

Addressing challenges facing SARS relating to the application of transfer pricing in business restructurings

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ABSTRACT

Multinational enterprises have been widely accused of using aggressive tax planning schemes to avoid paying tax all over the world. The purpose of this study is to analyse the methods used by multinational enterprises in the context of business restructurings to shift profits from high to low tax jurisdictions. Transactions between associated entities have generally been manipulated by applying non-arm's length prices to these transactions, as well as devising agreements where the economic substance varies from the form of the transaction. The study aims to investigate some of the practical challenges faced by tax administrators in the application of the arm's length principle.

The study was conducted based on a literature review, as well as analysing specific examples reported in newspapers where multinational enterprises have used aggressive tax planning schemes to shift profits. International case law was also analysed to evaluate some of the factors considered by the courts in the determination of the arm's length price.

It was found that multinational enterprises definitely use aggressive tax planning schemes to shift profits. The practical challenges in the determination of arm's length prices, complexity of the transactions involved, as well as a lack of resources, especially in the developing nations, are some of the factors that cause tax administrators to battle to find a solution to deter and detect these schemes. Other methods such as the unitary taxation method and the country by country reporting concept have been brought forward as alternatives to the arm's length principle.

These alternatives have been proposed in an effort to find a solution to the challenges posed by the arm's length principle. Specific measures have also been recommended for developing nations' tax administrators to resolve the issues that they currently experience in this context.

KEYWORDS: Multinational Enterprises, Aggressive tax planning, Transfer pricing, Arm's length principle, Business restructurings, Substance over form, OECD Guidelines

OPSOMMING

Multi-nasionale ondernemings word wêreldwyd daarvan beskuldig dat hulle aggressiewe belastingskemas beplan om belasting vry te spring. Die doel van hierdie studie is om die metodes te ondersoek wat multi-nasionale ondernemings gebruik binne die konteks van besigheidsherstrukturering of die skuif van wins van hoë na lae belastingjurisdiksies. Transaksies tussen geassosieerde entiteite word dikwels gemanipuleer deur nie-armlengtepryse op hierdie transaksies toe te pas, en ook deur die ontwerp van ooreenkomste waar die ekonomiese wese van die transaksie van die vorm daarvan verskil. Die studie het ten doel om van die praktiese uitdagings wat belastingowerhede konfronteer met die toepassing van die armlengtebeginsel te ondersoek.

Die studie is gebaseer op 'n literatuurstudie en spesifieke voorbeelde van multi-nasionale ondernemings wat aggressiewe belastingskemas ontwikkel het om wins te verskuif soos in die pers vermeld. Internasionale hofsake is geanaliseer om die faktore wat deur die howe in ag geneem word tydens oorweging van die armlengteprys te ondersoek.

Die studie het bevind dat multi-nasionale ondernemings definitief aggressiewe belastingskemas gebruik om wins te verskuif. Die praktiese struikelblokke met die bepaling van die armlengtepryse, die kompleksiteit van die betrokke transaksies en die tekort aan hulpbronne, veral onder ontwikkelende nasies, is van die faktore wat belastingadministrateurs laat stoei om 'n oplossing te vind om hierdie skemas op te spoor en af te weer. Ander metodes soos die unitêre belastingmetode en die konsep van land-vir-land rapportering is al voorgestel as alternatiewe vir die armlengtebeginsel.

Die genoemde alternatiewe word voorgestel in 'n poging om 'n oplossing te vind vir die uitdagings wat die armlengtebeginsel inhou. Spesifieke maatstawwe word voorgestel vir die belastingadministrateurs van ontwikkelende lande om sodoende die spesifieke kwessies wat hulle ervaar in hierdie konteks aan te spreek.

SLEUTELWOORDE: Multi-nasionale ondernemings, aggressiewe belastingbeplanning, oordragprys, armlengtebeginsel, besigheidsherstrukturering, wese bo vorm, OESO riglyne

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CHAPTER 1

INTRODUCTION

1.1 INTRODUCTION AND BACKGROUND

Aggressive tax planning by Multinational Entities (hereafter referred to as MNEs) has been a major concern for both developed and developing nations around the world. MNEs have been accused of taking advantage of loopholes in the tax legislation to avoid paying taxes. One of the strategies that the MNEs have been using is transfer pricing in business restructurings. The Organisation for Economic Co-operation and Development (OECD) generally defines business restructuring as a multinational enterprise's cross-border redeployment of functions, assets and/or risks, even though it has acknowledged that there is no legal or universally accepted definition (OECD, 2010a:4).

Within the South African context, the Commissioner of the South African Revenue Service (SARS) told parliament's finance committee on 8 May 2012 that SARS has detected an increase in the use of cross border structuring and transfer pricing manipulations by businesses to unfairly and illegally reduce their local tax liabilities (Anon, 2012a). Transfer pricing by large multinationals has therefore been earmarked as one of the seven main focus areas in the SARS compliance programme. The programme has now been published on the SARS website and it covers periods 2012/13 – 2016/17.

The fact that transfer pricing is included in the top seven of SARS' focus areas for the next five years, indicates that it poses a high risk of non-compliance. This is mainly due to the high risk of revenue loss by the fiscus due to these aggressive tax planning practices by MNEs. Even though the actual losses in revenue cannot be quantified, SARS estimates that multinational enterprises account for more than 70% of world trade, so there is an imperative to counter unacceptable transfer pricing practices (SARS, 2012:13). An understanding of the MNEs business restructuring practices is therefore required in an effort to combat the revenue losses by the fiscus as a result of these practices.

One of the key questions that arise during a business restructure is whether the pricing under the business structure satisfies the arm's length principle. The dual objective of the arm's length principle (protecting a country's tax base while limiting risks of double taxation) is shared by both OECD and non-OECD countries (OECD, 2011c:3). The effect of non-arm's length transactions is the shifting of profits usually from a high tax jurisdiction to a low tax jurisdiction.

Today, countries have differing experiences and approaches in their transfer pricing examinations of business restructurings. This lack of a common understanding of how the arm's length principle should apply to business restructurings creates significant uncertainties for businesses and for tax administrations (Silberztein 2008:1).

1.2 PROBLEM STATEMENT

The research problem that will be investigated in this study is how SARS can address the practical challenges of applying the transfer pricing arm's length principle in business restructurings. Non-arm's length transactions have a significant revenue loss impact, not only on SARS, they cause concern for all the revenue authorities all around the globe.

1.3 OBJECTIVES

The research objectives to address the problem statement are as follows:

- i. To identify the practical challenges relating to the arm's length principle including uncertainties regarding the principle despite the "new guidelines" that have been issued by the OECD in this regard (Chapter 3 and Chapter 5);
- ii. To critically analyse how the arm's length principle can be used by MNEs as an aggressive tax planning tool (Chapter 2);
- iii. To critically analyse the substance over form principle in the context of business restructurings – allocation of risk in connection with the economic substance of the transaction (Chapter 4);

- iv. To clarify if long term losses as a result of business restructurings necessarily evidence inflated non-arm's length prices that result in tax revenue losses (Chapter 4);
- v. Make recommendations on possible ways of dealing with the practical challenges of applying the arm's length principle (Chapter 6).

