional arm's length approach and is consistent with economic theory.[13]

It should be noted, however, that the BEPS Action Plan rejects a radical switch to a formulary apportionment system ("Unitary approach") in resolving these transfer pricing problems. Rather, due to difficulties in developing such a method which would be suitable for universal adoption[14], it advocates building on the existing separate entity approach in terms of the arm's length principle. That notwithstanding, the essence of the favoured approach should, the DTC submits, give rise to similar results to what, it is advocated, the unitary approach should achieve.

This is due to the principle, set out in the proposed revised guidelines emanating from Actions 8-10, that profits arise where activities take place and value is created. Furthermore, increased transparency of the results of the arm's length principle (as determined through the recommendations on documentation as indicated by Action 13, including country-by-country reporting), will increase the ability of Revenue authorities to establish the position.

Thus, although the allocation of an MNE's global profits will not be based on a 'formula', by using factors which quantify the actual geographical location of its activities, and applying the arm's length principle to those activities with the benefit of visibility of where all other activities take place, tax administrations, like SARS, will be able to secure tax on the income which reflects the true profits based on South African activities, risks and functions[15].

[11] Chorvat at 1266.

[12] Chorvat at 1260.

[13] Chorvat at 1260.

[14] Explanation by UN representative, Ilke Ritter, at TP Minds seminar, Cape Town, 24/25 November 2015.

[15] Objective supported by SACTWU submission 18/8/2015 at 3/4.

It should further be noted that the OECD has indicated that further work will be undertaken on the transactional profit split method (TPSM) and financial transactions.[16]

In addition to the discussion on Actions 8-10 and 13 of the BEPS Action Plan, this report will cover the question of the suitability of, and need for, advance pricing agreements (APA's) in the South African transfer pricing context. It should be noted that APA's are also discussed in the DTC report on Action 14.

The concepts of transfer pricing and "Illicit financial flows" are often confused and it is important to distinguish these two concepts upfront. 'Transfer pricing' is, as indicated above, simply the price at which goods and services are transferred between connected parties. Provided the arrangements between the parties, and the consequent pricing, reflect what would arise between unconnected parties acting in their own interests (ie a price that would be negotiated arm's length), the transfer pricing is not illegal, and cannot be viewed as an 'illicit financial flow".

An 'illicit financial flow' is "money that is illegally earned, transferred or utilized. If it breaks laws in its origin, movement or use, it merits the label".[17] Such flows include the proceeds of activities commonly understood to be illegal eg money laundering (drugs, arms etc) but also include the proceeds of such illegal activities as tax evasion. This can, thus, include illegal transfer mis-pricing[18]. Actions to counter BEPS can thus assist in countering illicit financial flows[19] but are not designed specifically, or only, for that purpose, as to counter such flows requires a much broader initiative. (It should be noted that a combination of South African organisations and government departments are working together to combat illicit financial flows).[20]

The transfer pricing guidelines issued by the OECD and UN are designed to assist MNEs to determine what the arm's length market prices and arrangements of their cross border arrangements should be, and how, once determined, they can demonstrate this to tax administrations. Since, as indicated above, the rules have not been clear and transparent enough to achieve this objective in the past, the Reports on Actions 8-10 and 13 have been designed to significantly tighten the guidelines to ensure the arm's length principle is achieved.

[16] OECD/G20 2015 Final Report on Actions 8-10 at 12.

[17] "Illicit Financial Flows from Africa: Hidden Resources for Development" by Global Financial Integrity (prepared by Dev Kar and Devon Cartwright Smith (www.gfip.org) at p7.

[18] Presentation by Kathy Nicolaou-Manias on 'Illicit Financial Flows, AbusiveTransfer Pricing and Trade Mis-pricing' (11 Sept 2015) Slide 5.

[19] Ibid.

[20] Presentation by Kathy Nicolaou-Manias on 'Illicit Financial Flows, AbusiveTransfer Pricing and Trade Mis-pricing' (11 Sept 2015) Slide 19.

2 OECD GUIDANCE FOR APPLYING THE ARM'S LENGTH PRINCIPLE

The guidance set out in the OECD's 2015 Final Report on Actions 8-10 requires the development of transfer pricing rules which create transfer pricing outcomes in line with value creation. In this regard, the current provisions of Chapter I, Section D of the 1995 Transfer Pricing Guidelines are deleted in their entirety and replaced.

In brief, the revised guidance[21] advocates analysing the contractual obligations between the parties against the actual transaction between the parties, and ensuring that the profits are allocated where value is created. It furthermore, guardedly, advocates the disregard of transactions that lack commercial rationality.

So, for example:

- where a company contractually assumes risks over which it has no meaningful control or financial capacity to assume them, the risks and consequent rewards related thereto are to be allocated to the party who does.
- Similarly for intangibles, the income is to be allocated to the companies which perform important functions, control economically significant risks and contribute assets.
- A capital-rich company merely providing funds to a group company without assessing financial risk will be entitled only to a risk-free return, or less. Such "cash-boxes" will thus not be entitled to excessive profits.

The importance of the adoption of the recommendations made in Action 13 (documentation and transparency) in achieving the successful implementation of the arm's length principle for the intra group movement of goods and services, covered in Actions 8 to 10, globally, is emphasised.

Furthermore, as indicated above, the need for using dispute resolution procedures in the form of Mutual Agreement Procedures (see DTC work on Action 14) to ensure double taxation does not arise as a consequence of different transfer pricing results being determined by different tax authorities is clear.

The details of the revised Chapter 1, Section D are as follows:

OECD notes that "comparability analysis" is at the heart of the application of the arm's length principle. Application of the arm's length principle is based on a comparison of the conditions in a controlled transaction with the conditions that would have been made had the parties been independent and undertaking a comparable transaction under comparable circumstances. There are two key aspects in such an analysis:

[21] OECD/G20 2015 Final Report on Actions 8-10.

- the first aspect is to identify the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations in order that the controlled transaction is accurately delineated; and
- the second aspect is to compare the conditions and the economically relevant circumstances of the controlled transaction as accurately delineated with the conditions and the economically relevant circumstances of comparable transactions between independent enterprises.

In this regard, the OECD provides the following guidance on identifying the commercial or financial relations between the associated enterprises and on accurately delineating the controlled transaction.[22]

2.1 IDENTIFYING THE COMMERCIAL OR FINANCIAL RELATIONS

The typical process of identifying the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations requires a broad-based understanding of the industry sector in which the MNE group operates (e.g. mining, pharmaceutical, luxury goods) and of the factors affecting the performance of any business operating in that sector. The understanding is derived from an overview of the particular MNE group which outlines how the MNE group responds to the factors affecting performance in the sector, including its business strategies, markets, products, its supply chain, and the key functions performed, material assets used, and important risks assumed. This information is likely to be included as part of the master file as described in Action 13 in support of a taxpayer’s analysis of its transfer pricing, and provides useful context in which the commercial or financial relations between members of the MNE group can be considered.[23]

The process then narrows to identify how each MNE within that MNE group operates, and provides an analysis of what each MNE does (e.g. a production company, a sales company) and identifies its commercial or financial relations with associated enterprises as expressed in transactions between them. The accurate delineation of the actual transaction or transactions between the associated enterprises requires an analysis of the economically relevant characteristics of the transaction. These economically relevant characteristics consist of the conditions of the transaction and the economically relevant circumstances in which the transaction takes place. The application of the arm’s length principle depends on determining the conditions that independent parties would have agreed in comparable transactions in comparable circumstances. Before making comparisons with uncontrolled

[22] OECD/G20 2015 Final Report on Actions 8-10 in para 1.33.

[23] OECD/G20 2015 Final Report on Actions 8-10 in para 1.33.

transactions, it is therefore vital to identify the economically relevant characteristics of the commercial or financial relations as expressed in the controlled transaction.[24]

The economically relevant characteristics or comparability factors that need to be identified in the commercial or financial relations between the associated enterprises in order to accurately delineate the actual transaction can be broadly categorised as follows (explained in some detail below):

- The contractual terms of the transaction.
- The functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices.
- The characteristics of property transferred or services provided.
- The economic circumstances of the parties and of the market in which the parties operate.
- The business strategies pursued by the parties.

This information about the economically relevant characteristics of the actual transaction should be included as part of the local file (for purposes of Action 13) in support of a taxpayer's analysis of its transfer pricing.[25]

(i) The contractual terms of the transaction

A transaction is the consequence or expression of the commercial or financial relations between the parties. The controlled transactions may have been formalised in written contracts which may reflect the intention of the parties at the time the contract was concluded in relation to aspects of the transaction covered by the contract including, in typical cases, the division of responsibilities, obligations and rights, assumption of identified risks, and pricing arrangements. Where a transaction has been formalised by the associated enterprises through written contractual agreements, those agreements provide the starting point for delineating the transaction between them and how the responsibilities, risks, and anticipated outcomes arising from their interaction were intended to be divided at the time of entering into the contract. The terms of a transaction may also be found in communications between the parties other than a written contract.[26]

However, the written contracts alone are unlikely to provide all the information necessary to perform a transfer pricing analysis, or to provide information regarding the relevant contractual terms in sufficient detail. Further information will be required by taking into consideration evidence of the commercial or financial relations provided by the economically relevant characteristics: the functions performed by each of the parties to the transaction, taking into account assets used and risks

[24] OECD/G20 2015 Final Report on Actions 8-10 in para 1.34.
[25] OECD/G20 2015 Final Report on Actions 8-10 in para 1.36.
[26] OECD/G20 2015 Final Report on Actions 8-10 in para 1.42.

assumed, together with the characteristics of property transferred or services provided, the economic circumstances of the parties and of the market in which the parties operate, and the business strategies pursued by the parties. Taken together, the analysis of economically relevant characteristics in all five categories provides evidence of the actual conduct of the associated enterprises.[27]

(ii) Functional analysis

In transactions between two independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed). Therefore, in delineating the controlled transaction and determining comparability between controlled and uncontrolled transactions or entities, a functional analysis is necessary. This functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions.

The analysis for each transaction focuses on what the parties actually do and the capabilities they provide. Such activities and capabilities will include decision-making, including decisions about business strategy and risks. For this purpose, it may be helpful to understand the structure and organisation of the MNE group and how they influence the context in which the MNE operates. In particular, it is important to understand how value is generated by the group as a whole, the interdependencies of the functions performed by the associated enterprises with the rest of the group, and the contribution that the associated enterprises make to that value creation. It will also be relevant to determine the legal rights and obligations of each of the parties in performing their functions. While one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transactions that is important.[28]

The functional analysis should consider the type of assets used, such as plant and equipment, the use of valuable intangibles, financial assets, etc., and the nature of the assets used, such as the age, market value, location, property right protections available, etc.[29]

Analysis of risks in commercial or financial relations

A functional analysis is incomplete unless the material risks assumed by each party have been identified and considered, since the actual assumption of risks would influence the prices and other conditions of transactions between the associated enterprises. A detailed discussion of this process is set out in the discussion on Action 9 (see 3.1 *et seq* below.

[27] OECD/G20 2015 Final Report on Actions 8-10 in para 1.43.

[28] OECD/G20 2015 Final Report on Actions 8-10 in para 1.51.

[29] OECD/G20 2015 Final Report on Actions 8-10 in para 1.54.

(iii) Characteristics of property or services

Differences in the specific characteristics of property or services often account, at least in part, for differences in their value in the open market. Therefore, comparisons of these features may be useful in delineating the transaction and in determining the comparability of controlled and uncontrolled transactions. Characteristics that may be important to consider include the following: in the case of transfers of tangible property, the physical features of the property, its quality and reliability, and the availability and volume of supply; in the case of the provision of services, the nature and extent of the services; and in the case of intangible property, the form of transaction (e.g. licensing or sale), the type of property (e.g. patent, trademark, or know-how), the duration and degree of protection, and the anticipated benefits from the use of the property. [30]

(iv) Economic circumstances

Arm’s length prices may vary across different markets even for transactions involving the same property or services. Therefore, to achieve comparability requires that the markets in which the independent and associated enterprises operate do not have differences that have a material effect on price or that appropriate adjustments can be made. As a first step, it is essential to identify the relevant market or markets, taking account of available substitute goods or services. Economic circumstances that may be relevant to determining market comparability include the geographic location; the size of the markets; the extent of competition in the markets and the relative competitive positions of the buyers and sellers; the availability (risk thereof) of substitute goods and services; the levels of supply and demand in the market as a whole and in which particular regions, if relevant; consumer purchasing power; the nature and extent of government regulation of the market; costs of production, including the costs of land, labour, and capital; transport costs; the level of the market (e.g. retail or wholesale); the date and time of transactions; and so forth. [31]

(iv) Business strategies pursued by the parties.

Business strategies must also be examined in delineating the transaction and in determining comparability for transfer pricing purposes. Business strategies would take into account many aspects of an enterprise, such as innovation and new product development, degree of diversification, risk aversion, assessment of political changes, input of existing and planned labour laws, duration of arrangements, and other factors bearing upon the daily conduct of business. Such business strategies may need to be taken into account when determining the comparability of controlled and uncontrolled transactions and enterprises. [32]

[30] OECD/G20 2015 Final Report on Actions 8-10 in para 1.107.

[31] OECD/G20 2015 Final Report on Actions 8-10 in para 1.110.

[32] OECD/G20 2015 Final Report on Actions 8-10 in para 1.114.

2.2 RECOGNITION OF THE ACCURATELY DELINEATED TRANSACTION

Every effort should be made to determine pricing for the actual transaction as accurately delineated under the arm's length principle. A tax administration should not disregard the actual transaction or substitute other transactions for it unless there are exceptional circumstances.[33] Because non-recognition can be contentious and a source of double taxation, every effort should be made to determine the actual nature of the transaction and apply arm's length pricing to the accurately delineated transaction, and to ensure that non-recognition is not used simply because determining an arm's length price is difficult. The key question in the analysis is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances, not whether the same transaction can be observed between independent parties. The non-recognition of a transaction that possesses the commercial rationality of an arm's length arrangement is not an appropriate application of the arm's length principle.[34]

2.3 LOSSES

When an associated enterprise consistently realizes losses while the MNE group as a whole is profitable, the facts could trigger some special scrutiny of transfer pricing issues. Of course, associated enterprises, like independent enterprises, can sustain genuine losses, whether due to heavy start-up costs, unfavourable economic conditions, inefficiencies, or other legitimate business reasons. However, an independent enterprise would not be prepared to tolerate losses that continue indefinitely. An independent enterprise that experiences recurring losses will eventually cease to undertake business on such terms. In contrast, an associated enterprise that realizes losses may remain in business if the business is beneficial to the MNE group as a whole.[35]

2.4 THE EFFECT OF GOVERNMENT POLICIES

There are some circumstances in which a taxpayer will consider that an arm's length price must be adjusted to account for government interventions such as price controls (even price cuts), interest rate controls, controls over payments for services or management fees, controls over the payment of royalties, subsidies to particular sectors, exchange control, anti-dumping duties, or exchange rate policy. As a general rule, these government interventions should be treated as conditions of the market in the particular country, and in the ordinary course they should be taken into account in evaluating the taxpayer's transfer price in that market. The question then presented is whether in light of these conditions the transactions undertaken by the

[33] OECD/G20 2015 Final Report on Actions 8-10 in para 1.121.

[34] OECD/G20 2015 Final Report on Actions 8-10 in para 1.123.

[35] OECD/G20 2015 Final Report on Actions 8-10 in para 1.129.

controlled parties are consistent with transactions between independent enterprises.[36]

2.5 USE OF CUSTOMS VALUATIONS

The arm's length principle is applied, broadly speaking, by many customs administrations as a principle of comparison between the value attributable to goods imported by associated enterprises, which may be affected by the special relationship between them, and the value for similar goods imported by independent enterprises. Valuation methods for customs purposes, however, may not be aligned with the OECD's recognised transfer pricing methods. That being said, customs valuations may be useful to tax administrations in evaluating the arm's length character of a controlled transaction transfer price and vice versa. In particular, customs officials may have contemporaneous information regarding the transaction that could be relevant for transfer pricing purposes, especially if prepared by the taxpayer, while tax authorities may have transfer pricing documentation which provides detailed information on the circumstances of the transaction. [37]

2.6 LOCATION SAVINGS AND OTHER LOCAL MARKET FEATURES

The features of the geographic market in which business operations occur can affect comparability and arm's length prices. 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. [38]

Location savings

In determining how location savings are to be shared between two or more associated enterprises, 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. [39]

Other local market features

[36] OECD/G20 2015 Final Report on Actions 8-10 in para 1.132.

[37] OECD/G20 2015 Final Report on Actions 8-10 in para 1.137.

[38] OECD/G20 2015 Final Report on Actions 8-10 in para 1.139.

[39] OECD/G20 2015 Final Report on Actions 8-10 in para 1.141.

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 suggest that the relevant characteristics of the geographic market in which products are manufactured or sold, 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 affect prices and margins that can be realised in the market. Similarly, the comparability and functional analysis conducted in connection with a particular matter may suggest that the relative availability of local country infrastructure, the relative availability of a pool of trained or educated workers, proximity to profitable markets, and similar features in a geographic market where business operations occur create market advantages or disadvantages that should be taken into account. Appropriate comparability adjustments should be made to account for such factors where reliable adjustments that will improve comparability can be identified. [40]

2.7 ASSEMBLED WORKFORCE

Some businesses are successful in assembling a uniquely qualified or experienced cadre of employees. The existence of such an employee group 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 *vis-à-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. [41]

2.8 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

[40] OECD/G20 2015 Final Report on Actions 8-10 in para 1.144.

[41] OECD/G20 2015 Final Report on Actions 8-10 in para 1.152.

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. In other circumstances such synergies may be negative, as when the size and scope of corporate operations create bureaucratic barriers not faced by smaller and more nimble enterprises, or when one portion of the business is forced to work with computer or communication systems that are not the most efficient for its business because of group wide standards established by the MNE group. [42]

2.9 CONCLUSION

Only once comparability, as set out above, has been established, can truly effective benchmarking be performed.

3 GENERAL ON TRANSFER PRICING IN SOUTH AFRICA

South Africa has transfer pricing legislation in section 31 of the Income Tax Act (“ITA”). 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 transacting 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,[43] which are also set out in SARS Practice Note 7.[44]

There have been no cases covering transfer pricing issues that have been heard in the South African tax or higher courts. A number of cases have, however, been settled between the taxpayers and SARS prior to reaching court, the details of which are not available to the public. The “Large Business Centre” (LBC) at SARS is the one that deals with transfer pricing issues.

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.

[42] OECD/G20 2015 Final Report on Actions 8-10 in para 1.157.

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

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

It is impossible to reliably calculate the extent of base erosion and profit shifting as a result of transfer pricing structures or transfer mis-pricing (evasion). In an effort to determine some sense of the magnitude of the transfer pricing BEPS challenge, the DTC has been advised that SARS has 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. However, 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

- Although the report on Actions 8-10 indicates that further work is still to follow, based on the DTC's analysis of the recommended changes to be made to the Transfer Pricing Guidelines as a consequence of the Action 8-10 report, and in line with the recommendations on the Action 13 report (see part 10 below), the DTC recommends that, in order to reduce the incidence of income not being taxed in South Africa when the risks, functions and values actually take place here, South Africa adopts all the recommendations pertaining to transfer pricing rules.
- It also recommends that the South African legislators should ensure that section 31 of the ITA refers to the OECD guidelines on the basis that it is obligatory to apply these guidelines for companies that are part of a group that falls above the threshold (EU750mn) requiring country by country reporting, but also recommended for smaller companies. Thus, as part of the mandatory application for groups above the threshold, it is recommended that all the documentation requirements should also be compulsory. This will ensure global consistency of application and documentation for such groups, as is recommended by the OECD.
- The legislators should, thus, 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. Without departing from the OECD Transfer Pricing Guidelines, the suggested General Ruling should include a set of principles reflecting the South African reality.
- Reference to the OECD Guidelines in section 31 will address any ambiguities and inconsistencies that may occur where the OECD Transfer Pricing Guidelines are for example updated, and the proposed updated South African Transfer Pricing Guidance is not. This will ensure clarity and foster a system

on which foreign investors can rely (in line with the National Development Plan), it is submitted that following the OECD Transfer Pricing Guidelines is preferable to ensure international compatibility, clarity and consistency.[45]

- In addition, the DTC recommends that it only be mandatory to take account of location savings advantages/disadvantages when determining the arm's length price following upon the issue of guidance by SARS/ Treasury as to how to make the specific adjustments for South Africa's specific circumstances.[46]
- The DTC, however, cautions that the determination of what is and what is not a "commercial transaction" may be difficult to determine and that the principles set out in South Africa's current general anti-avoidance rules be relied upon to determine whether SARS may simply ignore a transaction altogether.[47]
- It is also recommended that, for the purposes of providing certainty to inbound investors where loans are not significant, the BGR defines a safe harbour e.g debt to equity ratio (or in line with section 23M of the ITA), together with an interest rate (e.g. prime +2% - or in line with prevailing excon requirements) for inbound loans not exceeding, say, R100mn. In this manner inbound investors will obtain the certainty they need regarding loan requirements without having to expend significant amounts, on professional fees, to determine an arm's length amount for loans below the pre-defined limit. Without departing from the OECD Transfer Pricing Guidelines, the suggested BGR should include a set of principles reflecting the South African reality i.e as indicated above, guidance on local adjustments that should be made to non-South African comparables, safe harbours etc. (see also commentary on Actions 4 and 10 for more discussion on this point).
- The implementation of an Advanced Pricing Agreement (APA) regime would also facilitate certainty for investors. When APAs are introduced in South Africa, resourcing will be needed to build an Advanced Pricing Agreement unit (see section 8 below).
- As there are no South African company databases available to assist in determining an arm's length price in South Africa, and in order to ensure a level playing field for companies operating in South Africa and provide certainty, SARS/ Treasury should issue a set of guidelines for making adjustments to predefined global comparables to take account of the South African environment or, alternatively, make a decision not to require adjustment; It is, however, reiterated, as set out above that it is also recommended that, in order to ensure consistency and certainty, SARS/Treasury do not require locational (dis)advantage adjustments until it has issued such guidelines thereon, based on specifically defined country database sets.

[45] SAICA "Comment on DTC 1st Interim BEPS Report" (31 March 2015) para 17 and 18.

[46] Per recommendation by Deloitte 26 July 2015 at 7.

[47] Per recommendation by Deloitte 26 July 2015 at 7.

- 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 to audit the results[48].

The DTC, however, cautions that, although the objective of the transfer pricing rules, proposed by the OECD, is to secure the taxation of the profits of MNE's in those countries where the functions, risks, and value lie, South Africa could be a net loser in the equation if it fails to successfully lure MNE's to the country, due to other unattractive non-tax practices and policies.

The review of the detailed OECD recommendations, set out below, commences with Action 9, as the principles and guidelines set out therein set out the basis for those provided in the remaining actions 8, 10 and 13.

4 ACTION 9: ASSURE TRANSFER PRICING OUTCOMES ARE IN LINE WITH VALUE CREATION WITH REGARD TO RISKS AND CAPITAL

Determining risk is a matter that is difficult to determine in practice.
Commentators such as Monsenego[49] note the following:

> "The scope of the notion of risk may be difficult to determine. For example, if a distributor sells a drug that is proved to have side effects, risks may include decreased sales of the drug, damages paid to customers, bad reputation etc. In addition, each of these risks may have consequences from both a geographical and time perspective".

The above difficulties of determining risk have been compounded by the fact the 1995 OECD Transfer Pricing Guidelines did not provide a clear definition of the notion of risk, so differences in view existed regarding the extent to which risk is or may be assumed by associated enterprises so as to satisfy the economic substance requirement. This resulted in potentially conflicting views between tax administrators and taxpayers regarding whether or not a risk should be assumed by such associated enterprise.[50] Chorvat[51] for instance notes that "because current transfer pricing methods depend upon comparable transactions, the allocation of risk is inadequately addressed for transactions involving intangibles".

Writing on this matter, in 2003, Chorvat[52] suggested that a functional analysis (as applied in order to determine an arm's length return) should include a process analysis which considers the business risks and responsibilities of each business unit, the identifying aspects of the value added process which contribute to profit,

[48] Per SACTWU submission 18 August 2015 at 4.

[49] J Monsenego "The Substance requirement in the OECD Transfer Pricing Guidelines: What is the substance of the substance requirement?" (January/February 2014) *International Transfer Pricing Journal* at 13.

[50] Monsenego at 13.

[51] E Chorvat "Forcing Multinationals to Play Fair: Proposals for a Rigorous Transfer Pricing Theory" (2003) 54 *Alabama Law Review* at 1260.

[52] Chorvat at 1279.

specifically (but not limited to) business strategy, management, support, sales and marketing, operations, procurement as well as after sales support.[53] A similar approach appears to be followed in Germany[54] where a distinction is drawn between intermittent and routine risk, with higher return suggested for intermittent than routine risk.[55]

When the OECD issued its 2013 BEPS Action Plan, attention was given, under Action 9, to ensuring that transfer pricing outcomes are in line with value creation with regard to risks and capital. Action 9 required that:

- Countries should develop rules to prevent BEPS that result from transferring risks among, or allocating excessive capital to, group members.
- This would involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital.
- The rules to be developed would also require that returns are aligned with value creation and that income is not separated from the economic activities that produce it.

On the international front, the OECD noted that its work on this Action Plan would be co-ordinated with the work on interest expense deductions and other financial payments.

In October 2015, the OECD released its final report on the combined Actions 8-10 which all deal with ensuring that transfer pricing outcomes are in line with value creation. With respect to risks, the OECD work resulted in revisions to Section D of Chapter I of the Transfer Pricing Guidelines. In terms of these revisions the OECD defines risks as “the effect of uncertainty on the objectives of the business”.[56] In all of a company’s operations, every step taken to exploit opportunities, every time a company spends money or generates income, uncertainty exists, and risk is assumed. No profit seeking business takes on risk associated with commercial opportunities without expecting a positive return. This economic notion- that higher risks warrant higher anticipated returns- is what makes MNE groups pursue tax planning strategies based on contractual re-allocations of risks, sometimes without any change in the business operations.

- In order to address this, the Report determines that risks contractually assumed by a party that cannot in fact exercise meaningful and specifically defined control over the risks, or do not have the financial capacity to assume

[53] Chorvat at 1279.

[54] Para 3b of the German Regulations on Documentation of Income Allocation (“GAufzV”).

[55] A Voegele & C Zhang “Function and Risk Analysis in Germany” (2010) 11 *Corporate Business Taxation Monthly* at 16.

[56] OECD/G20 2015 Final Report on Actions 8-10 at 10.

the risks, will be allocated to the party that does exercise such control and does have the financial capacity to assume the risks. [57]

- The revised guidance also addresses the situation where a capital-rich member of the group provides funding but performs few activities. If this associated enterprise does not in fact control the financial risks associated with its funding (for example because it just provides the money when it is asked to do so, without any assessment of whether the party receiving the money is creditworthy), then it will not be allocated the profits associated with the financial risks and will be entitled to no more than a risk-free return, or less if, for example, the transaction is not commercially rational and therefore the guidance on non-recognition applies. [58]

The guidance ensures that:

- actual business transactions undertaken by associated enterprises are identified, and transfer pricing is not based on contractual arrangements that do not reflect economic reality;
- contractual allocations of risk are respected only when they are supported by actual decision-making;
- capital without functionality will generate no more than a risk-free return, assuring that no premium returns will be allocated to cash boxes without relevant substance;
- tax administrations may disregard transactions when the exceptional circumstances of commercial irrationality apply; and
- The mere fact that a transaction can't be seen between the parties does not mean that it should not be recognized. [59]

The concerns regarding transfer pricing with respect to transferring risks and allocating excessive capital to group members have particular relevance to determining how the business currently operates as well as to business restructurings. Risk is intricately linked to the flow of capital within a group- this in turn has significant implications on profits. Due to the seemingly amorphous nature of risk, it is often difficult to quantify the risk involved as well as its degree of correlation to profits. From an economic perspective authors such as Chorvat[60] explain the linkage between risk and capital in the following manner:

> The question on how to allocate capital so as to maximise income has been studied by economists for decades, if not centuries. As long as one assumes that multinational enterprises are trying to maximize profits, the question of how to allocate income among members of an integrated group is very similar to the question of how the group should allocate among investments… Thus, if we can determine the amount of capital allocated to a business unit, and

[57] OECD/G20 2015 Final Report on Actions 8-10 at 10.

[58] OECD/G20 2015 Final Report on Actions 8-10 at 11.

[59] OECD/G20 2015 Final Report on Actions 8-10 at 13.

[60] E Chorvat "Forcing Multinationals to Play Fair: Proposals for a Rigorous Transfer Pricing Theory" (2003) 54 *Alabama Law Review* at 1266.

> the degree of risk to which that capital is subject, we should be able to determine the amount of income that should be allocated to that business unit.

Risk bears a strong relation to the capital flow of a multinational entity (whether through a capital outflow's effect on risk and return or via over-capitalising through loan finance and shifting profits through excessive interest). The concern for tax officials is, firstly, how to prevent the transfer of risks by multinational enterprises to group members, designed to divert returns to desired jurisdictions and, secondly, how best to align returns with actual value creation within the inter-enterprise context.

The OECD notes that the assumption of risk by a party to a transaction can significantly affect the pricing of that transaction at arm's length. To assume a risk for transfer pricing purposes, the associated enterprise needs to control the risk and have the financial capacity to assume the risk:[61]

- The guidance on risks helps to accurately determine the actual contributions made by an associated enterprise that solely provides capital. Where the capital provider does not exercise control over the investment risks that may give rise to premium returns, that associated enterprise should expect no more than a risk-free return.
- The revised guidance ensures that a transfer pricing analysis is based on an accurate delineation of what the associated enterprises actually contribute in the transaction, and not on contractual terms, including contractual assumption of risk, that are not in practice performed.
- The guidance provides a basis for any transfer pricing analysis, but in so doing it also addresses some of the key BEPS challenges: allocating risks on paper does not in itself shift profits.
- The revisions reinforce the need for tax administrations to be able to disregard transactions between associated enterprises when the exceptional circumstances of commercial irrationality apply. The guidance emphasises that the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognised. Instead, the key question is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances.
- the guidance responds to the mandate to prevent inappropriate returns to capital and misallocation of risk by encouraging thoroughness in determining the actual arrangements between the associated enterprises so that pricing takes into account the actual contributions of those parties, including risks actually assumed, and by authorizing the non-recognition of transactions which make no commercial sense. [62]

[61] OECD/G20 2015 Final Report on Actions 8-10 at 14.
[62] OECD/G20 2015 Final Report on Actions 8-10 at 14.

The OECD recommends that the following relevant characteristics or comparability factors need to be identified in commercial or financial transactions between associated enterprises:

- The contractual terms. This is the starting point. However, other communications and actions will define whether these terms have been adhered to or are commercially realistic;
- The functions performed, taking into account assets used and risks assumed, will assist in the determining of the allocation of profits. The economic significance, in terms of frequency, nature and value to the respective parties to the transactions needs to be carefully evaluated. Fragmented activities need to be identified, the nature of their interdependencies and how they are coordinated. The ability of a party assuming a risk to, firstly, make the decision to bear that risk and, secondly, to carry the risk (together with risk mitigation strategies it adopts) needs to be determined, and the determination of another party that does so if these determinations fail. ('The purported assumption of risk ….when a risk outcome is certain is by definition not an assumption of risk, since there is no… risk. Similarly the *ex post* reallocations of risk by a tax administration, when outcomes are certain, may be inappropriate'[63];
- The characteristics of property transferred and services provided. Important characteristics include: for tangibles- physical features, their quality and reliability, availability and volume of supply; for services-nature and extent; for intangibles-form of transaction (license or sale, type (patent, trademark, know-how) duration and degree of protection and anticipated benefits;
- The economic circumstances of the parties. Comparability can be affected for equal transactions when they take place in different markets eg government policies like exchange controls and location savings. Thus, adjustments may be required to achieve true comparability.
- The business strategies of the parties eg market penetration schemes.

  - ➢ Regarding the penultimate bullet above, as there are no South African company databases available to assist in determining an arm's length price in South Africa, and in order to ensure a level playing field for companies operating in South Africa and provide certainty, DTC recommends that SARS/ Treasury issues a set of guidelines for making adjustments to predefined global comparables to take account of the South African environment or alternatively makes a decision not to require adjustment;

The factors, set out above are dealt with in more detail below.

4.1 TRANSFER PRICING FUNCTIONAL ANALYSIS WITH RESPECT TO RISK

[63] OECD/G20 2015 Final Report on Actions 8-10 at 28.

The general guidance on transfer pricing, as discussed above, also applies with respect to risks and capital. The OECD Guidance for applying the arm's length principle requires conducting a "comparability analysis" which is based on a comparison of the conditions in a controlled transaction with the conditions that would have been made had the parties been independent and undertaking a comparable transaction under comparable circumstances. The first step in carrying out a comparability analysis requires identifying the commercial or financial relations between the associated enterprises.[64]

The economically relevant characteristics or comparability factors that need to be identified in the commercial or financial relations between the associated enterprises requires one to determine the functions performed by each of the parties to the transaction, taking into account assets used and risks assumed.

4.2 ANALYSIS OF RISKS IN COMMERCIAL OR FINANCIAL RELATIONS

The OECD notes that a functional analysis is incomplete unless the material risks assumed by each party have been identified and considered since the actual assumption of risks would influence the prices and other conditions of transactions between the associated enterprises. Usually, in the open market, the assumption of increased risk would also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realised. The level and assumption of risk, therefore, are economically relevant characteristics that can be significant in determining the outcome of a transfer pricing analysis.[65] Further details on risk are dealt with in the discussion on Action 9 below, which deals with Guidance on "assure transfer pricing outcomes are in line with value creation with regard to risks and capital". The rest of the explanation below deals with other relevant issues relating to transfer pricing in general.

Risk is inherent in business activities. Enterprises undertake commercial activities because they seek opportunities to make profits, but those opportunities carry uncertainty that the required resources to pursue the opportunities either will be greater than expected or will not generate the expected returns. Identifying risks goes hand in hand with identifying functions and assets and is integral to the process of identifying the commercial or financial relations between the associated enterprises and of accurately delineating the transaction or transactions. [66]

The steps in the process for analysing risk in a controlled transaction, in order to accurately delineate the actual transaction in respect to that risk, can be summarised as follows:

[64] OECD/G20 2015 Final Report on Actions 8-10 in para 1.33

[65] OECD/G20 2015 Final Report on Actions 8-10 in para 1.56.

[66] OECD/G20 2015 Final Report on Actions 8-10 in para 1.57.

- Identify economically significant risks with specificity.
- Determine how specific, economically significant risks are contractually assumed by the associated enterprises under the terms of the transaction.
- Determine through a functional analysis how the associated enterprises that are parties to the transaction operate in relation to assumption and management of the specific, economically significant risks, and in particular which enterprise or enterprises perform control functions and risk mitigation functions, which enterprise or enterprises encounter upside or downside consequences of risk outcomes, and which enterprise or enterprises have the financial capacity to assume the risk.
- Steps 2-3 will have identified information relating to the assumption and management of risks in the controlled transaction. The next step is to interpret the information and determine whether the contractual assumption of risk is consistent with the conduct of the associated enterprises and other facts of the case by analysing:
    - whether the associated enterprises follow the contractual terms and
    - whether the party assuming risk, as analysed under (i), exercises control over the risk and has the financial capacity to assume the risk.
- The actual transaction, as accurately delineated by considering the evidence of all the economically relevant characteristics of the transaction, should then be priced taking into account the financial and other consequences of risk assumption, as appropriately allocated, and appropriately compensating risk management functions.[67]

The term “risk management” is used to refer to the function of assessing and responding to risk associated with commercial activity. Risk management comprises three elements:

- the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function;
- the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function; and
- the capability to mitigate risk, that is the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation. [68]

Some risk management functions can be undertaken only by the party performing functions and using assets in creating and pursuing commercial opportunities, while

[67] OECD/G20 2015 Final Report on Actions 8-10 in para 1.60.
[68] OECD/G20 2015 Final Report on Actions 8-10 in para 1.61.

other risk management functions can be undertaken by a different party. Risk management should not be thought of as necessarily encompassing a separate function, requiring separate remuneration, distinct from the performance of the activities that optimise profits. [69]

It should also be noted that risk management is not the same as assuming a risk. Risk assumption means taking on the upside and downside consequences of the risk with the result that the party assuming a risk will also bear the financial and other consequences if the risk materialises. A party performing part of the risk management functions may not assume the risk that is the subject of its management activity, but may be hired to perform risk mitigation functions under the direction, and for the benefit, of the risk-assuming party. For example, the day-to-day mitigation of product recall risk may be outsourced to a party performing monitoring of quality control over a specific manufacturing process according to the specifications of the party assuming the risk. [70]

The financial capacity to assume risk can be defined as "access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if the risk materializes". Access to funding by the party assuming the risk takes into account the available assets and the options realistically available to access additional liquidity, if needed, to cover the costs anticipated to arise should the risk materialise. This assessment should be made on the basis that the party assuming the risk is operating as an unrelated party in the same circumstances as the associated enterprise, as accurately delineated under the principles of this section. Where a party assuming risk receives intra-group funding to meet the funding demands in relation to the risk, the party providing the funding may assume financial risk but does not, merely as a consequence of providing funding, assume the specific risk that gives rise to the need for additional funding. Where the financial capacity to assume a risk is lacking, then the allocation of risk requires further consideration. [71]

Control over risk involves the first two elements of risk management defined above, that is:

- the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and
- the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision making function. [72]

[69] OECD/G20 2015 Final Report on Actions 8-10 in para 1.62.

[70] OECD/G20 2015 Final Report on Actions 8-10 in para 1.63.

[71] OECD/G20 2015 Final Report on Actions 8-10 in para 1.64.

[72] OECD/G20 2015 Final Report on Actions 8-10 in para 1.65.

It is not necessary for a party to perform the day-to-day mitigation as, in having control of the risks, such day-to-day mitigation may be outsourced. However, where these day-today mitigation activities are outsourced, control of the risk would require capability to determine the objectives of the outsourced activities, to decide to hire the provider of the risk mitigation functions, to assess whether the objectives are being adequately met, and, where necessary, to decide to adapt or terminate the contract with that provider, together with the performance of such assessment and decision-making. In accordance with this definition of control, a party requires both capability and functional performance in order to exercise control over a risk.[73]

The capability to perform decision-making functions and the actual performance of such decision-making functions relating to a specific risk involve an understanding of the risk based on a relevant analysis of the information required for assessing the foreseeable downside and upside risk outcomes of such a decision and the consequences for the business of the enterprise. Decision-makers should possess competence and experience in the area of the particular risk for which the decision is being made and possess an understanding of the impact of their decision on the business. They should also have access to the relevant information, either by gathering this information themselves or by exercising authority to specify and obtain the relevant information to support the decision making process.[74]

Risk mitigation refers to measures taken that are expected to affect risk outcomes. Such measures may include measures that reduce the uncertainty or measures that reduce the consequences in the event that the downside impact of risk occurs. Control should not be interpreted as requiring risk mitigation measures to be adopted, since in assessing risks businesses may decide that the uncertainty associated with some risks, including risks that may be fundamental to their core business operations, after being evaluated, should be taken on and faced in order to create and maximise opportunities.[75]

4.3 THE PROCESS OF ANALYSING RISK

Step 1: Identify economically significant risks with specificity: There are many definitions of risk, but in a transfer pricing context it is appropriate to consider risk as the effect of uncertainty on the objectives of the business. In all of a company's operations, every step taken to exploit opportunities, every time a company spends money or generates income, uncertainty exists, and risk is assumed. A company is likely to direct much attention to identifying uncertainties it encounters, in evaluating whether and how business opportunities should be pursued in view of their inherent risks, and in developing appropriate risk mitigation strategies which are important to shareholders seeking their required rate of return. Risk is associated with

[73] OECD/G20 2015 Final Report on Actions 8-10 in para 1.66.

[74] OECD/G20 2015 Final Report on Actions 8-10 in para 1.66.

[75] OECD/G20 2015 Final Report on Actions 8-10 in para 1.68.

opportunities, and does not have downside connotations alone; it is inherent in commercial activity, and companies choose which risks they wish to assume in order to have the opportunity to generate profits. No profit-seeking business takes on risk associated with commercial opportunities without expecting a positive return.

Downside impact of risk occurs when the anticipated favourable outcomes fail to materialise. Companies are likely to devote considerable attention to identifying and managing economically significant risks, in order to maximise the positive returns from having pursued an opportunity. It will look at how to identify changing market trends, how to anticipate political and social changes, and how to create demand. The significance of a risk depends on the likelihood and size of the potential profits or losses arising from the risk. [76]

Risks can be categorised in various ways, but a relevant framework in a transfer pricing analysis is to consider the sources of uncertainty which give rise to risk. The OECD provides the following non-exclusive list of sources of risk, which is intended to provide a framework that may assist in ensuring that a transfer pricing analysis considers the range of risks likely to arise from the commercial or financial relations of the associated enterprises, and from the context in which those relations take place. Reference is made to risks that are externally driven and those that are internally driven in order to help clarify sources of uncertainty.

- Strategic risks or marketplace risks;
- Infrastructure or operational risks;
- Financial risks;
- Transactional risks; and
- Hazard risks. [77]

Determining the economic significance of risk and how risk may affect the pricing of a transaction between associated enterprises is part of the broader functional analysis of how value is created by the MNE group, the activities that allow the MNE group to sustain profits, and the economically relevant characteristics of the transaction. The analysis of risk also helps to determine comparability. Where potential comparables are identified, it is relevant to determine whether they include the same level of risks and management of risks. [78]

Step 2: Contractual assumption of risk: The identity of the party or parties assuming risks may be set out in written contracts between the parties to a transaction involving these risks. A written contract typically sets out an intended assumption of risk by the parties. Some risks may be explicitly assumed in the contractual arrangements. Other risks might be implicitly assumed.[79]

[76] OECD/G20 2015 Final Report on Actions 8-10 in para 1.71.

[77] OECD/G20 2015 Final Report on Actions 8-10 in para 1.72.

[78] OECD/G20 2015 Final Report on Actions 8-10 in para 1.73.

[79] OECD/G20 2015 Final Report on Actions 8-10 in para 1.73.

The assumption of risk has a significant effect on determining arm's length pricing between associated enterprises, and it should not be concluded that the pricing arrangements adopted in the contractual arrangements alone determine which party assumes risk. Therefore, one may not infer from the fact that the price paid between associated enterprises for goods or services is set at a particular level, or by reference to a particular margin, that risks are borne by those associated enterprises in a particular manner. It is the determination of how the parties actually manage and control risks, as set out in the remaining steps of the process of analysing risk, which will determine the assumption of risks by the parties, and consequently dictate the selection of the most appropriate transfer pricing method. [80]

Step 3: Functional analysis in relation to risk: In this step the functions in relation to risk of the associated enterprises that are parties to the transaction are analysed. The analysis provides information about how the associated enterprises operate in relation to the assumption and management of the specific, economically significant risks, and in particular about which enterprise or enterprises perform control functions and risk mitigation functions, which enterprise or enterprises encounter upside or downside consequences of risk outcomes, and which enterprise or enterprises have the financial capacity to assume the risk. [81]

Step 4: Interpreting steps 1-3: Carrying out steps 1-3 involves the gathering of information relating to the assumption and management of risks in the controlled transaction. The next step is to interpret the information resulting from steps 1-3 and to determine whether the contractual assumption of risk is consistent with the conduct of the parties and the other facts of the case by analyzing whether the associated enterprises follow the contractual terms and whether the party assuming risk, exercises control over the risk and has the financial capacity to assume risk. The significance of step 4 will depend on the findings. [82]

Step 5: Allocation of risk: If it is established that the associated enterprise assuming the risk based on steps 1 – 4 does not exercise control over the risk or does not have the financial capacity to assume the risk, then the risk should be allocated to the enterprise exercising control and having the financial capacity to assume the risk. If multiple associated enterprises are identified that both exercise control and have the financial capacity to assume the risk, then the risk should be allocated to the associated enterprise or group of associated enterprises exercising the most control. The other parties performing control activities should be remunerated appropriately, taking into account the importance of the control activities performed. [83]

[80] OECD/G20 2015 Final Report on Actions 8-10 in para 1.80.
[81] OECD/G20 2015 Final Report on Actions 8-10 in para 1.82.
[82] OECD/G20 2015 Final Report on Actions 8-10 in para 1.86.
[83] OECD/G20 2015 Final Report on Actions 8-10 in para 1.98.

In exceptional circumstances, it may be the case that no associated enterprise can be identified, that both enterprises exercise control over the risk and have the financial capacity to assume the risk. As such a situation is not likely to occur in transactions between third parties, a rigorous analysis of the facts and circumstances of the case will need to be performed, in order to identify the underlying reasons and actions that led to this situation. Based on that assessment, the tax administrations will determine what adjustments to the transaction are needed for the transaction to result in an arm's length outcome. [84]

Step 6: Pricing of the transaction, taking account of the consequences of risk allocation

The accurately delineated transaction should then be priced in accordance with the tools and methods available to taxpayers and tax administrations taking into account the financial and other consequences of risk-assumption, and the remuneration for risk management. The assumption of a risk should be compensated with an appropriate anticipated return, and risk mitigation should be appropriately remunerated. Thus, a taxpayer that both assumes and mitigates a risk will be entitled to greater anticipated remuneration than a taxpayer that only assumes a risk, or only mitigates, but does not do both. [85]

5 ACTION 8: ASSURE TRANSFER PRICING OUTCOMES ARE IN LINE WITH VALUE CREATION WITH REGARD TO 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.[86]

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 to the area of transfer pricing. This is demonstrated by cases such as the Canadian case of *Canada v GlaxoSmithKline Inc,* [87] and the Australian case of *Commissioner of Taxation v SNF (Australia) Pty Ltd.*[88]

[84] OECD/G20 2015 Final Report on Actions 8-10 in para 1.99.