1.4 RESEARCH METHOD

The study employs a method of non-empirical research with qualitative literature review and case law. Various sources of literature are consulted including academic journals, various OECD guidelines and bulletins, published technical articles and newsletters, tax legislation, newspaper articles, as well as textbooks. In addition, a critical analysis of international case law is performed. International case law that is analysed during this study includes case law from the following countries: Australia, the United States of America and Canada. The countries stated above have been selected mainly because there is very little if any case law on transfer pricing in the South African context. Furthermore, South Africa, like most developing nations, has a set of functioning transfer pricing rules that could still be improved compared to the above-named developed countries that have advanced tax systems. Developing countries with already implemented rules could be offered assistance in bringing their legislation to international standards through help in drafting more sophisticated and encompassing rules, advance pricing agreements, and simplified compliance procedures (Anon, 2012b). An analysis of case law originating from the above-named countries, which are all members of the OECD, will provide good guidance in the South African context as South Africa is constantly aligning its legislation to OECD international best practices.

All the documents that have been consulted are in the public domain, hence there are no ethical considerations.

1.5 OVERVIEW

Listed below is a brief summary of the chapters that will be included as part of this study.

Chapter 1: Introduction.

Chapter 1 gives a brief overview of the research topic and the objectives of the dissertation. It also gives a brief summary of the motivation for choosing the topic and it describes the research method and design that will be used during the research process.

Chapter 2: Understanding how business restructuring can be used as an aggressive tax planning tool.

Chapter 2 analyses how business restructuring can be used by multinational companies as an aggressive tax planning technique, with the result that some taxpayers gain an unfair competitive advantage.

Chapter 3: Arm's length principle and the practical challenges

Chapter 3 takes a look at the factors that can assist in the determination of the arm's length transactions in cases where comparables are not found. It touches on the practical challenges and on issues such as how difficult it is to provide prescriptive criteria that can be used as a benchmark in all situations. Silberztein (2008:1) points out that "The arm's length principle does not require compensation for loss of profit/loss potential per se. The question is whether there are rights or other assets transferred that carry profit/loss potential and should be remunerated at arm's length, taking account of the perspectives of both the transferor and the transferee".

Chapter 4: Substance over form principle in relation to business restructurings and how transactions can be manipulated.

Chapter 4 seeks to ascertain the consistency of the allocation of risk between associated entities with the economic substance of the transactions. This will also be analysed in conjunction with whether the contractual terms provide for an arm's length allocation of risk.

Chapter 5: Critical analysis of the OECD transfer pricing guidelines

This chapter seeks to critique the guidelines that have been provided by the OECD as well as to analyse the guidance provided by other tax bodies such as the Joint Committee on Taxation (JCT) in the context of income shifting and transfer pricing.

Chapter 6: Conclusion and recommendations on the best possible way of dealing with the practical challenges of applying the arm's length principle. The chapter also makes conclusions and recommendations on the aggressive tax planning arrangements used by MNEs.

CHAPTER 2

UNDERSTANDING HOW BUSINESS RESTRUCTURING CAN BE USED AS AN AGGRESSIVE TAX PLANNING TOOL

2.1 INTRODUCTION

According to Choudhury and Mishra (2007:1) multinational business organisations have increasingly felt the need to restructure their businesses to provide more centralised control and effective management of various businesses in services, manufacturing and distribution functions. The pressure of competition in a globalised economy, savings from economies of scale, the need for specialisation and the need to increase efficiency and lower costs are all described as important in driving business restructuring (OECD, 2010a:16). Although it should be acknowledged that tax is no longer necessarily the primary purpose of business restructurings, most MNEs take advantage of such restructurings as an aggressive tax planning tool. Reducing or eliminating taxes is attractive to corporations as it boosts shareholder value, post-tax earnings and returns to shareholders, and it also increases company dividends and executive rewards as these are linked to reported earnings (Sikka & Willmott, 2010:3).

The loss of revenue to tax authorities is significant both in African developing countries as well as in the developed nations. As a result, South Africa has championed an initiative led by Oupa Magashula, Commissioner General of the South Africa Revenue Service, Nhlanhla Nene, South Africa's Deputy Finance Minister and Pascal Saint-Amans, Director the OECD's Centre for Tax Policy and Administration. The initiative is aimed at helping developing countries to strengthen their domestic revenues by making their tax systems fairer and more effective. Building on that concept, the OECD will establish an independent foundation, to be up and running by the end of 2013, that will provide international auditing expertise and advice to help developing countries better address tax base erosion, including tax evasion and avoidance (OECD, 2012b:1).

The initiative is much needed for developing countries as “African countries are vulnerable to higher revenue loss through tax crimes because of a lack of knowledge on detecting and prosecuting sophisticated evasion tactics” (Anon, 2012a). This initiative will assist with the provision of tax experts to help with international tax audits involving complex transactions, one of which is aggressive tax planning by MNEs through transfer pricing business restructurings.

2.2. THE MEANING OF “AGGRESSIVE TAX PLANNING” IN RELATION TO TRANSFER PRICING IN BUSINESS RESTRUCTURINGS

Aggressive tax planning is a source of increasing concern for many countries and they have developed various strategies to deal with it. The OECD (2011a:1) reported that due to the recent financial and economic crisis, global corporate losses have increased significantly. The OECD further noted that the numbers at stake are vast, with loss carry-forwards as high as 25% of GDP in some countries. This is as a result of the fact that some corporations unfairly claim losses to avoid tax by for example overpricing transactions from low-tax to high-tax countries and underpricing transactions in the opposite direction. Due to the unethical practices adopted by MNEs operating in developing countries, tax revenues from corporate profits and capital have been shrinking in comparison to the revenues raised from ordinary citizens (Otusanya, 2011:320). In other words, ordinary citizens who are supposedly the poor are paying more tax than the rich MNEs.

The Christian Aid organisation blames tax havens as tax havens help wealthy individuals and multinational companies (as well as criminals, corrupt leaders and terrorists) move their wealth and profits offshore to avoid paying tax (Christian Aid, 2005:10). Through offshore tax havens, fraud and transfer pricing schemes, billions of dollars go untaxed (Otusanya, 2011:320). For instance, Sikka and Willmott (2010:5) report that microstates like the Cayman Islands do not levy taxes on corporate profits and therefore local tax authorities have little reason to be concerned with transfer pricing practices. This means that MNEs with subsidiaries in such areas are inclined to shift their profits to these destinations where no tax is levied.

According to Otusanya (2011:5), MNEs constantly search for new ways of increasing their profits, and one way in which they do so is by developing complex financial structures in order to avoid or evade the payment of taxes. This argument is supported by the OECD in its report released in March 2012 dealing specifically with hybrid mismatch arrangements. The report outlines that these arrangements exploit differences in tax treatment of instruments, entities or transfers between two or more countries, and this leads to double non-taxation. It also argues that while there may be several layers of complexity, these arrangements are based on similar underlying elements and aim at achieving the same goal.