[85] OECD/G20 2015 Final Report on Actions 8-10 in para 1.100.

[86] PWC "Paying Taxes: The Global Picture" (2014) at 19.

[87] 2012 SCC.

[88] [2011] FCAFC 74.

Profit shifting which involves the use of IP has two important characteristics: Firstly, it is a driver of value creation in multinational firms; and secondly, it is highly mobile. It is, thus, no surprise that most of the companies currently accused of avoiding taxes have IP intensive business models[89] involved in intra-company allocation of IP.[90] 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.[91]

In order to avoid such high taxes, taxpayers often take advantage of the fact that IP is intangible in nature and, as mentioned, it can be easily moved from country to country through the use of planned licensing structures.[92] 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.[93] Profits can then be effectively shifted from the foreign subsidiary to the offshore patent owning company which may end up paying little or no tax on the royalties received.[94] Fees derived by the licensing and patent holding company from the exploitation of the IP will be either exempt from tax or subject to a low tax rate in the tax-haven jurisdiction.[95]

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.[96] In most cases, high withholding taxes can be reduced when countries enter into double taxation treaties.[97] In order to benefit from the reduced withholding taxes that taxpayers in 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

[89] 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.

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

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

[92] WH Diamond & DB Diamond *Tax Havens of the World* at INTRO /2.

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

[94] 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.

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

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

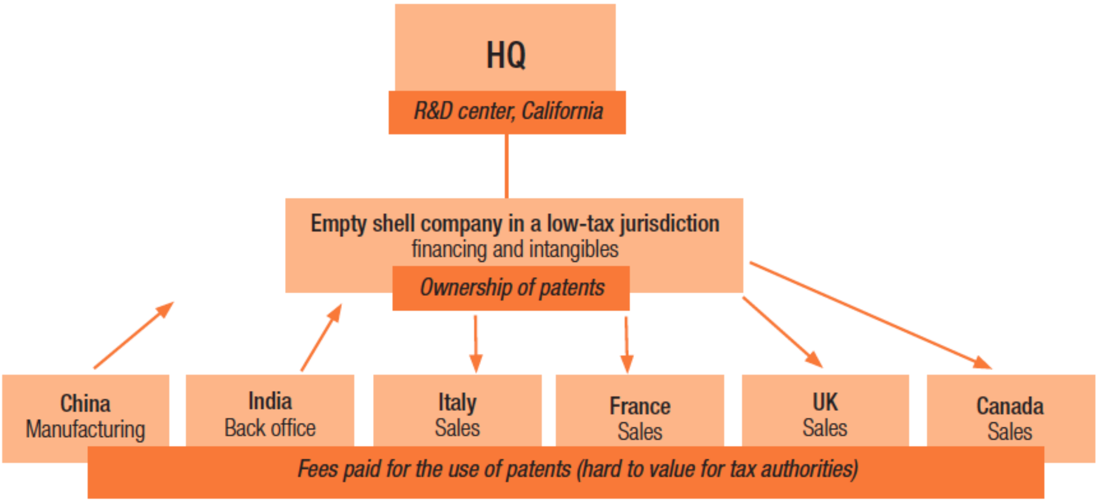
[97] Tomsett at 48-49.

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.[98] The Netherlands is an example of a country which has been utilised for establishing sublicensing companies with the aid of such structures.[99] Large international firms with extensive intra-firm trade and high R&D generally make use of tax havens to avoid taxes.[100]

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 (for example, Ireland). In this kind of structure the manufacturing subsidiary in China would pay a fee for the use of the patented methodology in its manufacturing process and the sales subsidiaries would pay royalties for selling the patented product under its patented name. Aggressive tax planning then takes two forms: firstly, profit shifting from California to Ireland, which retains a portion of the royalties that, without its existence, would flow directly to the US and, secondly, base erosion in the subsidiaries (when the fee paid is excessive compared to the value of the patent).

FIGURE 6: INTANGIBLES


HQ
R&D center, California
Empty shell company in a low-tax jurisdiction
financing and intangibles
Ownership of patents
China
Manufacturing
India
Back office
Italy
Sales
France
Sales
UK
Sales
Canada
Sales
Fees paid for the use of patents (hard to value for tax authorities)

5.1 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

[98] Spitz & Clarke at 94.

[99] Ginsberg at 50; Doggart at 36-37; Tomsett at 48-49.

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

the central flaws and loopholes in current national and international tax laws rendering these tax avoidance strategies possible. [101]

5.1.1 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. A Conduit Company is incorporated in the Netherlands.[102] 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 IP-holding company as an Irish corporation because tax residency is based on jurisdiction of incorporation according to US tax law. [103] The US Parent Company developed the IP and is therefore the owner thereof. The tax consequences of this structure are as follows:

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

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[104], 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 Company 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 asset 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. [105]

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

[101] 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.

[102] 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.

[103] Fuest et al at 4.

[104] The US Income Tax Reform Act (1986) requires transfer of intangibles to related foreign parties to be transferred at arm's length.

[105] Fuest *et al* at 5.

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.[106]

(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.[107]

(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 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.[108]

(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.[109]

(f) US CFC rules are circumvented:

[106] Ibid.

[107] Fuest *et al* at 6.

[108] Ibid.

[109] Ibid.

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[110]. 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. [111]

5.1.2 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[112]. 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.[113] 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:

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. [114]

(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. [115]

[110] The purpose of the Subpart F provisions is to eliminate deferral of USA tax on some categories of foreign income by taxing certain USA persons currently on their pro rata share of such income earned by their controlled foreign corporations (CFCs). See further on Subpart F https://www.irs.gov/pub/int_practice_units/DPLCUV_2_01.PDF accessed on 25 January 2016.

[111] Ibid.

[112] In light of the OECD BEPS initiative the UK is currently dismantling its current patent box regime.

[113] Fuest *et al* at 7.

[114] Fuest *et al* at 8.

[115] Ibid.

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. [116]

5.2 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. [117] 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 generally 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 multi-national enterprises entities involved in the transfer and then splits the profits between the two based on allocation keys – sales, staff and investment.

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

The 2013 OECD BEPS Report[118] recommended 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;

[116] Ibid.

[117] OECD "Revised Discussion Draft on Transfer Pricing Aspects of Intangibles" (30 July 2013) in para 35.

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

- 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".[119] This was followed on 19 July 2013 by the "Revised Discussion Draft on the Transfer Pricing Aspects of Intangibles"[120] which culminated in the September 2014 "Report on Transfer Pricing Aspects of Intangibles"[121] and chapter on Intangibles in the Report on Actions 8-10 issued in October 2015, which provide guidance on determining arm's length conditions for transactions that involve the use or transfer of intangibles.

5.3 THE SEPTEMBER 2014 REPORT AND OCTOBER 2015 FINAL REPORT ON TRANSFER PRICING OF INTANGIBLES

The OECD September 2014 and October 2015 reports on the transfer pricing for intangibles refer 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 are 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; and
- provide final modifications to the guidance on the transfer pricing treatment of local market features and corporate synergies.[122]

The 2015 Report summarises the guidance provided in its chapter on intangibles as being to ensure that:

- legal ownership alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible. The group companies performing important functions, controlling economically significant risks and contributing assets, as determined through the accurate delineation of the actual transaction, will be entitled to an appropriate return reflecting the value of their contributions. Thus, it is necessary to determine

[119] Ibid.

[120] Ibid.

[121] 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)

[122] OECD/G20 2014 Report on Action 8 at 9.

who *controls* the risk, funding, and performance of outsourced functions in relation to the development, enhancement, maintenance, protection and exploitation of the intangible-associated enterprises performing value creating functions related to the development, maintenance, enhancement, protection and exploitation of the intangibles can expect appropriate remuneration. Where risk is assumed, the ability of the enterprise, assuming that risk, to exercise control there-over, and to financially support such risks must be clear;

- entitlement of a member of an MNE group to profits and losses will depend on the entity's true risks and functions, and an arm's length remuneration must be determined for these risks and functions;
- an associated enterprise providing funding must only be entitled to a risk adjusted return on funding (this will be a risk-free return where that enterprise does not exercise control over the financial risks);
- the guidance on valuation techniques is appropriately expanded;
- a rigorous transfer pricing analysis must be performed by taxpayers to ensure hard-to-value intangibles are priced at arm's length. The Guidance also considers the aspects of *ex-post* versus *ex-ante* information on the valuation of such hard-to-value intangibles and when the use of *ex-post* information is appropriate for use by tax administrations. [123]

The guidelines indicate that further guidance will be issued in 2016 and the full set of guidelines reviewed in 2020, in view of experience seen by then.

5.3.1 CHAPTER VI: TRANSFER PRICING GUIDELINES FOR INTANGIBLES

Chapter VI of the 2010 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations has been revised to provide guidance specifically 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. [124]

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

[123] OECD/G20 2015 Final Report on Actions 8-10 at 64.

[124] OECD/G20 2014 Report on Action 8 at 27; OECD/G20 2015 Final Report on Actions 8-10 at 66.

relevant member of the MNE group.[125] 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.[126]

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

5.3.2 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 enterprises should require compensation in circumstances where no such compensation would be provided in transactions between independent enterprises.[127] In the Transfer Pricing Guidelines, the word "intangible" is thus 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; and
- whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.[128]

For an item to be considered an intangible:

- it need not be an intangible for accounting purposes;

[125] OECD/G20 2014 Report on Action 8 at 28; OECD/G20 2015 Final Report on Actions 8-10 at 66.
[126] Ibid.
[127] OECD/G20 2014 Report on Action 8 at 28; OECD/G20 2015 Final Report on Actions 8-10 at 67.
[128] OECD/G20 2014 Report on Action 8 at 28-29; OECD/G20 2015 Final Report on Actions 8-10 at 67.

- 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).[129]

In a transfer pricing analysis of a matter involving intangibles, it is important to identify the relevant intangibles with specificity. Rather than focusing on accounting or legal definitions, the thrust of a transfer pricing analysis involving intangibles should be the determination of the conditions that would be agreed on between third parties for a comparable transaction.[130] The functional analysis should, thus, identify the relevant intangibles at issue, the manner in which they contribute to the creation of value in the transactions under review, the important functions performed and specific risks assumed in connection with the development, enhancement, maintenance, protection and exploitation of the intangibles, 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. [131]

5.3.3 CATEGORIES OF INTANGIBLES

The OECD gives the following examples of items often considered as intangibles. It makes clear, however, that this guidance is purely for the purposes of transfer pricing and not for other purposes eg double tax treaties (article 12) or customs. 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. [132]

(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

[129] OECD/G20 2014 Report on Action 8 at 29; OECD/G20 2015 Final Report on Actions 8-10 at 67.

[130] Actions 8-10 Report 2015 at 66

[131] OECD/G20 2014 Report on Action 8 at 30; OECD/G20 2015 Final Report on Actions 8-10 at 68.

[132] OECD/G20 2014 Report on Action 8 at 33; OECD/G20 2015 Final Report on Actions 8-10 at 70.

enterprise. Know-how and trade secrets may relate to manufacturing, marketing, research and development, or any other commercial activity. [133]

(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. [134]

(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, and are not intangibles.
- 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. [135]

(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. [136]

(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

[133] OECD/G20 2014 Report on Action 8 at 33; OECD/G20 2015 Final Report on Actions 8-10 at 71.

[134] OECD/G20 2014 Report on Action 8 at 34; OECD/G20 2015 Final Report on Actions 8-10 at 71.

[135] OECD/G20 2014 Report on Action 8 at 34-35; OECD/G20 2015 Final Report on Actions 8-10 71-72.

[136] OECD/G20 2014 Report on Action 8 at 35; OECD/G20 2015 Final Report on Actions 8-10 at 72.

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.

- 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. [137]

  The absence of a single precise definition of goodwill makes it essential for taxpayers and administrations to specifically describe the relevant intangibles and to consider whether independent enterprises would provide compensation therefor.[138]

5.3.4 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. 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. [139] 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. [140] 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

[137] OECD/G20 2014 Report on Action 8 at 35; OECD/G20 2015 Final Report on Actions 8-10 at 72.
[138] OECD/G20 2015 Final Report on Actions 8-10 at 73.
[139] OECD/G20 2014 Report on Action 8 at 13.
[140] Ibid.

(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.[141]

(a) 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. [142] 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.[143]

(b) 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. [144]

5.3.5 OWNERSHIP OF INTANGIBLES AND TRANSACTIONS INVOLVING THE DEVELOPMENT, ENHANCEMENT, MAINTENANCE, PROTECTION AND EXPLOITATION OF INTANGIBLES

The OECD advises that, even though countries must ensure that transfer pricing outcomes for intangibles are in line with value creation, there are challenges in

[141] Ibid.

[142] OECD/G20 2014 Report on Action 8 at 13.

[143] OECD/G20 2014 Report on Action 8 at 18.

[144] OECD/G20 2014 Report on Action 8 at 37.

determining the value of an intangible when pricing a MNE's operations. SAICA[145] explains as follows: when a MNE conducts its businesses operations, the various components of the business can be attributed to a country where the cost, including tax cost, is the lowest. However, the commercial reality is that an end product that generates revenue results from this global effort, which revenue usually arises wherever the item is sold. The further reality is that a company only has actual cost to really determine what the input is to the final product, but realises the revenue as a single amount elsewhere. Yet, because of the company's global operations, local fiscal authorities in each country will require a fictional determination of the value of the goods to ensure that an "appropriate" portion of the revenue benefits are attributed to that country. What is "appropriate" becomes a debate specific to each country.

The OECD refers to the challenges that can arise for a MNE allocating the profits of an intangible appropriately so that each country gets its fair share.[146] SAICA[147] gives this simplistic example: "If it costs R10 to generate the intellectual property pertaining to the product in country 1, R10 to source the raw materials in country 2 and R10 to assemble in country 3, then how much of a profit should go to each country if the product is sold for R40 in country 4? Is the value add the same in each country for it to be fair or is the IP, for example, a larger contributor to the ultimate value, as market forces dictate it to be so at such time or is the country where the ultimate sale price is extracted the largest contributor? Are value creation, risk and capital input really the best factors to determine 'fair' as they ostensibly tend to favour the manufacturing leg of the value chain?"

SAICA[148] notes that it should be acknowledged that the task of determining the fictional arm's length price as opposed to actual cost is not a mundane one. The complexity imposed and uncertainty this complexity brings, may be a contributing factor as to why certain taxpayers are enabled to "abuse" the pricing system whereas others are just overly burdened by it. When solutions and proposals are sought to address unwanted practices, it should be done with due consideration of the complex task at hand and the principles of administrative fairness and simplicity to the taxpayer.

The OECD advises[149] that "(n)otwithstanding these potential challenges, applying the arm's length principle and the provisions of Chapters I-III within an established framework can, in most cases, yield an appropriate allocation of returns derived by an MNE group from the exploitation of intangibles".

[145] SAICA "Comment on DTC 1st Interim BEPS Report" (31 March 2015) para 11.
[146] OECD/G20 2015 Final Report on Actions 8-10 at 74.
[147] SAICA "Comment on DTC 1st Interim BEPS Report" (31 March 2015) para 13.
[148] SAICA "Comment on DTC 1st Interim BEPS Report" (31 March 2015) para 14.
[149] OECD/G20 2015 Final Report on Actions 8-10 at 74.

- Although the proposed changes to Chapter VI of the OECD Guidelines have yet to be tested, the DTC is of the view that, on this basis, South Africa needs to adopt the principles set out in order to align with its trading partners' methodology, but like the OECD, the DTC recommends that South Africa reserves its rights to review and refine the methodology over time, as it becomes clear whether it satisfies the correct allocation of profits principle.

In summary, then, the framework for analysing transactions involving intangibles between MNE's requires the following steps[150]:

- Identify the intangibles used or transferred with specificity, together with the economically significant risks associated with the development, enhancement, maintenance, protection and exploitation of the intangibles;
- Identify the full contractual arrangements to determine the true legal ownership. If no legal owner is identified under applicable law or contracts, the member of the MNE group which controls decisions regarding exploitation and has practical capacity to restrict others from using the intangible will be the legal owner for transfer pricing purposes;
- Identify the parties performing important functions using a functional analysis. In performing this work it is necessary to determine which member(s) of the MNE group perform and exercise control over the development, enhancement, maintenance, protection and exploitation functions, which member(s) provide funding and which members assume the various risks relating to the intangible(s). Where intangibles are self-developed these factors may be difficult to determine. Thus, the evaluation needs to carefully identify which parties control outsourced functions and what compensation is attributable to e.g. the legal owner versus the associated enterprises involved in development, enhancement, maintenance, protection and exploitation functions;
- Confirm the consistency of the contractual arrangements to the conduct of the parties, noting in particular whether any particular party who carries economic risk actually controls those risks and has the financial capacity to assume the risks relating to development, enhancement, maintenance, protection and exploitation of the intangibles; and
- Delineate the actual control relating to the development, enhancement, maintenance, protection and exploitation of the intangibles taking into account the legal ownership, the contractual relations, and the conduct of the parties;
- Determine the arm's length price consistent with each parties' contribution of functions, risks assumed and assets used. It should be noted that the determination of the legal owner, for example, does not determine the required remuneration on an arm's length basis - all the factors will ultimately

[150] OECD/G20 2015 Final Report on Actions 8-10 at 74.

need determine this, and suitable compensation must be provided to each party providing input (control, risk, assets and functions) to the intangible.

The OECD warns that, because the actual outcomes and manner in which the risks associated with the intangible are unknown at the time of the MNE making decisions regarding the intangibles, it is important to distinguish between the anticipated (*ex-ante*) remuneration (i.e. expected at the time of the transaction) and the actual *(ex-post)* remuneration (i.e. the actual remuneration earned by a group member.[151]

As in third party transactions, the terms and level of compensation payable to a group member will be determined *ex-ante.* The actual *ex-post* profit and loss may differ from the expected results depending on how the risks associated with the intangible play out. The OECD suggests that tax authorities rely on the *ex-ante* returns determined by the MNE, provided that the evaluation of the where the risks lay was reasonably performed upfront ie the companies which actually carried the risks receive the increased or decreased compensation,[152] on the basis that the MNE could not reasonably have been expected to anticipate unforeseen circumstances. The ultimate compensation of each member of the group should ultimately reflect the compensation that a comparable third party would have received in similar circumstances[153].

The OECD advises that the marketing entity/distributor which may enhance marketing intangibles eg trademarks, through its operations should not specifically be compensated for the enhancement of intangibles, over and above its distribution activities, if it is acting merely as an agent (with the owner providing promotional expenditure), whereas where it performs its own marketing activities and the enhancement can clearly be attributed to its activities, its relative compensation should reflect this[154]

In order to determine the most appropriate method for measuring the transfer prices for intangibles the Guidelines look at the use of databases and the need to assess whether comparability adjustments may be needed. They state that any of the 5 methods may be appropriate, depending on the circumstances, but state that 'one sided methods, including the resale price method and the TNMM are generally not reliable methods for directly valuing intangibles'.[155] The CUP method may be considered provided it is appropriate in light of the available comparables. Where such comparables do not exist, the transactional profit split method ("TPS") is considered to be most appropriate. In evaluating the reliability of the TPS methods, however, the availability of reliable and adequate data regarding combined profits,

[151] OECD/G20 2015 Final Report on Actions 8-10 at 77.

[152] OECD/G20 2015 Final Report on Actions 8-10 at 84.

[153] OECD/G20 2015 Final Report on Actions 8-10 at 85.

[154] OECD/G20 2015 Final Report on Actions 8-10 at 86.

[155] OECD/G20 2015 Final Report on Actions 8-10 at 99.

appropriately allocable expenses, and the reliability of factors used to divide combined income should be fully considered.[156]

Where intangibles are transferred in combination with other business transactions, the OECD advises that the various parts of the package must be separately identified, but the interactions of the eg services and intangibles may enhance both (eg in a franchising arrangement). In addition, delineating the transaction as the provision of products or services, or the transfer of intangibles, does not necessarily dictate the use of a particular transfer pricing method. For example the cost plus method will not be appropriate for *all* services transactions and the profit split method will not be appropriate for *all* intangible transactions.[157]

In order to determine the value of an intangible that is being transferred the OECD recommends the following factors be taken into account:

- Exclusivity;
- Extent and duration of legal protection;
- Geographic scope;
- Useful life;
- Stage of development
- Rights to enhancements, revisions and updates; and
- Expectations of future benefits.

The Guidelines look at valuation techniques, such as discounted cash flows, but caution that it is essential to consider the assumptions and other motivations that underlie the particular applications of the techniques.[158] It is furthermore made clear that valuations of intangibles used in purchase price allocations for accounting purposes are not appropriate for transfer pricing purposes and should be used with caution.

Where the value is highly uncertain at the time of transfer (Hard to Value Intangibles or “HTVI”), there are a variety of methods independent enterprises might adopt e.g. the use of anticipated benefits, or alternatively they may look at shorter term agreements which cater for contingent events with milestone payments. [159] Specialised knowledge, expertise and insight may be required to determine which events are relevant or could have been foreseen.

It is acknowledged that tax administrations may not have the expertise to deal with these instances and tend to rely on taxpayer information. In such circumstances *ex-post* outcomes may provide some insight to *ex-ante* pricing arrangements between associated enterprises, and differences may give the tax administration an indication

[156] OECD/G20 2015 Final Report on Actions 8-10 at 101.

[157] OECD/G20 2015 Final Report on Actions 8-10 at 91.

[158] OECD/G20 2015 Final Report on Actions 8-10 at 102.

[159] OECD/G20 2015 Final Report on Actions 8-10 at 108.

that the pricing arrangement agreed upon at the time of the transaction may not adequately have taken into account the relevant developments or events that would affect the intangible and the pricing arrangement adopted.[160] However, this situation should be distinguished from the situation in which hindsight is used by taking *ex-post* results for tax assessment purposes, without considering whether such *ex-post* results could reasonably been anticipated at the time the transaction was entered into. The information provided by the taxpayer will be critical to this determination.

5.4 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 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.

5.4.1 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 exchange control (EXCON) approval. Royalties are divided into two categories, namely, royalties associated with a process of manufacture; and other royalties.

In this regard, it is important to clarify the extent to which transfer pricing rules for intangibles specifically are aligned with rules and practice of the South African Reserve Bank (SARB) and the Department of Trade and Industry (DTI). As regards the first category (royalties associated with a process of manufacture), the SARB has delegated its authority to the DTI. This means that applications for approval of such royalties are required to be submitted to the DTI. Although there are guidelines issued relating to manufacturing royalties, the arm's length standard is not applicable to such transactions. The EXCON and DTI restrictions mean that, in practice, South Africa allows 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. 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

[160] OECD/G20 2015 Final Report on Actions 8-10 at 109.

rarely approved. This may lead to double taxation where the Revenue Authority of the licensor seeks to enforce a greater royalty.

There is arguably a further inconsistency between the treatment of inbound and outbound royalties due to different EXCON rules for inbound royalties and the current operation of section 31 of the ITA. While section 31 of the ITA is applicable to the use of foreign owned intangibles in South Africa, it is not applicable to the circumstances prescribed in sections 31(5) of the ITA ie in relation to headquarter companies. Further, this section arguably does not take account of the pricing of any value added in South Africa to the underlying intangibles. These issues should be considered in light of the objectives of the relief afforded to headquarter companies and in respect of high tax foreign group companies.

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. Thus, in practice royalties of much higher rates are only sometimes not 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 limit the transfer of South African owned IP to a foreign related party to circumstances where it can be demonstrated that the consideration will be arm's length:

> The EXCON Regulations state:
>
> **4.3.2 Disposal of patents, copy-rights, trademarks, franchises and/or intellectual property in general**
>
> The disposal of any of the aforegoing requires prior approval of the Financial Surveillance Department. Applications should be supported by the agreement or contract of sale. If not evident therefrom, a clear explanation of how the values were arrived at must accompany the application. The transfer of South African owned intellectual property by way of sale, assignment or cession and/or the waiver of rights in favour of non-resident in whatever form, directly or indirectly, is not allowed without the prior approval of the Financial Surveillance Department."

This assists in inhibiting 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, although it does not remove the risk to the South African fisc altogether.

(b) Implications of the exchange control restrictions

The EXCON and DTI restrictions mean that, in practice, South Africa often permits only 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 – may be limited[161] (as discussed above, due to the limitations placed on such strategies, by EXCON). As is discussed fully below, there are also 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 both to the South African tax authorities and EXCON. Thus this matter is not of primary concern in the South African environment.

- However, the tax and transfer pricing implications of any future liberalisations of the EXCON rules should be carefully considered since, if the EXCON rules which currently act as an effective means of blocking many of the BEPS strategies relating to IP, which exist in the global tax planning community, were to be removed, the exposure of the South African fiscus would be increased.
- It should be also be noted that, due to the exchange control legal and regulatory framework that exists between the SARB and the delegated powers of the Authorised Dealers (and the DTI), the rules relating to the application of the EXCON requirements on the import, export and the use of intellectual property are not readily available and not consistently applied. Greater transparency of these exchange control rules should be considered. [162]

[161] The Exchange Control regulations do not prohibit the transfer of IP outside South Africa, but do require that approval be obtained before such a transfer is made. See rule 4.3.2 quoted above.

[162] PWC "Comments on DTC BEPS First Interim Report" (30 March 2015) at 23.

5.4.1.1 Section 23I of the Income Tax Act

Section 23I of the ITA 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 the South African person that uses it, or a connected person to that person. Therefore, even if it were possible to obtain EXCON approval to export IP from South Africa, any subsequent licensing back of that IP, to the South African person who sold it offshore or a group company, would have adverse tax implications.

5.4.1.2 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 the time they 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. This would be in line with the OECD proposals, where appropriate.

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

- The strategic decision-making process involving the IP development and commercialization and
- 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; and
- 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.

In line with the proposed recommendations and the OECD Guidelines the DTC recommends that:

- Research should be undertaken into the volume and values of deductions for the various deductions or allowances, such as the section 11D R&D tax deduction as this may provide an indication if this is an actual concern.
  The tax return information and the information reported to the Department of Science and Technology may assist in this regard. [163]
- Furthermore, where a South African taxpayer acts as a contract R&D service provider to a non-South African taxpayer with little substance, but which has the contractual risks and provides the capital for the development of the IP, the following should be considered to evaluate the arm's length nature of the transaction between South Africa and the non-resident:
  - The substance and control by the intangible owner over the development, enhancement, maintenance or protection of the intangibles;
  - Where a profit split method or cost contribution arrangement is used, consideration should be given to i) the 'separate entity approach', i.e. recognition of the terms and conditions between the parties and the terms and conditions which would exist were the parties dealing at

[163] PWC "Comments on DTC BEPS First Interim Report" (30 March 2015) at 23.

arm's length; ii) legal and economic ownership of the underlying intangibles and the tax and exchange control impact hereof; and iii) the appropriate allocation keys for the costs or profit to be split;

- Another corroborative measure could be to evaluate the non-resident's return on capital employed to evaluate the arm's length nature of the intangible owner's expenses and income (i.e. downstream license income from other group companies); and
- Whether the income of the intangible owner is imputed under SA CFC rules. [164]

5.4.1.3 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 ITA. For countries with which South Africa has a DTA, 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,*[165] the court considered the issue of beneficial ownership by reference to four elements that must be considered in determining 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.

5.5 SUMMARY OF DTC CONCLUSION AND RECOMMENDATIONS ON TRANSFER PRICING OF INTANGIBLES FOR SOUTH AFRICA

- The DTC recommends that South Africa should adopt the OECD Guidelines set out above in order to align with its trading partners' methodology, but like the OECD, South Africa should reserve the right to review and refine the methodology over time, as it becomes clear whether it satisfies the correct allocation of profits principle.
- In principle, the OECD guidance on transfer pricing of intangibles should be adopted in South Africa. However the OECD's BEPS Action 8, which requires

[164] PWC "Comments on DTC BEPS First Interim Report" (30 March 2015) at 23.
[165] 2012 TCC 273.

countries to enact legislation to prevent transfer pricing using intangibles, may not require major legislative attention in South Africa at this stage, since current EXCON restricts the outbound movement of intangibles and royalty payments, and local legislation, act as deterrents. This is unlike other countries, especially in Europe where taxpayers have greater freedom as regards excessive payments of royalties or relocation of IP, this does not appear to have the same local traction in terms of audit and disputes.[166]

  - South African developed IP cannot be readily exported without Exchange Control or the Department of Trade and Industry (DTI) approval, and royalty rates for payments in respect of offshore IP 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.
  - The current application of section 31 of the ITA – or even the general anti-avoidance provisions contained in sections 80A to 80L of the ITA – can also be applied to challenge the limited remuneration of a South African entity involved in the process of IP development.
  - Section 23I of the ITA 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. This can be further reinforced by cross boarder reporting rules on intangibles.

- Despite the above measures, the potential undervaluation of local intangibles in determining profit splits is a potential concern for South Africa.
- 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.
- Measures should be taken to ensure that the exchange control legal and regulatory framework that exists between the SARB and the delegated powers of the Authorised Dealers (and the DTI) relating to the import, export and the use of intellectual property are made readily available and that they are consistently applied. Greater transparency of these exchange control rules should be considered. [167]
- Consideration needs to be given to implementing an Advanced Pricing

[166] SAIT: Comments on DTC Interim Report on BEPS (March 2015) at 3.

[167] PWC “Comments on DTC BEPS First Interim Report” (30 March 2015) at 23.

Agreement regime which will assist investors to gain certainty regarding flows from intangibles (see section on APA's below).

- 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? Consideration could also be given to expanding the provisions of section 23I to prohibit the deduction of royalties payable/paid to connected entities which bear tax at a rate which is less than eg 75%[168] of the prevailing South African tax rate.
  - How is the transfer of intangibles, with highly uncertain values going to be priced (Reference may be had to the OECD Action 8-10 report)?
- 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. It may for instance be advisable to revisit South Africa's R&D Tax Incentive to ensure that it is comparable to that in South Africa's trading partners (This will be addressed further in the DTC report, still to be issued, on incentives).
- As a separate but related point, the South African Government could consider the attractiveness of South Africa as a destination for intangible related activity and consequent intangible related returns. The key factors that influence South Africa's attractiveness as:
  - The effective tax rate of the South African operations (considering all tax factors);
  - The certainty of tax treatment;
  - The availability of local skills; and
  - The ability of foreign skills to sustainably migrate to South Africa. On this point current immigration laws and its application do not promote the attraction of high skill individuals to South Africa. The impact of this can be to limit the case for greater intangible returns to SA. [169]

6 ACTION 8: UPDATING THE GUIDANCE ON COST CONTRIBUTION ARRANGEMENTS

The 2013 OECD BEPS Report[170] recommends that countries should develop rules to prevent BEPS that result from moving intangibles among MNE group members without arm's length compensation. This Report also required the OECD to update the guidance on cost contribution arrangements, the guidance which was in Chapter VIII of the Transfer Pricing Guidelines is now revised.

[168] This links into SARS current view of what constitutes a 'tax haven' see explanatory booklet to 2015 corporate income tax return (IT14) and is considered by the DTC to be reasonable.

[169] PWC "Comments on DTC BEPS First Interim Report" (30 March 2015) at 23.

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

The OECD 2015 Final Report on Action 8-10 defines Cost Contribution Arrangements (CCAs) as ‘a contractual arrangement among business enterprises to share the contributions and risks of joint development, production or obtaining intangibles, tangible assets or services with the understanding that such intangibles, tangible assets or services are expected to create benefits for the individual businesses of each of the participants’[171].

A CCA does not require the participants to combine their operations in order, for example, to exploit any resulting intangibles jointly or to share the revenues or profits. Rather, CCA participants may exploit their interest in the outcomes of a CCA through their individual businesses. The transfer pricing issues focus on the commercial or financial relations between the participants and the contributions made by the participants that create the opportunities to achieve those outcomes. [172]

If contributions to and benefits of the CCA are not valued appropriately, this will lead to profits being shifted away from the location where the value is created through the economic activities performed.[173]

- The guidance provides for determining whether the conditions established by associated enterprises for transactions covered by a CCA are consistent with the arm’s length principle.
- The guidance addresses some of the opportunities for BEPS resulting from the use of CCAs.
- Parties performing activities under arrangements with similar economic characteristics should receive similar expected returns, irrespective of whether the contractual arrangement in a particular case is termed a CCA.
- The guidance ensures that CCAs cannot be used to circumvent the new guidance on the application of the arm’s length principle in relation to transactions involving the assumption of risks, or on intangibles.
- The analysis of CCAs follows the framework set out in that guidance to ensure that:
    - The same analytical framework for delineating the actual transaction, including allocating risk, is applicable to CCAs as to other kinds of contractual arrangements.
    - The same guidance for valuing and pricing intangibles, including hard-to-value intangibles, is applicable to CCAs as to other kinds of contractual arrangements.
    - The analysis of CCAs is based on the actual arrangements undertaken by associated enterprises and not on contractual terms that do not reflect economic reality.

[171] OECD/G20 2015 Final Report on Actions 8-10 at 161 and 163.

[172] OECD/G20 2015 Final Report on Actions 8-10 at 163.

[173] OECD/G20 2015 Final Report on Actions 8-10 at 161.

- An associated enterprise can only be a participant to the CCA if there is a reasonable expectation that it will benefit from the objectives of the CCA activity and it exercises control over the specific risks it assumes under the CCA and has the financial capacity to assume those risks.

In summary the guidance ensures that CCAs are appropriately analysed and produce outcomes that are consistent with how and where value is created. [174]

A key feature of a CCA is the sharing of contributions. In accordance with the arm's length principle, at the time of entering into a CCA, each participant's proportionate share of the overall contributions to a CCA must be consistent with its proportionate share of the overall expected benefits to be received under the arrangement. Further, in the case of CCAs involving the development, production or obtaining of intangibles or tangible assets, an ownership interest in any intangibles or tangible assets resulting from the activity of the CCA, or rights to use or exploit those intangibles or tangible assets, is contractually provided for each participant. [175]

In a CCA, each participant's proportionate share of the overall contributions to the arrangement will be consistent with the participant's proportionate share of the overall expected benefits to be received under the arrangement. Each participant in a CCA would be entitled to exploit its interest in the CCA separately as an effective owner thereof, without requiring businesses to be combined. Each participant will not need to pay additional consideration to exploit the benefits (other than their contributions and balancing payments - see below).

In a CCA there is always an expected benefit that each participant seeks from its contribution. Each participant's interest in the results of the CCA activity should be established from the outset, even where the interest is inter-linked with that of other participants, *e.g.* because legal ownership of developed intangible property is vested in only one of them but all of them have effective ownership interests. [176] Like any other kind of contractual arrangement, the contractual agreement provides the starting point for delineating the actual transaction and performing the functional analysis to establish the division of responsibilities, risks and anticipated outcomes. The evaluation is the same as any other arrangement, including determining whether the parties contractually assuming risks are actually assuming these risks.[177]

The guidance issued in the 2015 revisions to the CCA transfer pricing guidelines (chapter VIII) is designed to support the revised guidance on intangibles, and ensure that CCA's address opportunities that arise for BEPS using CCAs.[178] Thus, parties

[174] OECD/G20 2015 Final Report on Actions 8-10 at 161.

[175] OECD/G20 2015 Final Report on Actions 8-10 at 165.

[176] OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.3 reiterated in OECD/G20 2015 Final Report on Actions 8-10 at 161.

[177] OECD/G20 2015 Final Report on Actions 8-10 at 163.

[178] OECD/G20 2015 Final Report on Actions 8-10 at 161.

performing activities under arrangements with similar economic characteristics should receive similar returns irrespective of the contractual arrangements, and the guidance ensures that CCA's are appropriately analysed and produce outcomes that are consistent with how and where value is created.

6.1 TYPES OF CCAs

There are two types of commonly encountered of CCAs: an arrangement for the joint development, production or the obtaining of intangible or tangible assets ("Development CCAs"), and those for obtaining services ("Services CCAs"). The main differences between the two types is that whilst development CCAs should create ongoing future benefits, but involve higher risks due to uncertainties, services CCAs create current benefits only which are more certain and less risky.[179]

Under a developed CCA each participant receives a share of rights in the developed property. In such a CCA, each participant is accorded separate rights to exploit the intangible property, for example in specific geographic areas or applications. The separate rights obtained may constitute actual legal ownership; or it may be that only one of the participants is the legal owner of the property, but economically all the participants are co-owners. In cases where a participant has an effective ownership interest in any property developed by the CCA and the contributions are in the appropriate proportions, there is no need for a royalty payment or other consideration for use of the developed property consistent with the interest that the participant has acquired. [180]

Service CCAs could exist for any joint funding or sharing of costs and risks, for developing or acquiring property or for obtaining services. For example, business enterprises may decide to pool resources for acquiring centralised management services, or for the development of advertising campaigns common to the participants' markets. [181]

6.2 APPLYING THE ARM'S LENGTH PRINCIPLE

A participant's contributions must be consistent with what an independent enterprise would have agreed to contribute under comparable circumstances given the benefits it reasonably expects to derive from the arrangement. What distinguishes contributions to a CCA from an ordinary intra-group transfer of property or services is that part or all of the compensation intended by the participants is the expected

[179] OECD/G20 2015 Final Report on Actions 8-10 at 165.

[180] OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.6 reiterated in OECD/G20 2015 Final Report on Actions 8-10 at 166.

[181] OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.7 amended by OECD/G20 2015 Final Report on Actions 8-10 at 166.

benefits to each from the pooling of resources and skills.[182] In addition, especially for development CCAs the participants agree to share in the upside and the downside consequences of the risks.

The expectation of mutual and proportionate benefit is fundamental to the acceptance by independent enterprises of an arrangement for sharing the consequences of risks materialising and pooling resources and skills. Independent enterprises would require that each participant's proportionate share of the actual overall contributions to the arrangement is consistent with the participant's proportionate share of the overall expected benefits to be received under the arrangement.

To apply the arm's length principle to a CCA, it is therefore necessary to determine that all the parties to the arrangement have the expectation of benefits, then to calculate each participant's relative contribution to the joint activity (whether in cash or in kind), and finally to determine whether the allocation of CCA contributions (as adjusted for any balancing payments) accords with their respective share of the benefits. It should be recognised that these determinations may bear a degree of uncertainty, particularly in relation to development CCAs. The potential exists for contributions to be allocated among CCA participants so as to result in an overstatement of taxable profits in some countries and the understatement of taxable profits in others, measured against the arm's length principle. For that reason, taxpayers should be prepared to substantiate the basis of their claim with respect to the CCA.[183]

6.3 DETERMINING PARTICIPANTS

Because the concept of mutual benefit is fundamental to a CCA, it follows that a party may not be considered a participant if that party does not have a reasonable expectation that it will benefit from the CCA activity itself (and not just from performing part or all of that activity). A participant therefore must be assigned an interest or rights in the intangibles, tangible assets or services that are the subject of the CCA, and have a reasonable expectation of being able to benefit from those interests or rights.[184] In the absence of such a potential benefit a participant may be considered to simply be a service provider to the CCA.[185]

[182] OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.8 amended by OECD/G20 2015 Final Report on Actions 8-10 at 166.

[183] OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.9 reiterated by OECD/G20 2015 Final Report on Actions 8-10 at 166.

[184] OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.10 and updated in OECD/G20 2015 Final Report on Actions 8-10 at 167.

[185] OECD/G20 2015 Final Report on Actions 8-10 at 168.

A party would also not be a participant in a CCA if it does not exercise control over the specific risks it assumes under the CCA, and does not have the financial capacity to do so. Furthermore, as would be expected of an independent party, a participant would be expected to perform a risk mitigation assessment and decision-making exercise regarding the risks it undertakes as a consequence of being a party to the CCA[186].

It will also be necessary for the participant to assess the benefits of participation in the CCA. If the activity continues to fail to produce any actual benefit over a period in which the activity would normally be expected to produce benefits, tax administrations may question whether the parties would continue their participation had they been independent enterprises. [187]

If the participants in a CCA decide that all or part of the subject activity will be outsourced to a separate company that is not a participant, an arm's length charge would be appropriate to compensate the company for services being rendered to the CCA participants.[188] In addition, the participants would each be expected to assess their control over the outsourced functions and the associated risks attached thereto. If the CCA is developing intangibles at least one of the participants in the CCA would be expected to exercise control over the development, maintenance, enhancement, protection, and exploitation of that intangible.

6.4 EXPECTED BENEFITS FROM THE CCA

The relative share of expected benefits might be estimated based on the anticipated additional income generated or costs saved or other benefits of each participant as a result of the arrangement. A frequently used method for services CCAs would be to reflect each participant's expected benefits using a relevant allocation key. The possibilities for allocation keys include: sales, units used, produced, or sold, gross or operating profit, the number of employees, capital invested, and so forth. Whether any particular allocation key is appropriate depends on the nature of the CCA activity and the relationship between the allocation key and the expected benefits. [189]

For development CCAs where the benefit may not be expected to materialise during the year of assessment projections of benefits may be used. This may, however, cause problems for tax administrations who will need to verify assumptions, especially when the eventual actual results are significantly different to the

[186] OECD/G20 2015 Final Report on Actions 8-10 at 168.

[187] OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.11.

[188] OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.12.

[189] OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.19.

projections. In some cases the CCA may end a number of years before the benefits are realised[190].

Adjustments may thus be required as circumstances change.

6.5 THE VALUE OF EACH PARTICIPANT'S CONTRIBUTION

For the purpose of determining whether a CCA satisfies the arm's length principle – i.e. whether each participant's proportionate share of the overall contributions to the CCA is consistent with the participant's proportionate share of the overall expected benefits – it is necessary to measure the value or amount of each participant's contributions to the arrangement. [191]

Irrespective of the type of CCA (development or services) all contributions of current or pre-existing value must be identified and accounted for appropriately with the arm's length principle. Since the value of each participants relative share of contributions should accord with its share of expected benefits, balancing payments may be required to ensure consistency.[192]

The evaluation process should recognise all contributions made by participants to the arrangement, at the time they are contributed, including property or services that are used partly in the CCA activity and also partly in the participant's separate business activities, and taking into consideration the mutual sharing of risks. [193] Whilst contributions should be measured at value, it is suggested that current contributions could be measured at cost. However, for development CCAs this will generally not provide a reliable basis for the application of the arm's length principle. Uncontrolled comparable arrangements then need to be sought.

Since contributions are based on expected benefits, this generally implies that where a cost reimbursement basis for valuing current contributions is permitted the analysis should initially be based on budgeted costs. Differences between actual and budgeted costs need to be analysed and explained.[194]

[190] OECD/G20 2015 Final Report on Actions 8-10 at 169.

[191] OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.13 and OECD/G20 2015 Final Report on Actions 8-10 at 169.

[192] OECD/G20 2015 Final Report on Actions 8-10 at 170.

[193] OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.16 and OECD/G20 2015 Final Report on Actions 8-10 at 170.

[194] OECD/G20 2015 Final Report on Actions 8-10 at 171-172.

6.6 BALANCING PAYMENTS

Where the value of a participant's overall contributions under a CCA, at the time the contributions are made, is not consistent with that participants share of expected benefits under the CCA, the arm's length principle will require that an adjustment be made because the consideration received by at least one of the participants for its contributions will be inadequate, and the consideration received by at least one other participant for its contribution will be excessive, relative to what independent enterprises would have received.

Such an adjustment will be made through a "balancing payment" which "tops up" the value of the contributions. Tax administrations may also require balancing payments where the value of contributions has been incorrectly determined. However, the guideline cautions that tax administrations should try to refrain from basing such adjustments on the results of a single fiscal year. They should rather evaluate the position over a period of years. The balancing payments should be treated as an additional contribution for the payer and a reduction in contributions for the recipient.

Where the commercial reality of an arrangement differs from the terms purportedly agreed by the participants, it may be appropriate to disregard part or all of the terms of the CCA. [195]

6.7 CCA ENTRY, WITHDRAWAL, OR TERMINATION

An entity that becomes a participant in an already active CCA might obtain an interest in any results of prior CCA activity, such as intangible property developed through the CCA, work in-progress and the knowledge obtained from past CCA activities. In such a case, the previous participants effectively transfer part of their respective interests in the results of prior CCA activity. Under the arm's length principle, any transfer of pre-existing rights from participants to a new entrant must be compensated based upon an arm's length value for the transferred interest. This compensation is called a "buy-in" payment. [196]

The amount of a buy-in payment should be determined based upon the arm's length value of the rights the new entrant is obtaining, taking into account the entrant's

[195] OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.26 and OECD/G20 2015 Final Report on Actions 8-10 at 173.

[196] OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.31 and OECD/G20 2015 Final Report on Actions 8-10 at 174.

proportionate share of overall expected benefits to be received under the CCA and any contribution it may be making going forward.[197]

Issues similar to those relating to a buy-in could arise when a participant leaves a CCA. In particular, a participant who leaves a CCA may dispose of its interest in the results of past CCA activity (including work in progress) to the other participants. If there is an effective transfer of property rights or interest at the time of a participant's withdrawal, the transferor should be compensated according to the arm's length principle. This compensation is called a "buy-out" payment.[198] It should be noted that where a services CCA is being transferred there may be not need to a buy-out payment as the benefits are generally current ie there is no future value.

When a CCA terminates, the arm's length principle would require that each participant receives a beneficial interest in the results of the CCA activity consistent with the participant's proportionate share of contributions to the CCA throughout its term (adjusted by balancing payments actually made including those made incident to the termination). Alternatively, a participant could be properly compensated according to the arm's length principle by one or more other participants for transferring its interest in the results of the CCA activity.[199]

6.8 DOCUMENTATION

In line with the documentation requirements set out in Action 13 the details of a CCA should be set out in the Master File and Local Files. Implicit in this is that each participant should have access to the details of the activities to be conducted under the CCAs, the identity and location of other parties involved in the CCA, the projections on which the contributions are to be made and the expected benefits determined, and the budgeted and expenditures for the CCA activity, at a level of detail commensurate with the complexity and importance of the CCA to the taxpayer. The guidelines provide a list of information that would be relevant and useful concerning the initial CCA and also over its duration.