The OECD illustrates the elements of a hybrid mismatch arrangement as generally using one or more of the following underlying elements:

- Hybrid entities: Entities that are treated as transparent for tax purposes in one country and as non-transparent in another country.
- Dual residence entities: Entities that are resident in two different countries for tax purposes.
- Hybrid instruments: Instruments that are treated differently for tax purposes in countries involved, most prominently as debt in one country and equity in another country.
- Hybrid transfers: Arrangements that are treated as transfers of ownership of an asset for one country's tax purposes, but not for tax purposes of another country, which generally sees a collateralised loan (OECD, 2012a:7).

The intended effects of the above elements of hybrid mismatch arrangements can be far-reaching, ranging from double deduction, no inclusion, to foreign tax credit generator schemes. The OECD (2012a:7) further outlines the effects of hybrid mismatch arrangements as falling into the following categories:

- Double deduction schemes: arrangements where a deduction related to the same contractual obligation is claimed for income tax purposes in two different countries.
- Deduction/no inclusion schemes: arrangements that create a deduction in one country, typically a deduction for interest expenses, but avoid a corresponding inclusion in taxable income in another country.

- Foreign tax credit generators: arrangements that generate foreign tax credits that arguably would otherwise not be available, at least not to the same extent or not without more corresponding taxable foreign income.

Furthermore, the report contends that the amounts involved in these transactions are substantial. New Zealand has been reported to have settled cases involving four banks in 2009 for a sum of NZD2.2Billion. Italy has reported settlements approximating EUR1.5Billion. In the United States, foreign tax credit generator transactions have been estimated at USD3.5Billion. These countries reported here, although they have developed advanced economies, mostly have subsidiaries and related entities in South Africa. It therefore means that South Africa is also affected by these transactions as the transactions involve two legs in two different countries. SARS should therefore be on the lookout for such complex transactions and respond appropriately to the rapidly changing markets and to the new complex aggressive tax planning schemes.

2.3 SPECIFIC EXAMPLES WHERE MNEs HAVE USED BUSINESS RESTRUCTURINGS TO SHIFT PROFITS

The aggressive tax planning tools analysed above will now be further examined by means of examples that show how the global trade in commodities and/or services are engineered to eventually deprive countries where profits are actually earned.

2.3.1 The case of SAB Miller

SAB Miller, one of the world's leading brewers, operates across six continents and has been accused of depriving poor countries of millions of revenue through aggressive tax planning. The giant multinational brewer, listed on the UK Stock Exchange, was accused by ActionAid, a global Non-Governmental Organisation (NGO) that tackles poverty, in its initial report released in November 2010.

Crotty (2010) reports in a damning report that ActionAid stated that its investigation used published financial information, interviews with government officials and undercover research to find out how SABMiller avoided tax across Africa and India.

“The cost to the governments affected may be as much as £20 million (R221m) per year” (Crotty, 2010). Crotty adds that ActionAid does stress that SABMiller “isn’t a lone bad apple”, noting that its avoidance practices conformed to “the model followed by multinational firms the world over”. The amount of lost revenue would have made a significant difference in improving the lives of the people in these developing countries through education and health systems, to mention but a few (own emphasis). The countries affected include India and four other African countries.

The report describes four methods used by SABMiller, and most multinational enterprises, to minimise tax payments. In SABMiller’s case, the methods involve large payments made by subsidiaries in developing countries to sister companies in tax havens. ActionAid claims that such payments, which were supposed to be made on an “arm’s-length basis”, could reduce or even eliminate profits in one place at a stroke of an accountant’s pen (Crotty, 2010). Crotty further reported that the ActionAid report focuses much attention on the Ghana operations and the report alleged that the Ghanaian operation makes no profit because of tax avoidance, and therefore pays no tax in that country.

Crotty (2010) further reports that management fees were paid to sister companies situated in European tax havens, mostly Switzerland. Lending of money between subsidiaries to maximize on the tax efficiencies for the benefit of the holding company was also cited as a method used by SAB Miller. Local brands invented by subsidiaries in the developing countries are not owned in the country where they were invented, brewed, or consumed, but are now owned by a company based in the Netherlands. Such brands included Castle, Stone and Chibuku. This enables the firm to pay next to no tax on the royalties they earn on these brands. Lastly, the newspaper reports how the ActionAid in its report lists the issue of subsidiaries procuring goods from a sister subsidiary in Mauritius also as a scheme used by SAB Miller to take advantage of the low tax rates in Mauritius.

The Norwegian commission of enquiry reports the transfer of ownership of brand names to subsidiaries in tax havens as one of the strategies used by MNEs. The Norwegian Commission of enquiry into capital flight from poor countries (2009:53) contends that companies charge royalties for the use of the brand name, reducing taxable profit in high-cost countries. A multinational company may transfer such

brand names to subsidiaries in tax havens at a very low price or free of charge. Such transfers of brand names, for instance, can be legal pursuant to the tax regime in certain countries. Accordingly, the commission argued that the fact that tax havens apply tax rates for foreigners alone that are effectively zero or close to zero, makes such transactions very attractive.

The African Tax Forum (ATAF) reacted to the reports by the ActionAid allegations of SAB Miller's aggressive tax planning practices by calling for a meeting to discuss SAB Miller's tax's profile in the four allegedly affected African countries it operates in. Crotty (2011) reports that forum executive secretary Logan Wort told the Wall Street Journal that the forum's mission was to train and provide technical support to tax officials in member countries so that they could plug tax "leakages". Crotty further reports that Martin Hearson, the author of the ActionAid report, welcomed the meeting by ATAF and believes that tax avoidance and evasion will come under increasing scrutiny in Africa due to such initiatives.

2.3.2 The big three banana producers tax haven case

Routing of commodity trade and its associated activities through tax havens has become an increasing trend among MNEs. This means that transactions are shifted between different countries to minimize tax bills. An investigation by The Guardian newspaper of three big banana companies revealed in 2007 that Dole, Chiquita and Fresh del monte have in some years paid tax at an effective rate of 8%, and yet the rate of tax in the US, where they have their headquarters, is 35% (Griffiths & Lawrence, 2007).

Griffiths and Lawrence (2007) report that MNEs have developed ways of bundling up parts of their business such as intellectual property, brands, logos, marketing, insurance and finance expertise and owning them offshore. Griffiths and Lawrence (2007) continue to state: "They can then charge for the use of these to other parts of their group subsidiaries onshore. In this way a banana may be sold by one subsidiary of a group in the country where it was grown to another group subsidiary offshore at little more than the cost of production in the originating country." The

banana is then eventually sold back onshore to a related sister company onshore in the final consuming country at a price close to the final retail price. Griffiths and Lawrence further contend that royalties for the use of brands distribution networks, insurance and marketing charged to the subsidiary in the final destination country accrue to the subsidiaries offshore where the tax rates are low. This is the same as was reported in the case of SAB Miller above.

The effect of the above transactions as noted by Griffiths and Lawrence (2007) is that “Dole, Chiquita, and Fresh Del Monte, the three companies that supply several UK supermarkets and between them control more than two thirds of the worldwide banana trade, generated over \$50bn (£24bn) of sales and \$1.4bn of global profits in the last five years. Yet they paid just \$200m, or just over 14% of profits, in taxes between them over that period, our analysis of their financial accounts reveals”.