[197] OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.32 and OECD/G20 2015 Final Report on Actions 8-10 at 174.

[198] OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.34 and OECD/G20 2015 Final Report on Actions 8-10 at 174.

[199] OECD "Cost Contribution Arrangements" in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 8.39 and OECD/G20 2015 Final Report on Actions 8-10 at 175.

6.9 RECOMMENDATIONS FOR SOUTH AFRICA ON CCAs

The DTC recommends that:

- Notwithstanding that CCA’s may be rarely seen in the South African context, as such arrangements arise offshore and may include South African entities, South Africa should adopt the proposed guidelines for CCA’s and ensure that it has sufficient exchange of information agreements in place to be able to derive the information that it requires should the taxpayer not be forthcoming;
- In line with the other recommendations, this recommendation again requires that SARS has the necessary resources and training to evaluate CCAs and obtain the necessary information.

7 ACTION 10: ENSURE TRANSFER PRICING OUTCOMES ARE IN LINE WITH VALUE CREATION: OTHER HIGH RISK TRANSACTIONS

The 2013 BEPS Action Plan Report required that countries should develop rules to prevent BEPS that result from engaging in transactions which would not, or would very rarely, occur between third parties. This would involve adopting transfer pricing rules or coming up with special measures to:

a) clarify the circumstances in which transactions can be recharacterised;

b) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and

c) provide protection against common types of base eroding payments, such as management fees and head office expenses.

The OECD’s guidance on these matters is set out below.

7.1 ACTION 10: CLARIFY THE APPLICATION OF TRANSFER PRICING METHODS, IN PARTICULAR TRANSACTIONAL PROFIT SPLIT METHOD, IN THE CONTEXT OF GLOBAL VALUE CHAINS

Traditionally considered one of the methods of last resort, the OECD has revisited the transactional profit split method (“TPSM”).[200]

It released a discussion draft on 16 December 2014, raising questions on difficulties encountered with the method. Based on the consultation that followed, the OECD concluded that it is necessary to clarify, improve and strengthen the guidance on when it is appropriate to apply the TPSM and when to do so, since experiences indicate that this method may not be straightforward for taxpayers to apply, and may not be straightforward for tax administrations to evaluate. It, furthermore, concluded that, when properly applied, the method has the potential to “align profits with value

[200] Deloittes submission to DTC: 26 July 2015 at 6.

creation in accordance with the arm's length principle"[201] and may be the most appropriate method where the other methods prove problematic.

In summary, it concluded that:

- Improved guidance needs to be developed to clarify the circumstances in which transactional profit splits are the most appropriate method for a particular case and to describe what approaches can be taken to split profits in a reliable way.
- The guidance on TPSM also needs to take into account changes to the transfer pricing guidance in pursuit of other BEPS actions, including changes in the guidance on applying the arm's length principle in performing a robust functional analysis; identifying and allocating risks, synergies; and intangibles.
- The guidance should take into account the conclusions of the Report on *Addressing the Tax Challenges of the Digital Economy* (OECD, 2015), developed in relation to BEPS Action 1, which noted that attention should be paid to the consequences of greater integration of business models as a result of the digitised economy, and the potential role for profit splits to account for such integration.
- In addition, the guidance should reflect further work being undertaken to develop approaches to transfer pricing in situations where the availability of comparables is limited, for example due to the specific features of the controlled transaction; and clarify how in such cases, the most appropriate method should be selected.
- This guidance is relevant to the work mandated by the G20 Development Working Group, on the impact of BEPS in developing countries, which includes the development of a toolkit for low income countries to address challenges these countries face due to the lack of comparables.

The OECD notes, in its 2015 Report that the TPSM will form the basis for draft guidance to be developed by WP6 during 2016 and expected to be finalised in the first half of 2017. A discussion draft of guidance will be released for public comments and a public consultation will be held in May 2016. [202]

In the meantime the scope of the revised guidance states that the current guidance should be supplemented with considerations of the following:

- The TPSM should not be the automatic alternative, should suitable comparables not be available, when the sharing of combined profits would not be expected if the parties are acting at arm's length;

[201] OECD/G20 2015 Final Report on Actions 8-10 at 55.
[202] OECD/G20 2015 Final Report on Actions 8-10 at 57.

- The use of the TPSM is not warranted simply because business operations are highly integrated - the businesses of all MNE's are integrated to a higher or lesser degree. The revised guidance will refer to the relevance of value chain analysis and look at sequential integration and parallel integration (which is often seen in the global trading of financial instruments where the TPSM may be viewed as appropriate);
- The current guidelines indicate that the TPSM may be appropriate where both parties make "unique and valuable contributions". Little guidance is given, however, as to what this is. Consideration is to be given to whether the sharing of risks would fall under this heading. In addition, a review of when independent enterprises adopt the method is to be undertaken;
- The method for splitting profits requires further guidance ie how to fulfil the need for a strong correlation between profit allocation factors and the creation of value in order to align with the arm's length principle;
- The TPSM can be used to support the TNMM range or determine royalty rates. The occasions when this is appropriate are to be spelt out.

More detail on the existing guidance and why the above is considered necessary is set out below.

7.1.1 CURRENT GUIDANCE ON TRANSACTIONAL PROFIT SPLIT METHOD

The TPSM is one of the methods advocated by the OECD in order to arrive at arm's length price in its 1995 Transfer Pricing Guidelines. This method is traditionally considered one of the methods of last resort.[203] Under the "profit split" method, the combined profit is identified and split between the connected parties in a controlled transaction. The profit is split by economically approximating the division of profits that would have been anticipated and reflected in an agreement made at arm's length.[204] The TPSM is usually applied where transactions are so interrelated that they cannot be evaluated separately.[205] The application of the TPSM relies on access to world-wide group data, which may be difficult to obtain.[206] The current guidance on the application of the TPSM indicates that:

- the main strength of the method is that it can provide solutions for highly integrated operations for which a one-sided method would not be appropriate (such as global trading of financial instruments);

[203] Deloittes submission to DTC: 26 July 2015 at 6.

[204] OECD Report of the Committee on Fiscal Affairs 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators' (1994) 172 *Intertax* 346 in para 131; G Campos 'Transfer Pricing of Major Trading Nations' (1996) *Bulletin for International Fiscal documentation* at 217; D Hay, F Horner, J Owens 'Past and Present Work in the OECD on Transfer Pricing and Selected Issues' (1994) 10 *Intertax* 435 in para 82.

[205] Hay *et al* at 435 in para 84.

[206] Hay *et al* at 435 in para 84.

- the TPSMs may also be found to be the most appropriate method in situations where both parties to the transaction make unique and valuable contributions, for example in the form of unique intangibles;
- the guidance makes the point that where each party makes unique and valuable contributions, reliable comparables information may be insufficient to apply another method; and
- the guidance stresses that the selection of a TPSM should be determined in accordance with the overall guidance for method selection in the Guidelines. [207]

While the guidance on splitting profits provides a number of examples of potential allocation keys, it focusses on asset-based and cost-based allocation keys. There is tentative mention of an approach which splits profits so that each party achieves the same return on capital.

Chapter VI of the Transfer Pricing Guidelines, which deals with Special Considerations for Intangibles, makes a number of references to the TPSM and to situations where the current guidance on its application may need to be clarified. For example, the guidance suggests:

- In some cases profit splits or valuation techniques may be useful for evaluating arm's length allocations of profit in situations involving the outsourcing of important functions where information on comparable uncontrolled transactions is unavailable.
- Where no information on comparable uncontrolled transactions is available, a TPSM is a method that may be useful in situations involving the pricing of transfers of intangibles. This may include the transfer of partially developed intangibles; or the transfer of all, or limited rights in a fully developed intangible. [208]

Aspects of Chapter I of the Transfer Pricing Guidelines may also prompt consideration of TPSM, but specific guidance has not yet been provided. Areas of particular interest in this regard include situations where multiple parties exercise control over a risk such that a sharing in the potential upside and downside of the risk may be appropriate, and the sharing of group synergies arising from deliberate concerted group action. [209]

7.1.2 SCOPE OF REVISED GUIDANCE

The OECD states that the revised guidance on the profits shift method will follow the current structure in Chapter II of the Transfer Pricing Guidelines, but should clarify and supplement the following matters.

[207] OECD/G20 2015 Final Report on Actions 8-10 at 57.

[208] OECD/G20 2015 Final Report on Actions 8-10 at 57.

[209] OECD/G20 2015 Final Report on Actions 8-10 at 57.

Most appropriate method: The December 2014 discussion draft on the use of TPSM stated that the consideration of TPSM does not imply any changes to the guidance for selecting the most appropriate method for arriving at an arm's length price. Nevertheless, comments on the discussion draft pointed to significant concerns regarding the potential for TPSMs to be misused; particularly so in cases where the nature of the transaction itself, based on the functional analysis of the parties, suggests that a sharing of combined profits would not be expected at arm's length. Concerns were also expressed that the method would be used in the absence of reliable comparables, without considering whether the TPSM was itself appropriate.[210]

Selecting the most appropriate method is particularly acute where there is a lack of reliable comparables data, as is very often the case in developing countries, and is relevant to the work mandated by the G20 Development Working Group on the development of toolkits to help low income countries address the challenge of the lack of comparables. [211]

Highly integrated business operations: While the current Guidelines state that TPSM may be found to be the most appropriate method where business operations are highly integrated, integration alone may be insufficient to warrant the use of such a method. All MNE groups are integrated to a greater or lesser degree, and so it is unclear how the criterion of integration should be applied. [212]

Additional guidance will be provided on when significant integration of business operations may lead to the conclusion that a TPSM is the most appropriate method.[213]

Unique and valuable contributions: The existing guidance on the application of TPSMs notes that such methods may be the most appropriate method in situations where both parties to the transaction make unique and valuable contributions. However, there is little further guidance in the current Guidelines about what constitutes a "unique and valuable contribution" aside from an example where intangibles are contributed by both parties to the transaction.
[214]

Additional guidance and examples will be provided to clarify what is meant by "unique and valuable" contributions in order to distinguish those circumstances when transactional profit split methods are likely to be the most appropriate method.[215]

[210] OECD/G20 2015 Final Report on Actions 8-10 at 58.
[211] OECD/G20 2015 Final Report on Actions 8-10 at 60.
[212] OECD/G20 2015 Final Report on Actions 8-10 at 58.
[213] OECD/G20 2015 Final Report on Actions 8-10 at 58.
[214] OECD/G20 2015 Final Report on Actions 8-10 at 58.
[215] OECD/G20 2015 Final Report on Actions 8-10 at 58.

Synergistic benefits: The guidance on group synergies provides that, where the synergistic benefits arise as a result of deliberate concerted action, such benefits must be shared by group members in proportion to their contribution to the creation of the synergy. While it may, in some circumstances be possible to benchmark the contributions of each part of the business, such a process may not be able to account for the potentially significant integration benefits which are achieved by the two parts acting in concert.[216]

Additional guidance will be provided on the circumstances to take into account in determining whether a TPSM could be the most appropriate method for dealing with scenarios with significant group synergies, and how such profit split methods could be applied.

Profit splitting factors: The over-arching objective of the BEPS Actions 8-10 is to ensure that transfer pricing outcomes are in line with economic value creation. Such an objective is achieved by accurately delineating the actual transaction and pricing it in accordance with the most appropriate method. The December 2014 discussion draft noted that TPSMs could make a contribution to achieving this aim and asked about experiences in using various approaches to splitting profits that might indicate ways of ensuring both greater objectivity and alignment with value creation in circumstances where application of the transactional profit split method is appropriate.

While there is general agreement that the splitting of profits should be based on a functional analysis of the parties' contributions, the mechanism by which the value of those contributions is quantified is not always clear.

- Possible mechanisms that are used in practice to various extents include invested capital, costs, surveys of functional contributions, weighting of factors, as well as equalised expected rates of return. Commentators observed advantages and disadvantages in these mechanisms, based on issues such as availability of information, measurability, subjectivity, and practicality, and the observations emphasise the current lack of guidance on what is a key aspect of applying a profit split method – how the profits should reliably be split.[217]
- Additional guidance will be provided that explains how to fulfil the need for a strong correlation between profit allocation factors and the creation of value in order to ensure an outcome that is consistent with the arm's length principle. Various mechanisms will be explained in detail, with examples of their application. In addition, the sensitivities and practical application of the various mechanisms, including the capability independently to verify the

[216] OECD/G20 2015 Final Report on Actions 8-10 at 58.

[217] OECD/G20 2015 Final Report on Actions 8-10 at 58.

underlying data, will be compared, in order that guidance is provided about the appropriate application of the mechanisms. [218]

Use of profit split to determine TNMM range, or converting to a royalty: The 2014 December discussion draft raised questions about the use of TPSM to vary the range of results derived from a TNMM analysis by reference to increase or decrease in consolidated profits achieved by the parties to the transaction. The draft also raised a question about using a profit split method to determine the expected share of profits, and then converting the analysis to a running royalty.[219]

- Additional guidance will be provided on the circumstances to take into account in evaluating whether a TPSM can be used to support results under a TNMM, or to determine royalty rates, or in other ways that are practical, respect the form of the contractual arrangements, and help simplify pricing outcomes.

7.1.4 RECOMMENDATIONS FOR SOUTH AFRICA ON THE PROFIT SPLIT METHOD

The DTC recommends that:

- ➢ South Africa should not attempt to issue its own guidelines regarding the TPSM, but should wait for the outcome of the OECD work still to be performed;
- ➢ The absence of local comparables should not be considered the determinant that the TPSM is the most appropriate method. The availability of all data should first be assessed. Failure to do so will lead to all countries that have no data adopting the TPSM, which will give rise to corresponding double taxation and transfer pricing disputes risks.[220]
- ➢ In the meantime, consideration should be given, by the South African Regulators, to the requirement for publication of data by South African companies, or for SARS and/or Stats SA to issue information, based on data available to them, that may be suitably be used for South African comparablilty purposes. Such data is common in the rest of the world, and is what the currently available databases[221] are based upon.

[218] OECD/G20 2015 Final Report on Actions 8-10 at 58.

[219] OECD/G20 2015 Final Report on Actions 8-10 at 58.

[220] Deloittes submission to DTC July 2015 at 6.

[221] E.g. Bureau van Dijk's Amadeus; Thompson Reuters; Royaltysource; Lexisnexis; Onesource; (all commonly used by taxpayers and tax authorities globally).

8 ACTION 10: PROVIDE PROTECTION AGAINST COMMON TYPES OF BASE ERODING PAYMENTS, SUCH AS MANAGEMENT FEES AND HEAD OFFICE EXPENSES - LOW VALUE-ADDING INTRA-GROUP SERVICES

8.1 BACKGROUND

A major BEPS concern among many developing countries in which MNE enterprises operate, including South African and other African countries, is that these enterprises keep claiming deductions for various head office expenses such as management, technical and service fees. Thus, they often pay little or no taxes in source countries alleging that they make losses year after year, yet they keep investing in those apparently unprofitable operations. Often there is no justification for such fees other than tax avoidance[222]. One possible explanation for the alleged losses is that profits are shifted to low tax jurisdiction while taxes are minimized in the source state.

In South Africa National Treasury has proposed the imposition of withholding taxes on certain forms of cross-border services. As a result, a withholding tax on service fees was enacted to come into effect on 1 January 2017.[223] It was, however, proposed in the 2016 Budget speech that this legislation will be deleted. This proposal, which is in line with the UN MTC, had been supported by the DTC[224], but on a more limited basis than set out in the current legislation.

However, as a Government Gazette[225] was issued on 3 February 2016, setting out the Ministers updated list of transactions considered to be reportable arrangements, which now includes specified services performed in South Africa, it is considered that this will act as a satisfactory mechanism for facilitating the identification of companies required to pay tax in South Africa in a more investor friendly manner (see further discussion on withholding tax in the DTC report on Action 6).

Concerns about excessive deductions of management fees are the reasons why some developing countries have signed treaties with specific articles on services, management and technical fees that deviate from the OECD and the UN MTC. Broadly these articles define services, management and technical fees in a similar manner as being "payments of any kind to any person, other than an employee of the person making the payments, in consideration for any services of a managerial, technical or consultancy nature, rendered in a contracting state".[226] In terms of these articles, the relevant fees may be taxed in the resident state.

[222] ActionAid 'Calling Time' 21.
[223] The withholding tax on service fees is contained in Part IVC of the Income Tax Act 58 of 1962.
[224] For further discussion see DTC report on Action 7.
[225] Government Gazette number 39650
[226] Article 12(4) of the Ghana and Germany treaty.

However these fees may also be taxed in the source state if the beneficial owner thereof is a resident of the other contracting state. In that case, the charge for the fee shall not exceed a certain percentage of the gross amount as agreed upon. For example, Ghana has signed treaties with Germany and Netherlands which combine “royalties and service fees”. Uganda has signed treaties with South Africa, Mauritius and the United Kingdom which contain an article on “technical fees”. Ghana has also signed treaties with Italy and Belgium that cover “management fees”.

Provisions on services, managements and technical fees do not only appear in treaties signed by small developing countries, there is also one in, for example, the US-India tax treaty. However there is no standard way of drafting these articles which makes treaty negotiations very difficult and creates uncertainties for tax payers who have to check the provisions of each treaty to be sure they’ve got it right. Since the articles on these types of fees deviate from what is in MTCs, the provisions adopted tend to be less well thought-out than those arising from debate and negotiation and adopted under the OECD or the UN MTCs.

Despite the widespread use of these articles, the OECD does not advocate for an article on these fees in the MTC. Currently under article 5 of the OECD MTC, a source country may only tax a foreign service provider (such as construction companies or management consultants) if it has a PE in the country for more than six month in a one year period, or under the UN MTC, the consultant must have a “fixed base” that they use regularly. However, MNE’s are able to come up with artificial schemes to avoid PE status (see also suggested changes to PE definition in OECD Report on Actions 7). Secondly since only profits attributable to a PE are taxed in the source state, where services are offered between the PE and its office, the arm’s length principle has to be applied to prevent transfer pricing.

Enforcing the arm’s length principle with respect to service fees is cumbersome for source countries because it is difficult to verify whether the service fee payments are appropriate. In 2012, the UN started work on a proposal for a new article on income from technical services that would allow developing countries to levy a tax on payments made to overseas providers of ‘technical services’. The UN Committee’s proposal allows a country to tax the income of a service provider even if it has no physical presence in their country. If, in future, South Africa signs a treaty with a country that is based on the UN MTC, it will have to deal with the implications of such an article.

The discussion on cross-border management services is also relevant to the principle of the attribution to profits to permanent establishments. Article 7(1) of the OECD and the UN Model Treaty provide that “the profits of an enterprise of a contracting state shall be taxable only in that state unless the enterprise carries on business in the other contracting state through a permanent establishment situated therein. And it is only the profits attributable to that permanent establishment that may be taxed in that state. Article 7(2) of the OECD MTC (inserted in the 2010 version) sets out the OECD authorised approach for attributing profits to PEs. The article states that:

> "For the purposes of this article and article 23A and 23B, the profits attributable in each Contracting State to the permanent establishment … are those it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise" (emphasis added)

In terms of this approach, the profits to be attributed to a PE are those which that PE would have earned if instead of dealing with its head office, it had dealings with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. Thus the PE is treated as if it were an affiliate company, and the income taxable in the source country is determined by estimating, through a series of assumptions, the amount of income that the PE would have earned if indeed it were an independent corporation.

The OECD recommends that 'transfer pricing' rules applicable to transfers between related persons be used to attribute income to a PE. This requires that the 'arm's length' principle be applied in determining the profits attributable to the PE. The 'arm's length' principle, as set out in art 9(1) of OECD Model Tax Convention, provides that when conditions are made 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. In line with the OECD approach, SARS Practice Note 7 advises taxpayers to take make use of transfer pricing rules to assist them to determine the amount of such an attribution.

The OECD approach of attributing profits to PEs, tries to recognise the economic differences between permanent establishments and subsidiaries by adopting the "functionally separate entity" approach whereby in attributing profits to a PE, its internal dealings are recognised by pricing them on an arm's length basis, without regard to the actual profits of the enterprise of which the PE is a part. This implies that non-actual management expenses, notional interest and royalties from head office may be charged on the PE.

However this approach differs from the UN Model Convention and the 2008 version of the OECD MTC (upon which many treaties are still based). The wording in the UN Model which is similar to that in the previous 2008 OECD MTC states that:

> "Subject to the provisions of paragraph 3, where an enterprise of a contracting state carries on business in the other contracting state through a permanent establishment situated

> therein, there shall in each contracting state be attributed to the permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment." (emphasis added)

The similarity between the OECD and the UN MTC in attributing profits to a PE is that both require that the "arm's length" principle, as set out in article 9, has to be applied to transfers between related persons by analogy to attribute income to the PE.[227] This requires that the OECD Transfer Pricing Guidelines[228] have to be applied to determine an arm's length price. In terms of both the OECD and the UN MTCs, the expenses incurred by the PE whether in the state in which the PE is situated or elsewhere are deductible.

The UN MTC and also the 2008 version of the OECD MTC differ from the current OECD MTC in that in the former, a "single entity" approach is used to attribute profits to a PE such that only the actual income and expenses of the PE are allocated, rather than the OECD "functionally separate entity" approach.

It has been argued that this approach may result in exploitation since it allows deductions for notional internal payments that exceed expenses actually incurred by the taxpayer.[229] Many countries,[230] including South Africa, have, consequently, not adopted the new Article 7 at this stage as it is presumed that this approach would have serious detrimental tax revenue consequences particularly through allowing financial services businesses deductions for notional payments on internal loans and derivatives involving PEs.[231] This is designed to preserve the source country's tax base.

Although the OECD advocates for the dynamic interpretation of treaties that takes into account the ongoing national and international developments in tax law, rather than the static approach of interpreting treaties in accordance with the contents of its

[227] AW Oguttu 'The Challenges of Taxing Profits Attributed To Permanent Establishments: A South African Perspective' *Bulletin for International Taxation* 64 No.3 (2010), 169; R. Russo 'Tax Treatment of 'Dealings' Between Different Parts of the Same Enterprise Under Article 7 of the OECD Model: Almost a Century of Uncertainty' *Bulletin for International Fiscal Documentation* 10 (2004), 24.

[228] Para 18 of the Commentary on art 7(2).

[229] Deloitte 'ATO paper on Profit Allocation to Bank Branches'. Available at http://www.deloitte.com/view/en_au/au/a79b8ba975c53310VgnVCM3000001c56f00aRCRD.htm accessed 14 October 2013.

[230] A number of OECD countries (including New Zealand) have entered reservations to the change and the United Nations Committee of Experts on International Cooperation in Tax Matters has not viewed changes as relevant to the United Nations Model Convention. A number of key economies (Brazil, China, Hong Kong, Indonesia, Malaysia, Thailand and India) are known to have reserved their position on the new Article 7.