2.3.3 Example of hybrid mismatch arrangements

The Norwegian Commission of Enquiry into Flight of Capital from Poor Countries, which was appointed in 2008 and submitted its report in 2009, reported two main transfer pricing methods that MNEs use for transferring profits. One of the reported methods is structuring the balance sheet of a company to minimize tax. The commission (2009:52) argues that MNEs do this through debt financing of subsidiaries in high-tax countries in order to achieve large tax deductions there, while financing subsidiaries in low-tax countries by equity. The report further contains the example of extensive use of internal banks by MNEs. The banks are equity financed, and the internal bank then lends this capital to companies in the same group located in high-tax countries. The commission (2009:53) concluded that the company achieves tax deductions on its debt in the high-tax countries, while income earned by the internal bank often remains untaxed. It is clear from this example that the one leg of the transaction is deductible in one country, and yet no tax is charged in the other country on the same transaction.

In its report on hybrid mismatch arrangements, the OECD (2012a:9) also illustrates that a company resident in country B (“B Co”) is funded by a company resident in country A (“A Co”) with an instrument that qualifies as equity in country A, but as

debt in country B. The illustration in the report goes on to explain that if current payments are made under the instrument, they are deductible interest expenses for B Co under country B tax law. The receipts of the same transaction are treated as exempt dividends for tax purposes in country A, also giving a deduction/no inclusion effect as demonstrated in the paragraph above.

2.4 CONCLUSION

Governments and tax authorities need to share relevant intelligence on strategies to counter aggressive tax planning and to measure their effectiveness. The OECD (2012b) reported that initiatives are also under way to give authorities in developing countries assistance from the OECD member countries in the form of tax experts that will assist with auditing of complex international tax audits. The OECD further reported that this is being championed by the SARS Commissioner and the South African Deputy Finance Minister. Tax authorities need to improve their legislation to counter the aggressive tax planning measures by corporations and they have to up-scale the skills and experience levels of the staff who work on highly complex audits that involve schemes like these. The OECD has suggested that countries should work together through the exchange of information to deter, detect and respond to aggressive tax planning while ensuring certainty and predictability for compliant taxpayers.

In the foreword of the 2011 OECD report, the OECD outlines strategies to detect and respond to these aggressive tax planning schemes, which include:

- Detection through audits;
- Special reporting obligations on losses;
- Mandatory disclosure rules;
- Rulings;
- Co-operative compliance programmes;
- Early engagement between taxpayers and tax authorities in the framework of disclosure initiatives;
- Co-operative compliance programmes. These also have positive effects, convincing some taxpayers not to use or promote certain schemes.

In the same report, the OECD also points out that responses require a comprehensive approach that focuses on aggressive tax planning schemes, as well as on their promoters and users.

As part of their effort to address the challenges relating to aggressive tax planning by MNEs, SARS should therefore consider the recommendations above by setting stricter requirements and regulations, improving legislation, as well as working with other organisations such as the OECD (which seems to be in place already) as part of the improvement process in addressing these challenges. Hybrid mismatch arrangements have been identified as a major concern and could perhaps be an issue for South Africa as it has many MNEs that are associated with the developed countries where their arrangements seem to be more prevalent. Consideration should therefore be given to specific rules to address hybrid mismatch arrangements.

CHAPTER 3

THE ARM'S LENGTH PRINCIPLE AND THE PRACTICAL CHALLENGES

3.1 INTRODUCTION

Article 9 of the OECD Model Tax Convention provides for the arm's length principle by stating that "where conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly" (OECD, 2010b:6).

The objective is to treat related members of an MNE as independent entities so as to bring parity of tax treatment between MNE members and independent parties (OECD, 2010b:7). In simple terms, arm's length price is a market price that is the product of genuine negotiation between two unrelated entities in a market. SARS defines the arm's length principle in its Practice Note 7 (SARS, 1999:9) by noting that it simply means that the transaction should have the substantive financial characteristics of a transaction between independent parties where each party will strive to get the utmost possible benefit from the transaction. According to the Christian Aid Organisation (2008:8), legitimate transactions are determined by using the arm's length principle and should be followed by paying the open market price. "This requirement is often flouted, however, with transactions mispriced to enable the parent company to move money around to minimise tax" (Christian Aid Organisation, 2008:8).

Business restructurings usually result in the reallocation of risk between associated parties, where the party with the increased risk is compensated by an increase in expected return. The OECD (2010a:7) emphasises that it is important for tax administrations to assess the reallocation of the significant risks of the business that is restructured and the consequences of that reallocation on the application of the arm's length principle to the restructuring itself and to the post-restructuring

transactions. Thus certain principles need to be taken into consideration in determining the arm's length price for a business restructuring.

3.2 PRINCIPLES TO CONSIDER IN DETERMINING THE ARM'S LENGTH PRINCIPLE FOR A BUSINESS RESTRUCTURING

Where there is data that shows a similar allocation of risks in a comparably uncontrolled transaction, associated entity transactions will also be considered to be at arm's length (OECD, 2010a:8). The challenges will arise in cases where no comparable is found to prove the consistency of a transaction with the arm's length principle. The OECD (2010a:9) contends that such cases will consequently require analysis of whether the allocation of risk in a transaction is one that would have been agreed on between independent parties under the given circumstances. The OECD (2010a:9) discusses two relevant factors that should be considered in the risk allocation process, namely the examination of which party(ies) has/have relatively more control over the risk, and secondly the financial capacity to assume that risk. The determination that the risk allocation in a controlled transaction is not one that would have been agreed on between independent parties should therefore be made with great caution while considering the facts and circumstances of each case (OECD, 2010a:9).

The OECD further clarifies that the issue of who has more control over the risk should be looked at in the context of the capacity to make the decision to take on the risk and decisions on whether and how to manage the risk internally or by using an external provider. It goes on to state that if risks are allocated to the party in the controlled transaction that has relatively less control over such risks, the tax administration may decide to challenge the arm's length nature of the risk allocation (OECD, 2010a:9). The OECD (2010a:11) acknowledges that there can be situations where either party has significant control over the risk (e.g. economic conditions, political environment and stock market conditions) and concludes that under such circumstances, control would not be a helpful factor in the determination of whether the risk allocation between the parties is at arm's length.

Another relevant, although not determinative, factor that can assist in the determination of whether a risk allocation in a controlled transaction is one which would have been agreed on between independent parties in comparable circumstances, is whether the risk-bearer has, at the time when risk is allocated to it, the financial capacity to assume (*i.e.* to take on) the risk (OECD, 2010a:11). In other words, where the transferee party does not have the capacity at the time of the restructuring to contain the effects of risk allocation should it materialise, it becomes doubtful as to whether the transaction was conducted at arm's length. Since the parties are associated, the transferor party is likely to then bear the consequences of such risks. The OECD (2010a:11) cautions that a high level of capitalisation by itself does not mean that the highly capitalised party carries risk.