[231] Deloitte 'Transfer Pricing Law Reforms' (2013). Available at http://www.deloitte.com/view/en_AU/au/insights/browse-by-job-title/cfos/f364b564daf7c310VgnVCM2000003356f70aRCRD.htm accessed 14 October 2013.

terms at the time it was concluded,[232] the OECD acknowledges that where the latest version of the Convention is "different in substance" from the previous version,[233] the previous version has to be applied in interpreting the treaty. As the current provisions relating to attribution of profits to PEs are "different in substance" to the 2008 version, the dynamic interpretation of the treaty would not apply. Since the OECD Model Tax Convention is not legally binding and it is the treaty that is a binding contract between the two States, if the two states wish to follow the new OECD approach, the two states can re-negotiate and amend the treaty or add a Protocol that incorporates the new OECD approach.[234]

Developing countries like South Africa are very concerned about the treatment of deductions and they are very sceptical about adopting the new article 7. Developing countries are especially sceptical about multinational companies that often try to avoid taxes levied on the PE by claiming deductions of various forms of fees charged to the headquarter office on the PE. Conflicts normally arise when the developing countries deny or limit the deductions for such fees.

Unlike article 7 of the OECD MTC, which permits the deduction of notional expenses between the PE and its foreign head office, article 7(3) of the UN MTC, clearly denies the deduction of such expenses. It states that:

> In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the Contracting State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in determining the profits of a permanent establishment, of amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices.[235]

As indicated above, the South African Revenue Service has indicated that, like its Africa counterparts, South African taxpayers must not adopt the latest OECD proposal, and rather remain in line with the UN Model.[236]

[232] Para 35 of the Introduction to the OECD MTC. Note that article 31 of the Vienna Convention on the Law of Treaties does not explicitly advocate a static or dynamic method of interpretation. See also Schenk-Geers, *International Exchange of information*, 48.

[233] Para 35 of the Introduction to the OECD MTC.

[234] See examples of Protocols to existing DTAs signed by South Africa and various countries as discussed below.

[235] GG 22313 dd 2001-05-24 which entered into force 9 April 2001.

[236] OECD MTC 2010 reference to country specific approaches.

8.1.2 OECD GUIDANCE ON "LOW VALUE-ADDING INTRA-GROUP SERVICES"

In its 2015 Final Report on Action 8-10, "low value-adding intra-group services", the OECD notes that nearly every MNE group must arrange for a wide scope of services to be available to its members, in particular, administrative, technical, financial and commercial services. Such services may include management, coordination and control functions for the whole group. The cost of providing such services may be borne initially by the parent, by one or more specially designated group members ("a group service centre"), or other group members.

An independent enterprise in need of a service may acquire the services from a service provider who specialises in that type of service or may perform the service for itself (i.e. in-house). In a similar way, a member of an MNE group in need of a service may acquire it from independent enterprises, or from one or more associated enterprises in the same MNE group (i.e. intra-group), or may perform the service for itself. Intragroup services often include those that are typically available externally from independent enterprises (such as legal and accounting services), in addition to those that are ordinarily performed internally (e.g. by an enterprise for itself, such as central auditing, financing advice, or training of personnel). It is not in the interests of an MNE group to incur costs unnecessarily, and it is in the interest of an MNE group to provide intra-group services efficiently. [237]

The OECD acknowledges that a number of countries have indicated that excessive charges for intragroup management services and head office expenses constitute one of their major BEPS challenges. In order to guide taxpayers regarding how to benchmark transactions involving cross-border services, and thereby provide protection against common types of base eroding payments, the OECD has proposed revisions to Chapter VII dealing specifically with management fees and head office expenses.

In combination with the G20 Development Working Group mandated to develop of toolkits which can be implemented by developing countries and which will protect these countries from base-eroding payments, the objective of this measure will assist developing countries in protecting their tax base from excessive intra-group service charges. [238]

[237] OECD/G20 2015 Final Report on Actions 8-10 at 143.

[238] OECD/G20 2015 Final Report on Actions 8-10 at 142.

8.1.3 THE SIMPLIFIED METHOD FOR DETERMINING ARM'S LENGTH CHARGES FOR LOW VALUE-ADDING INTRA-GROUP SERVICES

The aim of the "simplified approach", as its name suggests, is to propose an elective simplified approach which:

- specifies a wide category of common intra-group services which command a very limited profit mark-up on costs;
- applies a consistent allocation key for all recipients for those group services; and
- provides greater transparency through specific reporting requirements.[239]

The approach is designed to ensure, for payer countries, that the system through which the costs are allocated leads to an equal treatment for all associated enterprises that are operating in similar circumstances. Thus, the implications for South African taxpayers are that, where the approach is adopted, they will be charged for such services in a consistent manner to all other members of the MNE of which they are a part, and by all their different cross border connected parties providing similar services (clearly in order for this to apply the methodology needs to be applied by as many countries as possible). Equally, they will charge for such services, to their cross border connected parties in the same manner.

The approach "aims to guarantee that no overpricing takes place due to general agreement on categories of costs included in the cost base and general agreement on the determined moderate mark-up of 5% that should be charged".[240] The approach is designed to ensure that intermediate companies which have low functionality, will be transparent to payor companies.

A further benefit of the approach is that it removes the detailed benchmarking and testing of the benefits received and therefore creates a low cost methodology consistently applied for low value added services i.e. reduced compliance burden, but simultaneously provides the certainty that the relevant tax authorities will accept the approach.

Low value-adding intra-group services are defined as services performed by one member or more than one member of an MNE group on behalf of one or more other group members which:

- are of a supportive nature;
- are not part of the core business of the MNE group ;
- do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles; and

[239] OECD/G20 2015 Final Report on Actions 8-10 at 141.

[240] OECD/G20 2015 Final Report on Actions 8-10 at 141.

- do not involve the assumption or control of substantial or significant risk by the service provider and do not give rise to the creation of significant risk for the service provider. [241]

Examples of services that would meet the definition of low value-adding services are:

- accounting and auditing,
- processing and management of accounts receivable and accounts payable
- human resources activities,
- monitoring and compilation of data relating to health, safety, environmental and
  other standards regulating the business.
- information technology services
- internal and external communications and public relations support
- legal services,
- activities with regard to tax obligations,
- general services of an administrative or clerical nature.[242]

Activities that do not qualify for the simplified approach for low value-adding intra-group services are:

- services constituting the core business of the MNE group;
- research and development services (including software development unless falling within the scope of information technology services)
- manufacturing and production services;
- purchasing activities relating to raw materials or other materials that are used in the manufacturing or production process;
- sales, marketing and distribution activities;
- financial transactions;
- extraction, exploration, or processing of natural resources
- insurance and reinsurance; and
- services of corporate senior management (other than management supervision of services that qualify as low value-adding intra-group services).[243]

The Simplified method for determining arm's length charges for low value-adding intra-group services requires calculating, on an annual basis, the pool of costs incurred by all members of the group in performing services that fall within the category of low value-added beneficial intra-group services, but not including those services where a company performs services only for one other company. Once the costs have been identified, suitable allocation keys must be determined e.g HR cost determined by headcount. These must be used consistently and reasonably reflect the benefit received by the recipient of the service.

[241] OECD/G20 2015 Final Report on Actions 8-10 at 153.

[242] OECD/G20 2015 Final Report on Actions 8-10 at 154.

[243] OECD/G20 2015 Final Report on Actions 8-10 at 153-154.

Pre-defined documentation and reporting is required to support the simplified approach for submission to the tax administration:

- A description of the low- value added services, the beneficiaries, why the services are considered low-value added, the rationale for the provision of the services, the expected benefits thereof, the allocation keys and justification that they reasonably reflect the benefits received, and mark-up applied;
- Written contracts and agreements for the services; and
- Documentation and calculations showing the cost pool and the mark-up applied, and also the application of the allocation keys.

In order to assist developing countries, where excessive charges for intra group management services are viewed as being a major BEPS challenge, it suggested that a threshold be put in place whereby, if such services exceed the relevant threshold a full transfer pricing analysis would need to be performed, including evidence demonstrating detailed specific benefits received by the payor. It is suggested that the threshold be based on fixed financial ratios of the recipient party (e.g. proportion of intra group costs to total costs/turnover).[244]

A two-step implementation of the simplified approach is proposed: The first is for a large group of countries to agree on adopting the mechanism before 2018. OECD members have agreed to the approach in principle, and associated countries (which include South African) are considering it.[245] The second is for the OECD to perform further work on the design of the threshold and other implementation issues (To be finalised by end 2016).

8.1.4 OECD PROPOSED GUIDELINES

The proposed OECD Guidelines for Chapter VII of the transfer pricing guidelines refer to administrative, technical, financial and commercial services. Such services often include those that are typically available externally from third parties (legal and accounting) as well as those often performed internally (e.g. by the entity itself, such as internal auditing, financing advice, training or personnel). Such services may be provided together with other goods and services, including intangibles, and it is important for the principles of aggregation and segregations (in Chapter III of the Guidelines) to be considered to ensure no duplication.

The Guidelines set out the principles for the simplified method, but also advise on how to deal with these services in the absence of this method and also if the threshold for this method has been exceeded.

[244] OECD/G20 2015 Final Report on Actions 8-10 at 159.

[245] OECD/G20 2015 Final Report on Actions 8-10 at 142.

There are two issues in the analysis for intra group services. One is whether the services have actually been provided (the benefits test) and the other is what the charge for such a service should be, for tax purposes.

The benefits test provides that if the activity is not one that independent enterprises would have been willing to pay for, or which it would perform for itself, the activity should not be considered as an intra-group service under the arm's length principle. It should be noted that this principle applies equally to the simplified approach. However, under the simplified approach the taxpayer need only demonstrate that e.g. payroll services were provided rather than needing to demonstrate the individual acts that have given rise to the costs charged.

It is furthermore essential that reliable documentation is provided to the tax administration to verify that the costs have been incurred by the service provider.[246] A 'shareholder activity' would not ordinarily be an activity that would be charged for. Such activities include *inter alia* costs relating to the juridical structure of the parent (meeting, listing aspects etc.), costs relating to reporting requirements of the parent (e.g. consolidation, audit requirements for subsidiaries purely for parent reporting purposes), costs of raising funds for acquisition of new entities, investor relations etc., costs ancillary to corporate governance of the group as whole. If, on the other hand a parent company raises funds for its subsidiary to e.g. buy a new company, the parent would be viewed as providing a service to the subsidiary.

Intra-group services should not be viewed as providing benefit if they merely duplicate a service that another group member is performing for itself, or that is being performed by a third party. In addition, benefits that are incidental to a group company would also not be considered to be a service for which a charge should be levied e.g. the decision of the holding company to analyse whether to reorganise the group, or if the company has a higher credit rating merely by virtue of being a member of the group. If, however, the group member is provided a guarantee, in order that its credit rating is improved, then a charge would be warranted.

Centralised services like *inter alia* planning coordination, budgetary control, financial advice, accounting auditing, legal advice, computer services, assistance in the fields of production, buying, distribution and marketing, staff related services (e.g. recruitment and training), order management, customer service, call centres, R+D, and protecting IP would be considered to be intra-group services as an independent enterprise would be willing to pay for them.

The nature of the consideration for such services will depend on whether they are charged as and when supplied (a user charge) or whether the service provider

[246] OECD/G20 2015 Final Report on Actions 8-10 at 144.

company is ‘on call’ i.e. having staff and equipment available for use at any time[247]. In such circumstances an independent enterprise might agree to a ‘retainer’. However, this would not be appropriate if the potential need for the service would be remote, or where the services are readily available from other sources. In order to determine the level of benefit, the extent of the use of the service over several years should be considered. The guideline is clear that the mere payment for “management fees” is not evidence of services rendered.

On the basis that services have been rendered they can be charged for on the direct-charge method i.e. a specific charge for a specified service or an indirect charge method i.e. using a cost allocation and apportionment method. The latter is usually necessary because it is difficult for the service provider to determine exactly what costs were rendered to which group entity, but is not generally considered appropriate where third parties are provided the same services. In addition, it must be clear that the recipient has received an identifiable benefit, and the method for apportionment must make sense e.g. the allocation key must reflect a method that might apply for third parties e.g. sales promotion activities carried on centrally (trade fares, ad campaigns) may benefit the sales of a number of affiliates. The method for allocation must be one that a third party would be willing to accept.[248]

The Guideline requires that in determining the method for calculating the arm’s length compensation the perspective of the service provider and recipient must be considered. Generally, the method for compensating for services will be based on either a CUP or a cost based method (cost-plus or TNMM). If a cost-based method is used, it is important that if third party services are procured only the agency aspect is marked-up and not the third party costs. In addition, if a CUP method establishes a price, and the group costs exceed this it would not be appropriate to add an additional mark-up.

The Guidelines also recommend that where withholding taxes are levied on services they should only be applied to the mark-up and not the costs, as such withholding taxes can result in the service provider not recovering its costs.

8.1.5 THE SOUTH AFRICAN PERSPECTIVE

South Africa has EXCON rules that need to be considered in proposing the adoption of the ‘simplified method’.[249] However, on the basis that the approach is designed to provide a standardised ‘arm’s length’ approach it is recommended that SARB be approached to accept the method on the same basis as the tax authorities.

[247] OECD/G20 2015 Final Report on Actions 8-10 at 147.

[248] OECD/G20 2015 Final Report on Actions 8-10 at 48-49.

[249] Deloitte submission to DTC 26 July 2015 at 8.

On this basis, the reduced documentation and cost burden based on the safe harbour mark-up should be adopted in line with the OECD recommendations[250].

It is submitted that, in order to protect South Africa's tax base where such transactions are significant, a suitable threshold be determined, above which the normal rules, as set out in the guidelines should be applied.

8.1.6 RECOMMENDATIONS FOR SOUTH AFRICA

The DTC recommends that:

- In line with other countries, and to ensure the success of the simplified approach, South Africa adopts the simplified approach for low value added services, as proposed by the OECD, but also implements a suitable threshold. The level of this threshold should be evaluated once the further OECD work is complete.
- The proposed guidance on low value added services should be applied where real (as opposed to notional) expenses have been incurred.
- SARB should be approached to align with this approach.
- The withholding tax on service fees be scrapped (as per the 2016 Budget speech).

8.2 ACTION 10: TRANSFER PRICING GUIDANCE ON COMMODITY TRANSACTIONS

As noted above, developing countries identified transfer pricing of commodities as of critical importance to them since they create additional BEPS challenges for developing countries. Under the mandate of Action 10 of the BEPS Action Plan, which requires the development of transfer pricing rules to provide protection against common types of base eroding payments; the G20 and OECD countries have examined the transfer pricing aspects of cross-border commodity transactions between associated enterprises ("commodity transactions"). The outcome of this work is an improved framework for the analysis of commodity transactions from a transfer pricing perspective which should lead to greater consistency in the way that tax administrations and taxpayers determine the arm's length price for commodity transactions and should ensure that pricing reflects value creation.[251]

The IMF has noted that developing countries lose substantial amounts of revenue from MNEs involved in tax planning schemes especially, but not only, in the extractive industries.[252] However although the problem of transfer pricing in the extractive industry is a BEPS issue in developing countries, it was not initially a transfer pricing focus area in the BEPS Action Plan. This concern is, as the IMF

[250] Deloitte submission to DTC 26 July 2015 at 9.
[251] OECD/G20 2015 Final Report on Actions 8-10 in para 51.
[252] See IMF "Spillovers in International Corporate Taxation" (2014) at 7.

says, one of the "many situations that are more significant to or common in developing countries receive relatively little attention in existing transfer pricing guidance".[253] In this regard, the IMF explains that it is common for a MNE company to locate low risk, routine, light manufacturing or commercial ventures in developing countries so that productivity gains rarely translate themselves into higher local profit margins. In terms of the transfer pricing rules, these operations will be assigned a low fixed profit rates for tax purposes.[254]

Many developing countries incur tax losses from commodities that are exported at under- value to other companies in MNEs which are located in low tax jurisdictions. Tax losses also occur from equipment and other goods being imported at inflated prices into a given country from other companies in the MNE group, which are located in low tax jurisdictions, to obtain excessive tax deductible depreciation charges.[255] Developing countries are also concerned about schemes involving the interposition of entities between the multinational mining companies based in their countries and the market, leading to the developing country receiving a significantly low price on the end market price or contract price.[256] In most cases the interposed entities have little or no substance in the low tax jurisdiction, and often tax administrations face significant challenges obtaining information on the final market in the low tax jurisdictions and on the substance of the foreign entity involved.[257]

The International Mining for Development Centre[258] notes that "transfer pricing in the mining sector is crucial in sub-Saharan Africa, "particularly given the rapid growth in the economic importance of this sector, its technical and logistical complexity, the prevalence of multinational enterprise groups, increasingly fragmented supply chains, and high volumes of cross-border transactions between related parties. These factors create opportunities for transfer mispricing, which can take the form of underpayment for outbound supplies of mineral products and overpayment for inbound assets, services and finance provided to their mining operations in developing countries by foreign subsidiaries of MNE groups". Even relatively small percentage variations in transaction prices can translate into significant tax leakages where they relate to very large flows.[259] Similar leakages may also occur when payments for capital goods, finance or services provided by a related entity are overpriced.[260]

[253] IMF "Spillovers in International Corporate Taxation" (2014) at 32.

[254] IMF "Spillovers in International Corporate Taxation" (2014) at 32.

[255] ATAF "ATAF News: Giving Africa a voice on the burning issue of base erosion and profit shifting" (April 2015) at 1.

[256] ATAF "2nd Meeting: Cross Border Taxation Technical Committee" (3-4 March 2015) at 5.

[257] ATAF "ATAF News: Giving Africa a voice on the burning issue of base erosion and profit shifting" (April 2015) at 1.

[258] International Mining for Development Centre "Transfer Pricing in the Mining Section: An African Perspective – A Briefing Note" (September 2014) at 5.

[259] International Mining for Development Centre "Transfer Pricing in the Mining Section: An African Perspective – A Briefing Note" (September 2014) at 8.

[260] Ibid.

8.2.1 CONCERNS IN SOUTH AFRICA

In South Africa, SARS has identified the following key transfer pricing risks within the mining industry: fragmentation of the supply chain using intermediary marketing and sales entities; excessive debt deductions through thin capitalization; intra-group charges including services and royalty payments.[261]

SARS claims to have had some success in auditing these abuses and it has established a specialist unit to tackle transfer pricing.[262] SARS has stated that "over the last three years the transfer-pricing unit has audited more than 30 cases and has made transfer-pricing adjustments of just over R20-billion, at a conservative estimate, with an income tax impact of more than R5-billion." [263] Further that the auditing of a similar number of cases is in progress and others are in the process of being risk assessed.[264]

Since 1 October 2012, when the Tax Administration Act 28 of 2011 came into effect, SARS has been imposing hefty understatement penalties (up to 200%) on any transfer pricing adjustments made to a taxpayer's tax position (whether it results in actual tax being payable or not) followings audits conducted on mining and prospecting companies. Nevertheless SARS acknowledges that transfer pricing audits do not often yield quick results since certain schemes are complex and require much time and resources. One of the major risks area SARS identified, that is often very difficult to audit, is transactions involving fragmentation whereby MNEs enter in convoluted structures involving the inter-positioning of multiple companies, generally in low tax jurisdictions, (where they split out functions and risks) to divide profits.[265]

In such cases, SARS tries to test if there is substance in the transactions by scrutinising the broader structure or supply chain, looking out for elements of artificiality of transaction flows and/or agreements; high volumes as well as changes in transactions especially when there are changes in legislation. [266] SARS

[261] Nishana Gosai (SARS) “Transfer Pricing in the Mining Industry” (December 2011). Available at http://www.eisourcebook.org/cms/files/attachments/other/Transfer%20Pricing%20in%20the%20Mining%20Industry%20(RSA%20view).pdf accessed 3 August 2015.

[262] PWC “International Transfer Pricing: African Regional”. Available at http://www.pwc.com/gx/en/international-transfer-pricing/assets/south-africa.pdf accessed 9 March 2015.

[263] Times Live “Billions of Rands leave SA under the radar” Available at http://www.timeslive.co.za/thetimes/2015/01/11/billions-of-rands-leave-sa-under-the-radar accessed 8 March 2015.

[264] Ibid.

[265] Nishana Gosai (SARS) “Transfer Pricing in the Mining Industry” (December 2011). Available at http://www.eisourcebook.org/cms/files/attachments/other/Transfer%20Pricing%20in%20the%20Mining%20Industry%20(RSA%20view).pdf accessed 3 August 2015.

[266] Ibid.

acknowledges that “there is no easy solution to the problem” and that it is addressing the problem both from a domestic and international front.[267]

Although there are no cases on transfer pricing that have yet gone to court in South Africa, there have also been strong allegations and circumstantial evidence of mining companies shifting profits from South Africa to low tax jurisdictions exit using transfer pricing schemes. An October 2014 Business Times News Paper[268] put a spotlight on allegations of transfer pricing by the platinum mining company – Lonmin (whose parent company is based in the UK), which was been embroiled in the protracted wage demands by its Marikana rock drillers in 2012. The revelations arose from the materials made public in the proceedings of the “Farlam Commission of Inquiry” into the death of 34 Miners at the Marikina Mine in 2012.

The cross-examination of the company’s former Operations Chief revealed that between 2002 and 2008, Lonmin’s platinum marketing was done by its subsidiary Western Metals Sales Limited which was registered in tax-free Bermuda but operating out of London. For those marketing services, Lonmin paid about $170-million (R1.8-billion today) to Western Metals Sales Limited (Bermuda) even though it was not clear if the Bermuda company kept an office with staff who marketed its platinum.

The concern that arose was: if the marketing operations of Western Metals Sales Limited were done by the marketing staff in London, it was hard to imagine the commercial purpose the Bermuda-offshore company served, if not to reduce the tax burden. The cross-examination revealed that after 2007, Lonmin moved its marketing staff from London to its South Africa branch, Lonmin Management Services (LMS). So its marketing fees were diverted from Bermuda to the South African branch. Thus more millions were moved to the UK parent company through Lonmin’s South African branch (LMS).

From 2008 to 2012, Lonmin’s South African mines paid over R1-billion in sales commissions to LMS, according to figures before the commission. Lonmin disclosed in its 2013 annual report that 92% of its revenues were drawn from platinum sales to just two key customers. Concerns about the limited workload of the marketing division were raised and there were also transfer pricing concerns as to whether the service fees were fairly priced. Lonmin provided documents to the Farlam commission regarding its marketing function costs, which show that in 2011, for example, the marketing function cost LMS R17-million, while it received a marketing fee of R280-million – suggesting an enormous profit margin which Lonmin could not justify. There was also “management fees” paid by the South African mine, Western

[267] Ibid.

[268] A Crotty “Lonmin’s Failed gag Bid puts spotlight on transfer Pricing” *Business Times* 19 October 20142.

Platinum Limited to LMS from 2007 to 2012, this amounted to a further R1.4-billion that was channelled away from the South African mines.[269]

Further allegations of transfer pricing in the mining sector were made in a submission before the Portfolio Committee on Trade and Industry by the South African Mining Development Association (SAMDA)[270] - a mining Initiative by South African junior and black economic empowerment (BEE) mining investors. In its submission on "Transfer Pricing and Transformation within the Mining Industry" SAMDA alleges that large mining companies may be involved in transfer pricing to the detriment of BEE companies.[271] SAMDA alleges that some mining companies sell commodities to their marketing divisions in low tax jurisdictions and tax haven at lower than market related prices. This results in the shifting of profits to such jurisdictions; the declaration of low profits in South Africa and consequently the payment of low tax in the South Africa where the commodity is being produced, which is a loss to South Africa. [272]

Some of the schemes that mining companies are involved in, as cited by SAMDA include: under reporting of commodity prices in favour of contract pricing or recommended pricing; non-reporting of full range of products sold; inflated expenditure used to reduce profits locally; transfer of funds between connected South African companies, whereby funds are transferred to a company carrying an assessed loss so as to reduce prices; and exchange rate misreporting.[273] SAMDA states such schemes have impacted on the mining sector in that: the outflows of funds significantly exceeds what is spent locally; often projects committed to are scaled down, delayed or underfunded because of a perceived loss of profitability. Such schemes also impact on BEE partners to mining companies whose profits may be reduced as the dividends, which would have gone towards re-paying loans and funding products are shifted offshore, sometimes leading to cancelled BEE deals.[274] SAMDA alleges that engaging in transfer pricing schemes has contributed to the non-compliance with Mining Charter by mining companies.

[269] C Mckune "Questions Lonmin Must Answer" Mai& Guardian 16 October 2014.

[270] South African Mining Development Association (SAMDA): Submission to the Portfolio the Committee on Trade and Industry on "Transfer Pricing and Transformation within the Mining Industry" (3 September 2014). Available at https://www.google.co.za/#q=foreign+owned+mines+in+south+africa+ accessed 8 March 2015.

[271] Ibid.

[272] Ibid.

[273] South African Mining Development Association (SAMDA): Submissions to the Portfolio Committee on Trade and Industry on "Transfer Pricing and Transformation within the Mining Industry" on 3 September 2014 Available at https://www.google.co.za/#q=foreign+owned+mines+in+south+africa+ accessed 8 March 2015.

[274] Ibid.

8.2.2 RESPONSES TO TRANSFER PRICING OF COMMODITIES BY OTHER DEVELOPING COUNTRIES

The ability of a developing country like South Africa to curtail these abuses is hampered by challenges in the administration of transfer pricing legislation due in particular to the paucity of specialist expertise and experience and the difficulties in obtaining the information necessary for applying the arm's length principle. When it comes to commodities, these challenges are compounded by the "relative complexity of the mining sector, which can involve hard-to-value intangibles and other complex transactions, and by a lack of industry specific knowledge and experience within tax administrations."[275] These factors place significant pressure on tax administrations, limiting their current capacity to adequately monitor and address transfer pricing risks in the mining sector.[276]

Tax administrations also face difficulties in accessing information on the offshore entity that is party to the transaction, often this is complicated by the web of treaty network that the parties take advantage of.[277] In September 2014, the International Mining for Development Centre issued a briefing note which stated that reviews conducted by the World Bank Group of the mining taxation policy and administrative procedures of a number of mineral-rich African countries identified a strong need for a study focusing specifically on the administration of transfer pricing in the African mining sector. To date the results from this study have not been published, but it is clear that the focus on transfer pricing within the mining sector shows that all mining MNE's are coming under increased scrutiny.[278]

In response to these challenges some developing countries have adopted specific unilateral approaches for pricing commodity transactions, such as the so-called "sixth method" that was employed initially in Argentina but is now used by other South American countries such as Brazil, Peru and Chile. India is also applying this method.[279] This method makes specific reference to the use of publicly quoted commodity prices. Although there are difficulties in applying this method, the sixth method which uses quoted prices as a guide is considered clear in that it uses an objective standard that is easy to administer, since many commodities are traded on

[275] International Mining for Development Centre "Transfer Pricing in the Mining Section: An African Perspective – A Briefing Note" (September 2014) at 5.

[276] International Mining for Development Centre "Transfer Pricing in the Mining Section: An African Perspective – A Briefing Note" (September 2014) at 5.

[277] Nishana Gosai (SARS) "Transfer Pricing in the Mining Industry" (December 2011). Available at http://www.eisourcebook.org/cms/files/attachments/other/Transfer%20Pricing%20in%20the%20Mining%20Industry%20(RSA%20view).pdf accessed 3 August 2015.

[278] International Mining for Development Centre "Transfer Pricing in Mining: An African Perspective – A briefing Note" (September 2014). Available at http://im4dc.org/wp-content/uploads/2013/07/Transfer-pricing-in-mining-An-African-perspective-A-briefing-note1.pdf accessed 3 August 2015.

[279] International Mining for Development Centre "Transfer Pricing in the Mining Section: An African Perspective – A Briefing Note" (September 2014) at 9.

public exchanges. A quoted price can provide a clear and relatively objective point of reference. Hence, it can provide a basis for rules which are easy to administer and do not involve either subjective judgment or detailed examination of facts and circumstances.

In South Africa, there have been calls from civil society that the sixth method should be implemented, but the South African government has not considered applying this method presumably because there has not been internal guidance in the use of the method. [280]

With the emergence of unilateral approaches, the need to respond to the challenges of pricing commodity transactions, such as the use of the sixth method, highlighted the need for clearer guidance on the application of transfer pricing rules to commodity transactions. The OECD considered the difficulties faced by some countries: in determining adjustments made to quoted prices; verifying the pricing date, and accounting for the involvement of other parties in the supply chain.

It is further noted that several problems and policy challenges have been identified in respect of commodity transactions faced by tax administrations generally and, most acutely, by tax administrations of commodity-dependent developing countries. Countries have reported the following key transfer pricing issues that may lead to base erosion and profit shifting ("BEPS") in cross-border commodity transactions:

- The use of pricing date conventions which appear to enable the adoption by the taxpayer of the most advantageous quoted price;
- Significant adjustments to the quoted price, or the charging of significant fees to the taxpayer in the commodity producing country, by other group companies in the supply chain (e.g. processing, transportation, distribution, marketing); and,
- The involvement in the supply chain of entities with apparently limited functionality, which may be located in tax opaque jurisdictions with nil or low taxation. [281]

The OECD notes that these issues are pertinent for commodity dependent developing countries, for which the commodity sector provides the major source of economic activity, contributing in a significant manner to employment, government revenues, income growth and foreign exchange earnings. For many of these countries, dependence on commodities has defined their economic policy (making commodity exports the primary driver of growth and investment) and development trajectory.[282]

[280] International Mining for Development Centre "Transfer Pricing in the Mining Section: An African Perspective – A Briefing Note" (September 2014) at 9.

[281] OECD/G20 2015 Final Report on Actions 8-10 at 53.

[282] OECD "Discussion Daft on a BEPS Action 10: Cross-border Commodity Transactions" (16 December 2014 – 16 February 2015) in para 1.

8.2.3 OECD GUIDANCE ON TRANSFER PRICING OF COMMODITIES

In December 2014, the OECD issued a Discussion Draft on a BEPS Action 10 dealing with Cross-border Commodity Transactions.[283] In line with the OECD Work on Action 10, Chapter II of the Transfer Pricing Guidelines has been amended to include new guidance especially applicable to commodity transactions. In summary the new guidance, set out in the 2015 OECD Report (explained in detail below):

- clarifies how the comparable uncontrolled price (CUP) method can be applied to commodity transactions.
- advises that the CUP method would generally be an appropriate transfer pricing method for commodity transactions between associated enterprises.
- advises that quoted prices can be used under the CUP method, as a reference to determine the arm's length price for the controlled commodity transaction; and
- reasonably accurate comparability adjustments should be made, to ensure that the economically relevant characteristics of the controlled and uncontrolled transactions are sufficiently comparable.

The OECD recommends that with respect to the guidance for selecting the most appropriate transfer pricing method in the circumstances of a particular case, the CUP method would generally be an appropriate transfer pricing method for establishing the arm's length price for the transfer of commodities between associated enterprises. [284]

- In this regard, the OECD defines the term "commodities" to encompass physical products for which a quoted price is used as a reference by independent parties in the industry to set prices in uncontrolled transactions.
- The term "quoted price" is defined by the OECD to mean the price of the commodity in the relevant period obtained in an international or domestic commodity exchange market. In this context, a quoted price also includes prices obtained from recognised and transparent price reporting or statistical agencies, or from governmental price-setting agencies, where such indexes are used as a reference by unrelated parties to determine prices in transactions between them. [285]

Under the CUP method, the arm's length price for commodity transactions may be determined by reference to comparable uncontrolled transactions and by reference to comparable uncontrolled arrangements represented by the quoted price.

- Because quoted commodity prices generally reflect the agreement between independent buyers and sellers in the market on the price for a specific type

[283] OECD "Discussion Daft on a BEPS Action 10: Cross-border Commodity Transactions" 16 December 2014 – 16 February 2015.

[284] OECD/G20 2015 Final Report on Actions 8-10 in para 2.16A.

[285] OECD/G20 2015 Final Report on Actions 8-10 in para 2.16A.

and amount of commodity, traded under specific conditions at a certain point in time.

- A relevant factor in determining the appropriateness of using the quoted price for a specific commodity is the extent to which the quoted price is widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled transactions comparable to the controlled transaction. Accordingly, depending on the facts and circumstances of each case, quoted prices can be considered as a reference for pricing commodity transactions between associated enterprises. Taxpayers and tax administrations should be consistent in their application of the appropriately selected quoted price. [286]

For the CUP method to be reliably applied to commodity transactions, the economically relevant characteristics of the controlled transaction and the uncontrolled transactions or the uncontrolled arrangements represented by the quoted price need to be comparable.

- For commodities, the economically relevant characteristics include, among others, the physical features and quality of the commodity; the contractual terms of the controlled transaction, such as volumes traded, period of the arrangements, the timing and terms of delivery, transportation, insurance, and foreign currency terms.
- For some commodities, certain economically relevant characteristics (e.g. prompt delivery) may lead to a premium or a discount.
- If the quoted price is used as a reference for determining the arm’s length price or price range, the standardised contracts which stipulate specifications on the basis of which commodities are traded on the exchange and which result in a quoted price for the commodity may be relevant.
- Where there are differences between the conditions of the controlled transaction and the conditions of the uncontrolled transactions or the conditions determining the quoted price for the commodity that materially affect the price of the commodity transactions being examined, reasonably accurate adjustments should be made to ensure that the economically relevant characteristics of the transactions are comparable.
- Contributions made in the form of functions performed, assets used and risks assumed by other entities in the supply chain should be compensated in accordance with the guidance provided in these Guidelines. [287]

The Guidelines provide methods for determining comparability by looking at economically relevant characteristics eg physical features and quality of the commodity, contractual terms, volumes traded, period of arrangements, timing and

[286] OECD/G20 2015 Final Report on Actions 8-10 in para 2.16B.

[287] OECD/G20 2015 Final Report on Actions 8-10 in para 2.16C.

terms of delivery, transport, insurance and foreign currency terms. It requires adjustments where differences materially affect the price.

In order to assist tax administrations in conducting an informed examination of the taxpayer's transfer pricing practices, taxpayers should provide reliable evidence and document, as part of their transfer pricing documentation, the price-setting policy for commodity transactions, the information needed to justify price adjustments based on the comparable uncontrolled transactions or comparable uncontrolled arrangements represented by the quoted price and any other relevant information, such as pricing formulas used, third party end-customer agreements, premia or discounts applied, pricing date, supply chain information, and information prepared for non-tax purposes. [288]

A particularly relevant factor for commodity transactions determined by reference to the quoted price is the pricing date, which refers to the specific time, date or time period (e.g. a specified range of dates over which an average price is determined) selected by the parties to determine the price for commodity transactions. Thus the OECD provides Guidance on the determination of the pricing date for commodity transactions. This should prevent taxpayers from using pricing dates in contracts that enable the adoption of the most advantageous quoted price.

It also allows tax authorities to impute, under certain conditions, the shipment date (or any other date for which evidence is available) as the pricing date for the commodity transaction. [289]

- Where the taxpayer can provide reliable evidence of the pricing date agreed by the associated enterprises in the controlled commodity transaction at the time the transaction was entered into (e.g. proposals and acceptances, contracts or registered contracts, or other documents setting out the terms of the arrangements may constitute reliable evidence) and this is consistent with the actual conduct of the parties or with other facts of the case.
- Tax administrations should determine the price for the commodity transaction by reference to the pricing date agreed by the associated enterprises. If the pricing date specified in any written agreement between the associated enterprises is inconsistent with the actual conduct of the parties or with other facts of the case, tax administrations may determine a different pricing date consistent with those other facts of the case and what independent enterprises would have agreed in comparable circumstances (taking into considerations industry practices).
- When the taxpayer does not provide reliable evidence of the pricing date agreed by the associated enterprises in the controlled transaction and the tax administration cannot otherwise determine a different pricing date they

[288] OECD/G20 2015 Final Report on Actions 8-10 in para 2.16D.

[289] OECD/G20 2015 Final Report on Actions 8-10 in para 51.

may deem the pricing date for the commodity transaction on the basis of the evidence available to the tax administration; this may be the date of shipment as evidenced by the bill of lading or equivalent document depending on the means of transport.

- This would mean that the price for the commodities being transacted would be determined by reference to the average quoted price on the shipment date, subject to any appropriate comparability adjustments based on the information available to the tax administration.
- It is important to permit resolution of cases of double taxation arising from application of the deemed pricing date through access to the mutual agreement procedure under the applicable Treaty. [290]

The guidance developed under other BEPS actions is also relevant in dealing with issues relating to commodity transactions. In particular, the revised standards for transfer pricing documentation (Action 13 of the BEPS Action Plan) and the guidance in the chapter "Guidance for Applying the Arm's length Principle" (Action 9 of the BEPS Action Plan). [291]

This new guidance will be supplemented with further work mandated by the G20 Development Working Group, following reports by the OECD on the impact of base erosion and profit shifting (BEPS) in developing countries. The outcome of this work will provide knowledge, best practices and tools for commodity-rich countries in pricing commodity transactions for transfer pricing purposes. [292]

8.2.4 RECOMMENDATIONS FOR SOUTH AFRICA WITH RESPECT TO TRANSFER PRICING OF COMMODITIES

The DTC recommends, with respect to transfer pricing of commodities:

- South Africa should follow the OECD Guidelines on Commodities, including the additional guidelines, set out in Actions 8-10, with particular reference to quoted prices[293] and dates on which to apply these, as well as necessary adjustments, taking into account the comparability factors mentioned in the report (and others), and use these as the basis on which to establish a benchmark price. Such a price should be one that results in an appropriate level of profit for the affiliate based on its activities in the country, and taking into account the value it creates for the MNE as a whole. This includes the benefits of providing a source of supply combined with the management of stocks and of ultimate delivery, and access to raw materials which is a type of location-specific advantage.

[290] OECD/G20 2015 Final Report on Actions 8-10 in para 2.16E.

[291] OECD/G20 2015 Final Report on Actions 8-10 in para 51.

[292] OECD/G20 2015 Final Report on Actions 8-10 in para 51.

[293] The EFF's submission to the Davis Tax Committee supports the recommendation of the application of the quoted price (Sixth method) in South Africa at 31 and 39.

- Concern has been expressed[294] that one of the biggest risks facing the commodities sector is that most commodities are transported by sea. Bad weather, logistical problems and delays all impact the shipment date and result in demurrage. Since such delays and risk occur in transactions between independent parties, tax administrations should take such events into account before imputing a pricing date different to the contract date. It is submitted that the OECD recommendations now align with this proposal.
- SARS should consult with Industry to understand the "quoted price" data, its origins and how MNE's actually price the sale of commodities through the value chain, as well as South Africa's location in the context of key markets, the transport logistics and demurrage risks in order to:
    - determine the situations when it might be appropriate to apply the "deemed pricing date";[295] and
    - and to make it clear how it will implement the OECD proposals and the level of comparability adjustment it expects taxpayers to consider.
- SARS should issue guidance on the nature of adjustments that would be expected to be made to the quoted price, from a South Africa specific perspective, and only make such adjustments mandatory once such guidance has been issued;
- Consider the implementation of Advanced Pricing Agreements, discussed below, to ensure certainty for both taxpayers and SARS.
- Resources should be availed to ensure that SARS has capacity to apply the Guidelines on commodities, in particular, to facilitate the timely conclusion of MAP procedures to ensure non-double taxation).[296]

9 CONSIDERATION OF ADVANCE PRICING AGREEMENTS IN THE SOUTH AFRICAN CONTEXT

The recommendations set out above refer to Advance Pricing Agreements (APAs) as being a mechanism which may enhance the ability of SARS and MNEs operating in South Africa to achieve more certainty that transfer pricing is being appropriately determined in the context of the OECD Guidelines which, it is being recommended, will be adopted in the South African context. It is, thus, appropriate to consider the nature of the application of APAs in more detail.

'An APA is an "arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables, and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a period of time".

[294] Deloittes' submission to DTC (26 July 2015) at 5.

[295] Deloittes' submission to DTC: 26 July 2015 at 5.

[296] EFF Submission to the Davis Tax Committee on Illicit Financial Flows.

Where concluded bilaterally between treaty partner competent authorities, bilateral APAs provide an increased level of tax certainty in both jurisdictions, lessen the likelihood of double taxation and may proactively prevent transfer pricing disputes.'[297]

There are three types of APAs:

- A unilateral APA is an agreement between a taxpayer and the tax authority on the appropriate transfer pricing method to apply to its transactions with international parties. Such agreements typically operate for a period of five years, once finalised.
- A Bilateral APA is an agreement between tow tax authorities signed by the Competent Authorities under the relevant DTA through the mutual agreement procedure (MAP) article.
- A multilateral APA relates to an agreement between multiple tax authorities and taxpayers. These are rare and tend to be used only for specific projects.

APAs are generally applied looking forward but can be rolled back (per domestic rules permitting this).[298]

The United States established its APA programme in 1991 and has executed more than 1400 APAs since that date[299] (more than any other country) and the period for completion of such agreements ranges between 2.6 to 3.3 years[300].

Global inventories of disputes between treaty partners, largely composed of transfer pricing issues, have increased from 2352 cases in 2006 to 4566 in 2013.[301] With the adoption of the BEPS actions plans, especially country by country reporting, the number of transfer pricing disputes between treaty partners is likely to increase.[302] This is likely to make the attractiveness of the APA process more attractive to taxpayers wishing to avoid such disputes.

Despite the costs and time it takes to reach an APA, there are benefits to both the tax administration and the taxpayer in having this facility available.

Benefits to tax administrations include:

- Increased transparency, trust and credibility of tax authority;

[297] Section H, para 21 of the OECD draft paper “BEPS Action 14: Make dispute resolution mechanisms more effective”.

[298] Types of APA’s per presentation by PWC to DTC 24 August 2015 at slide 5.

[299] Bloomberg BNA: Article (26 November 2015): Do Advance Pricing Agreements still make Sense? By Steven C Wrappe.

[300] Presentation by PWC to DTC 24 August 2015 at slide 6.

[301] OECD Mutual Agreement Procedure Statistics for 2013 as quoted in Bloomberg BNA: Article (26 November 2015): Do Advance Pricing Agreements still make Sense? By Steven C Wrappe.

[302] OECD/G20 BEPS Project discussion on draft action 14 (Dec 18 2014) as quoted in Bloomberg BNA: Article (26 November 2015): Do Advance Pricing Agreements still make Sense? By Steven C Wrappe.

- Encourages FDI in country through upfront certainty provided to taxpayers through a contract sanctioned by law;
- Fosters closer and deeper relationships with treaty partners (bilateral and multilateral APAs);
- Reduces number of potential MAP disputes with other tax authorities;
- Provides solutions to complex transactions that are BEPS complianct;
- Promotes solutions and knowledge sharing through increased industry/taxpayer insight and thereby increased levels of TP competency of tax authority TP team, in part through discussing cases with other APA teams;
- Increase efficiency as less time needed to monitor compliance through TP audits;
- More cost effective as costs covered by taxpayer; and
- Gives control over the process – discuss TP considerations with taxpayer, but set out critical assumptions to provide protection if there are material changes to the taxpayer transaction.[303]

Benefits to taxpayers include:

- Gives upfront certainty (freedom from penalties and double tax, certainty in financial reporting and tax return disclosure) – essential for investment decisions;
- Enhanced relationship with tax administration due to greater transparency and thus trust;
- Controls costs (defined costs of APA versus undefined costs of subsequent transfer pricing dispute in the absence of an APA). In addition the potential to request roll forward and/or roll back of principles. Generally during the APA period the taxpayer needs only to produce documentation to support compliance with the APA and not other TP documentation; and
- Control over process- discuss TP considerations with tax administration, but set out critical assumptions to provide protection if there are material changes to the taxpayer transaction.[304]

9.1 CONSIDERATIONS FOR SOUTH AFRICA

Based on the above, APA arrangements clearly provide benefits to both tax administrations and taxpayers. Considerations that will need to be borne in mind in the South African context will be:

- The availability of qualified resources. Since taxpayers requesting APAs will be required to pay fees to support their request for an APA (much like the current advanced tax ruling regime in South Africa), the cost of ensuring that SARS has the relevant resources available should be covered. However, it will be important

[303] Presentation by PWC to DTC 24 August 2015 at slide 10.

[304] Presentation by PWC to DTC 24 August 2015 at slide 14 + Bloomberg BNA: Article (26 November 2015): Do Advance Pricing Agreements still make Sense? By Steven C Wrappe at 4-5.

that, if bilateral or multilateral APAs are to be entered into, the resources have sufficient authority and experience to ensure that the pricing in the APAs are correctly determined and that there is no bias in favour of a specific country, merely due to the negotiating abilities of the respective parties.

- The facility of APAs, and corresponding certainty of tax positions for both SARS and the taxpayer in South Africa, will assist in promoting the case for a hub for African investment.

9.2 DTC RECOMMENDATIONS

- ➢ The DTC recommends that SARS considers putting in place an APA regime in South Africa, subject to it ensuring it has adequate resources.

10 ACTION 13: RE-EXAMINE TRANSFER PRICING DOCUMENTATION.

10.1 BACKGROUND

In its 2013 Base Erosion and Profit Shifting (BEPS) Report,[305] 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:

- o In many countries, tax administrations have little capability of developing a "big picture" view of a taxpayer's global value chain.
- o There are divergences between approaches to transfer pricing documentation requirements which lead to significant administrative costs for businesses.
- o 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.[306]

10.2 OECD 2013 BEPS REPORT ON ACTION 13

On a domestic front, the OECD recommended, in 2013, that:

- o Countries should develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business.
- o 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.[307]

[305] OECD *Action Plan on Base Erosion and Profit Shifting* (2013) at 22.

[306] Ibid.

[307] Ibid.