The Australian Tax Office (ATO) in its ruling released in 2011 on transfer pricing and business restructures suggested the factors to consider when there are insufficient reliable uncontrolled comparable data. The considerations that might reasonably be expected under an agreement between independent parties dealing at arm's length in comparable circumstances can be determined by considering the following indications of arm's length behaviour and outcomes that might reasonably be expected to shape such an agreement:

- An arm's length outcome is one that makes business sense in the circumstances of the particular taxpayer;
- An independent party dealing at arm's length would seek to protect its own economic interest;
- An independent party dealing at arm's length would compare the options realistically available and seek to maximise the overall value derived from its economic resources;
- An option might be not to enter into a transaction because it does not make commercial sense for the particular taxpayer (ATO, 2011:4).

These factors outlined by the ATO are useful in assessing whether a transaction is at arm's length or not.

The relationship between the transfer pricing method used and the risk level that is left with the entity being compensated, is another important factor to consider during

a business restructuring. The intention should always be to select the method that produces the highest degree of comparability and that produces a reasonable estimate of an arm's length outcome. In its Practice Note 7, SARS (1999:14) states that the Commissioner endorses the Comparable Uncontrolled Price Method (CUP), Resale Price Method (RP), Cost Plus Method (CP), Transactional Net Margin Method (TNMM) and the Profit Split Method as acceptable transfer pricing methods. The appropriateness of the specifically selected method will depend on the particular situation and the extent of reliable data to enable its proper application. Although the Practice Note is considered by many to be redundant due to the various legislation changes since the Practice Note came into effect, the above-mentioned methods are still in line with the latest OECD guidelines. SARS is in the process of drafting an interpretation note that will provide guidance in line with the new legislation, but no changes are expected in the transfer pricing methods for the reason mentioned above. The OECD (2010a:13) maintains that the transfer pricing method should be consistent with the allocation of risk between the parties (provided such allocation of risk is arm's length), as the risk allocation is an important part of the functional analysis of the transaction.

There are so many other factors that should be considered in determining the arm's length price for a business restructuring. However, the factors stated above are generally considered to be the more important ones for tax administrators.

3.3 PRACTICAL CHALLENGES IN DETERMINING THE ARM'S LENGTH PRINCIPLE

“Identifying appropriate comparables is challenging for a number of reasons. There are in many countries important limitations with respect to publicly available information, *e.g.* where there is no requirement for companies to file detailed reporting with administrative bodies, or where the domestic market is too small to find comparable independent parties” (OECD 2011c: 18). This is particularly true in South Africa where it is not mandatory for companies to submit their annual financial statements to SARS. The information that is currently submitted on the income tax return is not detailed enough to provide sufficient evidence to make such

comparisons. In its Practice Note 7, SARS (1999:26) acknowledges the availability of information as one of the practical issues that may arise in fixing the transfer price.

The principle of arm's length requires the evaluation of uncontrolled transactions by both the tax administrators and taxpayers. These uncontrolled transactions should be compared with those of associated entities, so it is clear that a substantial amount of data is required and time is of the essence. In other words, the closer to the time of transaction the evaluation is done, the better. However, usually the evaluation is done long after the transactions have occurred. As a result, the availability of the information poses a challenge. Transfer pricing is therefore not an exact science, but is an exercise requiring significant professional judgment from both the taxpayer and the tax administrators.

According to Sikka (2009), international rules on transfer pricing rely on the notion of costs that are highly malleable. He also pointed out that many markets are thin and are dominated by the same multinationals. Tax rules require companies to use "arm's length" or normal commercial prices to transfer goods and services, but such prices are not always easy to find (Sikka, 2009). The issue of the availability of comparable prices as well as information is consistently displayed here.

Europe Aid (2011:15) asserts that "it is extremely difficult, especially in developing countries, to obtain adequate information on comparables for the following reasons:

- There tends to be fewer organised companies in any given sector than in developed countries;
- Existing databases for transfer pricing analysis focus on data from developed countries. This data may not be comparable or useful in performing benchmarking studies for companies operating in developing countries (at least without resource and information-intensive adjustments) and, in any event, are usually costly to access;
- The economies of developing countries may just have opened up or be in the process of opening up. There are many "first movers" who have come into existence in many sectors and areas hitherto unexploited or unexplored; in such cases, there is an inevitable lack of comparables."

This reveals some of the practical challenges faced by developing nations.

Developing countries are also under pressure from developed countries where MNEs have related party transactions affecting associated entities in both developed and developing nations. According to the Europe Aid (2011:16), the developing countries are expected to improve transfer pricing enforcement as well as the level of transparency regarding these transactions. Obviously a situation like this where the transaction affects both nations requires vigorous exchange of information between the affected countries, which should be based on solid legal grounds and comply with international standards. The problem however is that “developing countries still lag behind in double tax agreements (DTAs) containing a clause on the exchange of information or specific tax information exchange agreements (“TIEAs”), which represent a relatively new tool to improve cooperation between tax authorities in transfer pricing matters” (Europe Aid, 2011:16).

The other challenge with regard to comparability analysis is the complexity and uniqueness of transactions of MNEs so that it becomes difficult to find similar transactions on the market. For example, how much is the Kentucky Fried Chicken (KFC) logo really worth? It’s difficult to make market comparisons as the arm’s length price is not so obvious. There is a wide scope for manipulation and deliberate mispricing, especially with regard to intellectual property such as patents, trademarks and other proprietary information. Sikka and Willmott (2010:12) also acknowledge that globalisation has encouraged convergence around the arm’s length principle, but relatively few corporations dominate global trade and independent prices for intermediate goods are not easy to formulate. Given these circumstances, it becomes difficult to devise a plan of action in the absence of perfect comparables as well as the determination of whether a comparable is reliable.

The other practical issue surrounding the application of the arm's length principle is the fact that it is often complex and resource intensive to administer (OECD, 2011c:3). This is particularly applicable to developing and transitioning economies where administrative resources are limited. This is not as much of an issue for developed nations as they have built their legislation and practices over a number of years and they are still improving on them. In the case of South Africa, there has

been a noted trend where SARS has been recruiting more qualified staff in an effort to improve the skills level. However, it will take time to reach the required resources and experience levels. “One of the main challenges is that transfer pricing is highly specialised and in most African countries skills in this area are thin on the ground. The other obstacle is that the arm's length principle, on which transfer pricing rules are based, is tough to apply. Any assertion that a transaction either is or isn't arm's length needs credible supporting economic evidence, which is hard to find” (Ernst & Young, 2012a).

Sikka (2009) also contends that a lack of resources for tax authorities to combat the tax avoidance industry is one of the major challenges. “Ernst & Young alone employs over 900 professionals to sell transfer pricing schemes. The U.S. tax authorities employ about 500 full-time inspectors to pursue transfer pricing issues and Kenya can only afford between three and five tax investigators for the whole country” (Sikka, 2009). As much as the issue is more pronounced in the developing countries, it seems that even the developed countries' administrations are not able to match the resources of the private sector that has been accused of developing these schemes.