- 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.
- 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.[308]

10.3 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[309] was adopted in 1995, tax administrations and taxpayers had less experience in creating and using transfer pricing documentation.[310] 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

[308] Ibid.

[309] 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.

provide clear guidance with respect to the link between the process for documenting transfer pricing, the administration of penalties and the burden of proof.[311]

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 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.[312]

The OECD Discussion Draft on Transfer Pricing and country-by-country reporting[313] 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 guidelines 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 guidelines went through a public consultation process conducted by the OECD. The finalised guidelines were then set out in the September 2014 Report on Action 13 (discussed below).

10.4 OECD SEPTEMBER 2014 REPORT AND OCTOBER 2015 FINAL REPORTS ON ACTION 13

The September 2014 Report, on Action Plan 13[314] noted that Chapter V of the Transfer Pricing Guidelines has been revised to provide for:[315]

- The objectives of transfer pricing documentation rules;[316]
- 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.

The October 2015 final report largely confirms the principles set out in the 2014 Report and, thus, only where there are differences between the two Reports are such differences highlighted below.

[310] OECD/G20 2014 Discussion Draft on Action 13 in para 2.

[311] OECD/G20 2014 Discussion Draft on Action 13 in para 2; OECD/G20 2014 Report on Action 13 at 13.

[312] OECD/G20 2014 Discussion Draft on Action 13 in para 3; OECD/G20 2014 Report on Action 13.

[313] OECD/G20 2014 Discussion Draft on Action 13 in para 2.

[314] OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.

[315] OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.

[316] Ibid.

10.4.1 OBJECTIVES OF TRANSFER PRICING DOCUMENTATION REQUIREMENTS

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

10.4.4.1 To ensure taxpayers can assess their compliance with the arm's length principle[317]

- 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.
- 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 taxpayers' 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. [318]

10.4.1.2 To provide tax administrations with the information necessary to conduct an informed transfer pricing risk assessment [319]

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

[317] OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.

[318] OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.

[319] Ibid.

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, include:

- transfer pricing forms (to be filed with the annual tax return);
- transfer pricing mandatory questionnaires focusing on particular areas of risk;
- 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. [320]

10.4.1.3 To provide tax administrations with useful information to employ in conducting an appropriately thorough transfer pricing audit[321]

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, a 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. [322]

In cases where 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

[320] OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.

[321] OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.

[322] Ibid.

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.[323]

10.4.2 THE THREE-TIERED APPROACH TO TRANSFER PRICING DOCUMENTATION

In order to achieve the above three objectives 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:

(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.[324]

10.4.2.1 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. However, line of business presentation would be acceptable where well justified by the facts. In this instance, care should be taken to assure that

[323] Ibid.

[324] OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.

centralised group functions and transactions between business lines are properly described in the master file.[325]

10.4.2.2 The Local file

In contrast to the master file which provides a high-level overview, MNEs 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.

- 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.
- Cross reference to information already contained in the Master File may, however, suffice.[326]

10.4.2.3 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; and
    - 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

[325] OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.

[326] OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.

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. [327]

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

- high-level transfer pricing risk assessment purposes; and
- it may be used by tax administrations in evaluating other BEPS related risks and where appropriate for economic and statistical analysis. [328]

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

- should 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;
- on its own does not constitute conclusive evidence that transfer prices are or are not appropriate; and
- should not be used by tax administrations to propose transfer pricing adjustments based on a global formulary apportionment of income. [329]

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.

[327] OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.

[328] Ibid.

[329] Ibid.

- 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 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.

10.4.3 COMPLIANCE ISSUES

10.4.3.1 Contemporaneous documentation

The OECD recommends that:

- Each taxpayer should endeavour to determine transfer prices, for tax purposes, that 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. [330]

10.4.3.2 Time frame

The OECD states 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:

[330] OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.

- 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 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.[331]

10.4.3.3 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.

[331] OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.

- 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.[332]

10.4.3.4 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 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.[333]

10.4.3.5 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.[334]

10.4.3.6 Language

The OECD recommends that:

[332] OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.

[333] Ibid.

[334] Ibid.

- 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.[335]

10.4.3.7 Penalties

The OECD states that:

- 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. Another alternative is that the burden of proof could be shifted to the tax administration where adequate documentation has been provided.[336]

[335] OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.

[336] Ibid.

10.4.3.8 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.[337]
- 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.[338]

10.4.3.9 Other issues

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.[339]

Certifying of documentation: The OECD states 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.[340]

10.4.4 IMPLEMENTATION AND REVIEW

- The OECD advises that it is essential that the new guidance in Chapter V of the Transfer Pricing Guidelines, and particularly the new country-by-country report, be implemented effectively and consistently.

[337] Reference to the OECD Guide “Keeping it Safe” regarding confidentiality of exchanged information is recommended Final Report (2015) in para 45.

[338] OECD/G20 2014 Report on Action 13 and OECD/G20 2015 Final Report on Action 13.

[339] Ibid.

[340] Ibid.

- The OECD is of the view that taxpayers should deliver the master file[341] and local file directly to tax administrations in the relevant local jurisdiction.
- Following consultation, based on the 2014 Report on Action 13, the OECD recommends, in the 2015 Report, that the first country-by-country report be required to be files for MNE fiscal years beginning on or after 1 January 2016. However, the OECD acknowledges that some countries may need time to follow their domestic legislative processes in order to make adjustments to the law. In order to assist MNE groups, model legislation has been developed to assist the parent in the group to file the country by country report in their jurisdiction of residence. Based on the recommendation that companies be required to submit the country by country report to the relevant tax authorities up to one year after the tax return has been submitted, it is envisaged that the first country by country reports would be submitted by 31 December 2017. Groups with consolidated accounts for year ends different to December will thus submit during 2018 (reporting on the first year beginning on or after 1 January 2016).[342]

  The OECD recommends that all MNE groups be required to submit country by country reports each year except those with annual consolidated turnover less than EU750mn (or the nearest domestic currency equivalent). Using this criterion the OECD believes that 85% to 90% of MNE groups will not be required to submit country by country reports, but that those that will be required to submit control approximately 90% of global corporate revenues. The burden of reporting is thus matched with the benefit to tax administrations.[343]

  It is the intention of countries participating in the OECD/G20 BEPS project to reconsider the appropriateness of the applicable revenue threshold described in the preceding paragraph in connection with their 2020 review of implementation of the new standard, including whether additional or different data should be reported, as set out in the September Report.

  The OECD advises that no exemptions from filing the country by country report should be adopted apart from the exemption based on consolidated turnover, indicated above. In particular, no special industry exemptions should be provided, no general exemption for investment funds should be provided, and no exemption for non-corporate entities or non-public corporate entities should be provided. Notwithstanding this conclusion, countries participating in the OECD/G20 BEPS Project agree that MNE groups with income derived from international transportation or transportation in inland waterways that is covered by treaty provisions that are specific to such income and under which

[341] OECD/G20 2015 Final Report on Action 13 in para 49.

[342] OECD/G20 2015 Final Report on Action 13 in para 50.

[343] OECD/G20 2015 Final Report on Action 13 in para 53.

the taxing rights on such income are allocated exclusively to one jurisdiction, should include the information required by the country by country template with respect to such income only against the name of the jurisdiction to which the relevant treaty provisions allocate these taxing rights. [344]

Countries participating in the country by country reporting initiative are required to adopt the following underlying principles:

-Confidentiality: Jurisdictions should have in place and enforce legal protections of the confidentiality of the reported information. Such protections would preserve the confidentiality of the country by country report to an extent at least equivalent to the protections that would apply if such information were delivered to the country under the provisions of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, a TIEA or a tax treaty that meets the internationally agreed standard of information upon request as reviewed by the Global Forum on Transparency and Exchange of Information for Tax Purposes. Such protections include limitation of the use of information, rules on the persons to whom the information may be disclosed. [345]

-Consistency: Jurisdictions should use their best efforts to adopt a legal requirement that MNE groups' ultimate parent entities resident in their jurisdiction prepare and file the country by country report, unless exempted because they don't meet the threshold. Jurisdictions should utilise the standard template contained in Annex III of Chapter V of the Transfer Pricing Guidelines. Consequently no jurisdiction will require that the country by country report contain either additional information not contained in Annex III, nor will it fail to require reporting of information included in Annex III. [346] Thus, the country by country reports should reflect consistent information regardless of where they are prepared.

-Appropriate use: Jurisdictions should use appropriately the information in the country by country report template. In particular, with respect to using the country by country report for assessing high-level transfer pricing risk in assessing other BEPS-related risks. Jurisdictions should not propose adjustments to the income of any taxpayer on the basis of an income allocation formula based on the data from the country by country report. If such adjustments based on country by country report data are made by the local tax administration of the jurisdiction, the jurisdiction's competent authority will promptly concede the adjustment in any relevant competent authority proceeding. This does not imply, however, that jurisdictions would

[344] OECD/G20 2014 Report on Action 13 in para 8 and OECD/G20 2015 Final Report on Action 13 in para 55. .

[345] OECD/G20 2014 Report on Action 13 in para 13 and OECD/G20 2015 Final Report on Action 13 in para 57.

[346] OECD/G20 2014 Report on Action 13 in para 13 and OECD/G20 2015 Final Report on Action 13 in para 58.

be prevented from using the country by country report data as a basis for making further enquiries into the MNE’s transfer pricing arrangements or into other tax matters in the course of a tax audit. [347]

10.5 INTERNATIONAL CONCERNS

- In its September 2014 report on Action 13, the OECD stressed the need to consider business' 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 taxpayer perspective, compliance with the reporting template represents an absolutely massive investment in terms of human resources and systems capability enhancements.[348] 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.[349]
- 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

[347] OECD/G20 2014 Report on Action 13 in para 13 and OECD/G20 2015 Final Report on Action 13 in para 59.

[348] 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.

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

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.

In the first quarter of 2015, the OECD released a report on Action 13 which provided guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting,[350] in which the OECD recommended that:

- The master file and local file elements of the new transfer pricing documentation standard should be implemented through local country legislation or administrative procedures and that the master file and local file should be filed directly with the tax administrations in each relevant jurisdiction as required by those administrations. [351]
- Confidentiality and consistent use of the standards contained in Annex I and Annex II of Chapter V of the Transfer Pricing Guidelines, and included in the September Report, should be taken into account when introducing these elements in local country legislation or administrative procedures. [352]
- The OECD plans to develop mechanisms to monitor jurisdictions' compliance with their commitments and to monitor the effectiveness of the filing and dissemination mechanisms. The OECD also recognises the need for more effective dispute resolution which may increase as a result of the enhanced risk assessment capability following the adoption and implementation of a country by country reporting requirement and that the work under Action 14 of the BEPS Project should take that into account. [353]

It is clear that these considerations were taken into account when finalising the Action 13 Report as released in October 2015.

10.6 THE FRAMEWORK FOR GOVERNMENT-TO-GOVERNMENT MECHANISMS TO EXCHANGE COUNTRY BY COUNTRY REPORTS AND THE IMPLEMENTATION PACKAGE

- The OECD recommends that jurisdictions should require, in a timely manner, country by country reporting from ultimate parent entities of MNE groups resident in their country (that qualify for country by country reporting as explained above) and exchange this information on an automatic basis with the jurisdictions in which the MNE group operates and which fulfil the above conditions for obtaining and the use of the country by country report. In case a jurisdiction fails to provide information to a jurisdiction fulfilling the conditions for obtaining and the use of the country by country report, because:

[350] OECD/G20 2014 Report on Action 13.

[351] OECD/G20 2014 Report on Action 13 in para 5.

[352] OECD/G20 2014 Report on Action 13 in para 6.

[353] OECD/G20 2014 Report on Action 13 in para 6.

(a) it has not required country by country reporting from the ultimate parent entity of such MNE groups;
(b) no competent authority agreement has been agreed in a timely manner under the current international agreements of the jurisdiction for the exchange of the country by country reports: or
(c) it has been established that there is a failure to exchange the information in practice with a jurisdiction after agreeing with that jurisdiction to do so,
a secondary mechanism would be accepted as appropriate, through local filing or through filing the country by country reports by a designated member of the MNE group acting in place of the ultimate parent entity and automatic exchanging these reports by its country of residence. [354]

Countries participating in the OECD/G20 BEPS Project have therefore developed an implementation package for government-to-government exchange of country by country reports and incorporated into the Guidelines. More specifically:

- Model legislation requiring the ultimate parent entity of an MNE group to file the country by country report in its jurisdiction of residence has been developed. Jurisdictions will be able to adapt this model legislation to their own legal systems, where changes to current legislation are required. Key elements of secondary mechanisms have also be developed.
- Implementing arrangements for the automatic exchange of the country by country reports under international agreements have been developed, incorporating the above conditions for obtaining and using the country by country report. Such implementing arrangements include the competent authority agreements ("CAAs") based on existing international agreements (the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, bilateral tax treaties and TIEAs), and inspired by existing models developed by the OECD working with G20 countries for the automatic exchange of financial account information.

Participating jurisdictions endeavour to introduce necessary domestic legislation in a timely manner. They are also encouraged to expand the coverage of their international agreements for exchange of information. The implementation of the package will be monitored on an ongoing basis. The outcomes of this monitoring will be taken into consideration in the 2020 review.[355]

10.7 TRANSFER PRICING DOCUMENTATION IN SOUTH AFRICA

South African Revenue Service's (SARS) Practice Note 7, which was issued on 6 August 1999 contains quite detailed but rather unclear "documentation

[354] OECD/G20 2014 Report on Action 13 in para 60.
[355] OECD/G20 2014 Report on Action 13 in para 62.

guidelines".[356] 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". [357]

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 13, Chapter V of the Transfer Pricing Guidelines have also been revised to provide for transfer pricing documentation rules as discussed above.

It is noted that the 2015 Tax Administration Laws Amendment Act added sub-paragraph 3(b) to section 3 of the Tax Administration Act Laws Amendment Act (promulgated January 2016). The subsection now permits SARS to, retain information obtained in accordance with an international tax standard, and retain such information as 'relevant material' and treat it as 'taxpayer information' for purposes of the other provisions of the Act[358]. An international tax standard is defined, in short, as a) the OECD standard for the Automatic Exchange of Information in Tax Matters; b) the country by country reporting standard for multinational enterprises specified by the Minister; and c) any other standard for the exchange of information.

Thus, the mechanism facilitating the exchange of information on MNE's and country by country reporting has already been put in place. The definition of whom such MNE's are remains to be determined. However, a draft gazette has been issued setting out the documentary requirements for MNE's and indicates that it is those with a group turnover exceeding R1bn that would be required to maintain the documentation set out. This documentation appears to go beyond the requirements set out in OECD Action 13.

- ➢ The DTC recommends that South Africa remains in line with the OECD provisions in order to be perceived to be investor or business unfriendly. Furthermore, it is recommended that the threshold be retained at OECD levels of EU750mn, converted at the year end of the group, in order to ensure consistency throughout the global group.

[356] SARS Practice Note 7 in para 10.3.

[357] Ibid.

[358] Tax Administration Act (28 of 2011).

10.8 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 assess 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 specific, and are based on the 1995 OECD Guidelines, it is recommended that section 31 be amended to require that the OECD guidelines be followed by companies that are part of a group, the consolidated turnover of which is greater than the stated OECD threshold for transfer pricing documentation, currently EU750mn. This figure is recommended on the basis that the South African Rand fluctuates widely and, in order to comply with the OECD minimum standard for documentation, the group turnover figure should be measured, converted to Rands using the exchange rate at the end of each financial year of the group. This will ensure consistency of treatment of all companies in an MNE, globally, as is the OECD intention.

- In addition, it is recommended that SARS revises PN 7 to be in line with the OECD revised Transfer Pricing Documentation Guidelines in Chapter V and recommended for companies that are part of smaller groups. For several years there have been indications from SARS and the National Treasury that an updated transfer pricing Interpretation Note is imminent. SARS PN 7 is now 17 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 transfer pricing documentation guidelines and 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 for companies that are part of an MNE group with turnover greater that EU750mn 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. The table at the end of this section illustrates which countries have adopted the OECD documentation by the beginning of March 2016, which in the DTC's view supports the need for South Africa to be fully aligned. For smaller groups, similar documentation should be encouraged (see below for more specific point on this) on the basis that they need to support the terms and pricing of material transactions with transfer pricing documentation reflecting that methodologies in line with the OECD Guidelines have been followed.

- 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, is 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 implements the same, but remains in line with the prevailing OECD guidelines at any particular time. This will ensure consistency of treatment of companies in groups globally. Furthermore, as the country by country report is designed to provide information for risk assessment only, the relevant authority (e.g. SARS) would still be in a position to ask for detailed information regarding service fees paid by the local company.

- As the OECD recommends, with regard to compliance matters under the heading "materiality", disproportionate and costly documentation requirements should not imposed on smaller groups (than those with EU750mn). Smaller groups should not be required to produce the same amount of documentation that might be expected from larger enterprises. Such documentation could be recommended but not be obligatory, leaving the amount of transfer pricing documentation produced to support the pricing to the relevant smaller group. However, smaller groups should be obliged to provide information about their material cross-border transactions in their tax returns to facilitate risk assessment (as is presently the case), and upon a specific request of the tax administration in the course of a tax examination or for transfer pricing risk assessment purposes. It is however important that the thresholds for 'SMEs' and less material transactions be clarified. The tax administration could for instance consider the significance of the cross-border connected party transactions.[359]

- 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, especially in relation to financial assistance, instead of the rather vague information which exists in the Addendum to SARS PN 7.

- It is furthermore recommended that, for the purposes of providing certainty to inbound investors, where loans are not significant, the replacement IN for PN7 should define a safe harbour eg debt to equity ratio (or in line with s23M), together with interest rate (eg prime +2% - or in line with prevailing excon requirements) for inbound loans not exceeding, say, R100mn. In this manner inbound investors will obtain the certainty they need regarding loan requirements without having to expend significant amounts of money to determine an arm's length amount for loans below the pre-defined limit.

- 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

[359] SAICA "Comment on DTC 1st Interim BEPS Report" (31 March 2015) para 23.

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 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 in para 10.2.6 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, if applicable, should be submitted by no later than the year following the tax return filing deadline. 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. However clear guidance should be issued on which group company has the legal obligation to retain what transfer pricing documentation. In this respect a distinction should be made between in-bound and outbound groups. [360]

- 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, albeit that only the financial information is updated if no significant changes have arisen in the business. Database searches for comparables should, however, be updated at least every 3 years. It is recommended that SARS should consider including the above guidance in the recommended update to the PN 7.

- As regards 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. Such penalties are usually civil (or administrative) monetary penalties. It however states 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.

[360] PWC “Comments on DTC BEPS First Interim Report” (30 March 2015) at 23.

- Furthermore secondary adjustments are also applicable. Based on the principle that the transfer of economic value, arising from an incorrect transfer price, results in depletion in the asset base of the South African taxpayer; and a resultant potential loss of future taxable income for the fiscus, 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 results in a tax equivalent to the proposed 15% withholding tax. Because the imposition of the 15% withholding tax is an anti-avoidance measure and it is a tax levied on the South African company rather than on the foreign related party, no DTA relief would be available. This latter point needs to be made clear in the legislation or the revised PN 7.

- 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. It is recommended that SARS should consider such an incentive programme to encourage compliance. SARS could consider the incentive that the secondary adjustment will be waived if the documentation has been prepared in line with the guidelines.

- 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 2014, the OECD released a discussion draft entitled “Transfer Pricing Comparability Data and Developing Countries”, in respect of which many comments and suggestions were submitted to the OECD regarding the fact that most developing countries do not have (reliable) comparables, which could be used to benchmark the pricing in respect of transactions between connected persons. The reasons for the lack of suitable comparables vary; often there is no requirement for private companies to disclose financial information, or the financial reporting standards applied vary. Listed companies normally operate within a group and can therefore not be used as reliable comparables in that these companies are not independent, and connected party transactions may impact on their financial results. The OECD, in its 2014 discussion draft “Transfer Pricing Comparability Data and Developing Countries” provided four possible approaches to deal with the issue:
  - primarily focus was placed on improving the availability of direct comparables from local sources (expanding the range of data in

commercial databases to include data from developing countries and providing such countries with access);
  - using the available data more effectively (guidance or assistance in the use of commercial databases, adjustments etc.);
  - relying on approaches which do not focus on direct comparable data (e.g. safe harbours, value chain analysis, use of the profit split method, sixth method); and
  - advance pricing agreements and mutual agreement proceedings.

- It is therefore important that SARS builds a database of comparable information and that this data base is accessible to taxpayers. Until such database is built and made available to taxpayers, SARS should provide taxpayers with clear guidance regarding alternative options, i.e. ideally all the above four approaches recommended by the OECD with clear guidance regarding the use thereof from a South African perspective.

- SARS needs to ensure that it maintains and grows its highly skilled transfer pricing team, and to ensure it includes lawyers and accountants, business analysts and economists. Such a team will ensure an understanding of commercial operations. This will require that measures are taken to identify, employ and retain sufficient skilled personnel, especially in the regions.

- Information required from corporates, via the ITR14 submissions, needs to be improved so that timely decisions can be made on the risk assessment of companies, and any consequent queries and adjustments. The guidance provided by SARS in the Tax Return Guide in respect of the relevant information is often unclear and needs significant improvement. In addition, the Tax Return Guide is updated once in a while, however, taxpayers are not notified of these updates, which may result in a taxpayer completing transfer pricing related disclosure following specific guidance, but at the time the tax return is submitted via e-filing, the guidance (or even the question in the tax return) may have changed without the taxpayer being sufficiently notified of this.[361]

- Guidance regarding the transfer pricing related disclosures in the ITR14 should be clarified either in the Tax Return Guide, and any changes should be brought to the attention of taxpayers, or guidance should be included in the overall South African transfer pricing guidance. [362]

[361] SAICA “Comment on DTC 1st Interim BEPS Report” (31 March 2015) para 26.
[362] SAICA “Comment on DTC 1st Interim BEPS Report” (31 March 2015) para 27.

- 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.
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- With respect to financial institutions, financial data available to SARS usually includes publically available and non-publically available data. Care should therefore be taken to ensure that even when SARS builds a database, taxpayers such as financial institutions can still make use of non-publically available data so that they can be able to defend their positions against these comparables. This will also minimise the uncertainties for taxpayers with respect to updating their data and other administrative issues surrounding data keeping.[363]

- The use of safe harbour rules is often disputed. However, recent developments in the OECD have led to a change in the relevant guidance and there is globally more support for the use of safe harbour rules. Despite the concern that safe harbour rules limit the arm's length principle in that, when applying a safe harbour rule, less focus is placed on what independent third parties would have achieved in similar circumstances, particularly where less significant transactions are considered, the use of safe harbours may help contain compliance costs. For example, a safe harbour rule has been proposed by the OECD/G20 in terms of the BEPS initiative regarding the pricing for low value adding services. The use of safe harbours in South Africa should be considered. In particular, see recommendation regarding inbound loans amounting to less than, say R100mn.

[363] Comments submitted to the DTC by the Banking Association South Africa (BASA) on the "DTC First Interim Report on BEPS Action 1" (25 March 2015) at 2.