Sheppard (2012a) argues that the damage of the arm's length approach has been and is substantial. Billions of dollars are wasted annually around the world on governmental enforcement efforts that have little chance of success, and on meeting expensive compliance requirements. This reaffirms the above contention that the application of the arm's length is an administrative burden, especially in developing countries.

The OECD (2010b:7) acknowledges that the arm's length principle is viewed by some as inherently flawed because the separate entity approach may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses. It goes on to argue that there are no widely accepted objective criteria for allocating the economies of scale or benefits of integration between associated enterprises. Chapter 5 deals with a critical analysis of the OECD transfer pricing guidelines and part of the criticism relates to other issues surrounding the arm's length principle.

SARS in its Practice Note endorses and analyses the transfer pricing methods recognized by the OECD. Part of the Practice Note deals with the various transfer pricing methods, as well as the practical problems that each method poses. The Commissioner spells out the following as practical challenges of the CUP method of applying the arm's length principle:

- It is usually very difficult to find a transaction between independent enterprises that is sufficiently similar to a controlled transaction, without differences that have a material effect on price.
- Where differences exist between the controlled and uncontrolled transactions, or between the enterprises undertaking those transactions, it may be difficult or impossible to determine reasonably accurate adjustments to eliminate the effect on price (SARS, 1999:16).

The resale price method has been condemned by the Commissioner for having the following practical problems:

- The biggest problem is to determine an arm's length resale price gross margin. It is usually very difficult to find a transaction between independent enterprises that is similar to a controlled transaction and where differences do not have a material effect on the margin.
- Accounting policies also play an important role and appropriate adjustments should be made to ensure that the same types of costs are included for the comparison. The items of cost taken into account to arrive at a gross margin may differ from company to company.
- The application of this method sometimes requires access to segregated product data. While this information may be available in respect of the controlled party being examined, it will usually not be available in respect of uncontrolled entities used as benchmarks (SARS, 1999:17).

The cost plus method has come under scrutiny by SARS because of the following shortcomings:

- The application of the cost plus method presents certain difficulties, in particular the determination of costs, as some companies are more effective than others and will incur lower costs.

- In addition there may be circumstances where there is no discernible link between the level of costs incurred and a market price.
- Accounting policies also play an important role and appropriate adjustments should be made to ensure that the same types of costs are included for the comparison. The types of cost included to arrive at a gross margin may differ from company to company.
- The application of this method sometimes requires access to segregated product data. While this information may be available in respect of the controlled party being examined, it will usually not be available in respect of the uncontrolled entities used as benchmarks (SARS, 1999:18).

The TNMM has been criticized for the following reasons:

- The net margin of a taxpayer can be affected by factors that do not necessarily have an influence on price or gross margins, thereby reducing the reliance that can be placed on the results in applying the TNMM.
- Information about the taxpayer required to apply the TNMM may not be available at the time of determining an arm's length price. It may, for example, not be possible to determine the net margin that will result from the controlled transaction.
- Information on the uncontrolled transaction may not be available.
- As with the CP and RP methods, the TNMM is a one-sided analysis, as it does not consider the effect of the determined price on the other party to the transaction. However, because operating expenses affect the calculations, the result for the TNMM is likely to be less reliable than that determined under the other methods. It is important, therefore, to check that the profit resulting from applying the TNMM is consistent with what one may expect, based on first principles.
- It is often difficult to determine a transfer price once an appropriate margin has been determined (SARS, 1999:20).

Lastly, the Commissioner identified the following as the practical challenges of the profit split method:

- The application of the profit split method relies on access to world-wide group data, which may be difficult to obtain.

- The allocation of profits is subjective.
- This method may result in a less reliable measure of the arm's length price than an analysis under one of the other methods (SARS, 1999:22).

3.4 CONCLUSION

The OECD has raised the question of whether the arm's length principle is too complex to administer for those countries that have limited administrative resources, and in particular for developing and transitioning economies. In light of this, the OECD has made a recommendation: "One key to success may be to tailor legislative measures and the deployment of administrative capacities to the strategic needs and administrative resources of each particular country. This typically means prioritising transfer pricing enforcement activities in accordance with the circumstances of each particular economy and in particular the type of cross-border trade, its complexity and the number of large taxpayers concerned; setting enforcement objectives that are realistic given the administration's capacities; and designing compliance requirements that are reasonable for taxpayers given the size of the cross-border trade." (OECD, 2011c:4).

It is generally a challenge to find information to use as comparables for the arm's length principle. Banks, investment banks, asset managers and insurance companies are highly regulated with significant disclosure requirements. Deloitte (2012:1) states that there are regulatory filings that disclose information that may be useful in establishing arm's length prices for certain functions or services. Tax authorities should therefore utilise these disclosures in an effort to determine the arm's length prices. However, in the case of South Africa, more exchange of information between various organisations could come in handy, for example exchange between the Registrar of Companies and SARS will make it easier for the Commissioner to access Annual Financial Statements of all the registered companies. Modernisation of systems will also come a long way in assisting in the confidential dissemination of information between various organisations as the storage and transfer of information is easier with electronic data.

The various practical issues associated with the use of the arm's length principle could partly be resolved by the concept of country by country reporting developed by Tax Justice Network's (TJN) senior adviser Richard Murphy (Sheppard, 2012a). Country by country reporting would require each MNE to provide certain detailed information, for example the tax charge included in its accounts of each subsidiary and affiliate in each country in which it operates. According to Sheppard (2012a), country by country reporting would also disclose if there was deliberate material mispricing of goods or services across international borders. Sheppard also argues that country by country reporting would be extremely valuable in order to try to determine whether arm's length principles are being complied with.

In the case of South Africa, the Commissioner needs to further pursue the initiative of getting assistance from other OECD member countries in the form of tax experts to assist in the sharing of skills and knowledge as South Africa has relatively little exposure and experience in complex transfer pricing transactions. This is evidenced by the fact that there is hardly any case law in the area of transfer pricing in the South African context. None could be found as part of the literature review performed. Secondment of SARS staff to other OECD member countries could also prove to be worthwhile for skills development in this area.

In this regard, the Africa Tax Administration Forum (hereafter ATAF) has made an effort on the continent. "The Africa Tax Administration Forum has made concerted efforts to build the transfer pricing capacity of the revenue authorities on the continent and these efforts are ongoing. Also, much work has already taken place, under the auspices of the United Nations, on drafting specific guidance for developing countries" (Ernst &Young, 2012a).

Taxpayers are generally required to be able to explain and produce support for the positions on the local corporate tax returns and to show that they conform to the arm's length principle. "One important principle that is emerging is based on the realization that in such a volatile area, the only clear path to certainty lies in advance discussions with the authorities. Tax rulings and advance pricing agreements (APAs) once thought to be solely the realm of the biggest and most sophisticated taxpayers are increasingly being seen as an everyday defence tool." (PwC, 2011:20).

The current legislation prohibits SARS from issuing an advance ruling on a transfer pricing matter (Ernst & Young, 2012b). Section 76G (1) (a) (iii) of the Income Tax Act (58 of 1962) provides that the Commissioner may not accept an application for an advance tax ruling for the pricing of goods or services supplied by or rendered to a connected person in relation to the application. Additionally, in terms of Advance Pricing Agreements (APA's), SARS (1999, 34) states that due to various factors, the APA process will not in the foreseeable future be made available to South African taxpayers. Ernst and Young (2012b) also confirmed that "South Africa does not currently have an APA program, although one is being considered. The legislation also currently prohibits SARS from providing an advance ruling to establish a price. With the expected change in legislation that will shift the focus from price to that of overall terms and conditions, this may change as well". SARS should therefore consider some legislation that cover APAs as this will assist in determining an agreeable arm's length price between SARS and the taxpayer given the current challenges surrounding the arm's length principle as analysed in 3.3 above.

CHAPTER 4

SUBSTANCE OVER FORM PRINCIPLE IN RELATION TO BUSINESS RESTRUCTURINGS AND HOW TRANSACTIONS CAN BE MANIPULATED

4.1 INTRODUCTION

Directly linked to the arm's length principle in Chapter 3 is the substance over form principle. The Joint Committee on Taxation (JCT) (2010:133) defines the substance over form principle in its glossary of terms as follows: "two companies that execute a contract will allocate responsibility for performing any necessary activities between themselves. The allocation of responsibility as provided in the contract is referred to as the 'form' of the deal. The actual performance of those activities is referred to as the 'substance' of the deal. If either, or both, of the two companies do not actually perform the activities as required by the contract, then the substance does not match up to the form. This is important because contracts between related parties are given great weight in evaluating comparability under the arm's-length standard. Where substance does not match up to form, a taxpayer may be engaged in aggressive transfer pricing and inappropriate income shifting."

Based on this definition, it becomes crucial for the parties involved in a transaction as well as the tax administrators to understand the contractual terms of the agreement. The terms of a transaction that need to be reviewed to determine the form may be found in written contracts or in correspondence and/or other communications between the involved parties, for example a written policy. "In a transfer pricing context, a written policy can be regarded as the form of an intra-group arrangement whereas the actual implementation of that policy is the substance" (Kader, 2011). One of the factors that will have an influence on the substance over form principle in terms of the review of the economic substance of a transaction (similar to the arm's length principle) is the allocation of risk.

In examining the risk allocation between associated enterprises and its transfer pricing consequences, the OECD (2010a: 7) suggests that it is important to review not only the contractual terms, but also the following additional questions:

- Whether the conduct of the associated enterprises conforms to the contractual allocation of risks;
- Whether the allocation of risks in the controlled transaction is arm's length; and
- What the consequences of the risk allocation are.

The issue of whether the conduct of the associated entities conforms to the contractual allocation of risks is directly linked to the substance over form principle of a transaction. Where the conduct (substance) is such that it is different from the contractual allocation (form), then tax administrators can start questioning whether the transaction is not a “sham” and if the involved parties are not engaging in aggressive transfer pricing.

The issue of whether the allocation of risks in the controlled transaction is arm's length mainly focuses on the notion of control over the risk and the financial capacity to assume the risk. This has already been discussed in detail in Chapter 3.

Lastly, the consequences of the risk allocation are also directly linked to the substance over form of the transaction. Based on the terms of the contract, one should be able to determine the party that has been allocated the risk. It follows that the costs, if any, of managing and mitigating, as well as the costs from realisation of the risk, should be borne by the same party (OECD, 2010a:13). This is the reason why it is important, as discussed in Chapter 3, to determine if the transferee has the financial capacity to assume the risk. Where the transferor ends up bearing the costs of the consequence of the risk allocation, the substance of the transaction then differs from its form and this results in the manipulation of transactions.

4.2 APPLYING THE SUBSTANCE OVER FORM PRINCIPLE

Where the substance of the transaction differs from its form, the transaction can therefore be disregarded by the tax administrators as a sham transaction. According to the OECD (2010b:18) there are two particular circumstances in which it may,

exceptionally, be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction. The first is where the economic substance of a transaction differs from its form. In such a case the tax administration may disregard the parties' characterisation of the transaction and re-characterise it in accordance with its substance.

The second circumstance arises when, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those that would have been adopted by independent enterprises that behave in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price.

An example of the first circumstance as given by the OECD would be “an investment in an associated enterprise in the form of an interest bearing debt when, at arm's length, having regard to the economic circumstances of the borrowing company, the investment would not be expected to be structured in this way. In this case it might be appropriate for a tax administration to characterise the investment in accordance with its economic substance with the result that the loan may be treated as a subscription of capital” (OECD, 2010b:18). Brincker (2012) also confirms this argument by stating that more often than not such a shareholders' loan is used to fund the start-up operations of the offshore entity and it is not expected that the loan will be serviced for the foreseeable future. Brincker concludes that in particular, it has been proposed that these types of loans should be treated as share capital in line with the decision to treat certain forms of debt as shares.

An example of the second circumstance mentioned above as stated by the OECD (2010b:18) would be a sale in terms of a long-term contract for a lump sum payment of unlimited entitlement to the intellectual property rights arising as a result of future research for the term of the contract. The example goes on further to elaborate that “while in this case it may be proper to respect the transaction as a transfer of commercial property, it would nevertheless be appropriate for a tax administration to conform the terms of that transfer in their entirety (and not simply by reference to

pricing) to those that might reasonably have been expected had the transfer of property been the subject of a transaction involving independent enterprises. Thus, in the case described above, it might be appropriate for the tax administration, for example, to adjust the conditions of the agreement in a commercially rational manner as a continuing research agreement” (OECD, 2010b:18).

Edward Nathan and Sonnenbergs (2011) point out that tax authorities have introduced various ways to counteract opportunistic behaviour of Intellectual Property (IP) companies, e.g. by the introduction of strict substance requirements and/or Controlled Foreign Companies (CFC) legislation. Edward Nathan and Sonnenbergs give the following examples of popular IP holding locations and the substance requirements they introduced in an effort to counteract this behaviour:

- Luxembourg - various requirements to benefit from IP tax regime, including that the IP must have been created or acquired after 31 December 2007.
- Singapore - strict requirement for incentives regarding business spending, employment and IP valuation.
- Madeira - at least one employee/director on payroll and if it employs less than 6 employees, investment of at least EUR 75,000 in Madeira.
- Switzerland - Some treaty abuse rules in place and an exemption applies if the company employs at least one qualified foreign employee in activities beyond the mere passive administration of the company's assets (Edward Nathan and Sonnenbergs, 2011).

Edward Nathan and Sonnenbergs (2011) concluded by asserting that “IP companies may require a minimum level of 'substance' to anchor their IP ownership and corresponding royalty flows in that country. The interpretation of 'substance' has been moving from a pure 'legal interpretation' to a more 'substance over form' interpretation”.

In the cases described above, the structures of the transactions seem to be derived from the relationship between the parties as opposed to the commercial substance of the transactions. Under these circumstances, the tax administrators can adjust the conditions to reflect how the transactions would have been structured if the economic and commercial substance of the transactions had been considered. In

other words, the arm's length price would then be taken into consideration by the tax administrators.

PricewaterhouseCoopers (PwC) (2008:13) points out that to prevent this, manuals detailing standard operating procedures should be adopted, especially in the context of large projects. PwC further explains that once a structure is established and functionally operational, it is important to implement a periodic review to test the course of conduct. This review should include an examination and verification of the following factors:

1. Validation with structures, operations and transaction flows to ensure that they are in line with the substance and the form.
2. Ensurance that as the business continues to develop and expand, operational activities are not unintentionally altered to create a mismatch between form and substance.

“The testing should include an analysis of financial results and the application of the selected transfer pricing methodologies to assess whether the related structures and operations are within the appropriate range” (PricewaterhouseCoopers, 2008:13).

There is a high risk for tax administrators that the substance of the transaction may end up being different from the legal form because of the versatility of the contractual terms and conditions between associated entities, be it for economic, legal or fiscal reasons (OECD, 2010b:18). This is so especially in a case where the changes in the terms and conditions has not been properly documented and effected. The OECD goes on to further point out that very often, contracts within an MNE could be quite easily altered, suspended, extended, or terminated according to the overall strategies of the MNE as a whole, and such alterations may even be made retroactively. Tax administrators therefore need to determine the underlying agenda behind such contractual arrangements.

However, a limit should be placed on the substance over form approach as the taxpayers should not lose their protection from written contracts because tax administrations ignore them and claim that the substance of a transaction is different to its form. In other words, the form of the transactions should not be thrown out the window, but must be considered in conjunction with the substance.

4.3 ANALYSIS OF CASE LAW IN RELATION TO SUBSTANCE OVER FORM AND ARM'S LENGTH PRINCIPLES

As previously highlighted, there is very little if any case law in South Africa in relation to transfer pricing. The following international cases will be analysed in relation to the substance over form and arm's length principles.

4.3.1 Talbots Inc. case

The *Talbots Inc. v. Commissioner of Revenue* (2009) is a classic example of a case of transfer pricing issues that can arise at a state's level in the United States of America. Its decision emphasises economic substance in the transfer of intangibles. However, the principles of the case are equally applicable to the MNEs transfer pricing intangible property issues that may arise for MNEs trading in different countries. The decision in this case was made by the Massachusetts Appellate Tax Board in 2009 and reaffirmed by the Massachusetts Appellate Tax Court in 2011.

According to Barrett (2009), Talbots Inc improperly avoided paying the 9.5% Massachusetts corporate excise tax on as much as \$392 million of revenue by using "sham" transactions that "lacked economic substance." Barrett further explains that the company set up a Delaware subsidiary with a single office in Illinois to hold the various Talbots trademarks. Making "royalty" payments to the subsidiary for use of the trademarks, Talbot then deducted the sums on its Massachusetts tax returns. The driving force and the motive behind the formation of the wholly owned subsidiary was tax avoidance, as the transactions lacked economic substance and a valid non-tax business purpose. The sham transaction doctrine allows the Commissioner to disregard transactions with no economic substance or business purpose other than tax avoidance (*The Talbots, Inc v Commissioner of Revenue* (2011) 79 Mass 159).

According to Ceteris (2009), states in the U.S. (hereinafter referred to as states) typically attack the Intangible Holding Companies (IHCs) structure on three grounds: Firstly, they argue that IHCs have no valid business purpose other than that of reducing the company's tax liability. Consequently, the economic substance of

intercompany royalty payments is not supportable. Secondly, the states argue that the royalty payments are higher than those that would have been paid in arm's length transactions between unrelated corporate entities. Finally, the states argue that even though the IHC may be based in another state and has no physical presence in the state making the claim, by collecting a royalty from a parent company or sibling operating unit that does operate within the state, the IHC has taxable nexus with respect to the state making the tax claim.

In this case the Massachusetts tax commissioner disallowed the deductions that Talbots claimed for royalties paid to its IHC for use of its trademarks. The court argued that there was no dispute that there was a legitimate reason for Talbot to acquire the trademarks, but then there was no evidence of a business purpose save for a tax benefit to explain why Talbots chose to acquire the trademarks through a wholly owned subsidiary. As such Talbots did not meet its burden of proving a purpose for transfer of trademarks other than a tax benefit (*The Talbots, Inc v Commissioner of Revenue* (2011) 79 Mass 159). The scenario in this case is typical of how MNEs also manipulate intellectual property and transfer it between two different countries mainly for a tax benefit.

4.3.2 General Electric (GE) Capital Case

“Often in a group context guarantees are provided by a parent company in respect of the debt of a subsidiary (or vice versa) and subsidiaries guarantee the debt of a sister entity. The question arises whether a fee should be charged by the entity providing the guarantee to a group company in the other jurisdiction. In other words, would independent third parties acting at arm's length have charged a fee?” (Hofmeyr, 2011). This was debated and decided upon in the case of *General Electric Capital Canada v Her Majesty the Queen* (2010).

GE Capital Canada Inc, is an indirect wholly owned subsidiary of GE Capital, a U.S. corporation not resident in Canada. GE Capital Canada is a financial services company operating in Canada providing financing, leasing services and real estate, among other things. The parent company in the U.S. charged its subsidiary a 1% fee for guaranteeing the subsidiary debts owing to third party creditors (*General Electric*

Capital Canada Inc v Her Majesty the Queen (2010) FCA 344). The subsidiary pursued to deduct the fees that were disallowed by the Canadian Revenue Agency (CRA). The amounts were disallowed on the grounds that the subsidiary received no economic benefit from this transaction and the arm's length price would be zero. In other words, the CRA argued that even though there was an arrangement (form) for the parent to pay the guarantee fees of the subsidiary, the economic benefit (substance) of the transaction was zero, and for this reason the CRA tried to apply the substance over form principle in this case.

Both parties made extensive submissions in an attempt to support the methodology to be used in determining whether the guarantee fees had been provided to the subsidiary on an arm's length basis. The court ruled in favour of the GE Capital Canada that the 1% fee paid to its parent for the economic benefit derived from the arrangement did not exceed an arm's length price. According to Hands (2010:2) the court ruled that GE Capital Canada could not have raised the necessary funds at the low interest rates it benefitted from without the explicit guarantee from GE Capital, and therefore the guarantee was in fact necessary in order for the subsidiary to execute its business plan.

According to Hofmeyr (2011), in the appropriate circumstances a fee will not have to be charged for a guarantee provided in a group context. Hofmeyr further argues that one must ensure that both parties have given due consideration that takes into account the benefits and risks to each party when they decide whether or not a fee should be charged for the guarantee. Finally, one should not lose sight of the exchange control implications of cross-border guarantees. This case clearly shows that the analysis of determining whether one is dealing at arm's length is technical and controversial. At the same time, one can only provide guidance, and it's difficult to give hard and fast rules as various applications will depend on a case by case basis.

4.3.3 The case of SNF (Australia) Pty Ltd v Commissioner of Taxation

The background to the case is that the taxpayer was a wholly owned subsidiary of SPMC SA, formerly SNF SA ("SNF France"), a company resident in France. The

taxpayer was in the business of manufacturing and selling polyacrylamide products to end users in the mining, paper and sewage treatment industries (Commissioner of Taxation v SNF Australia (2011) ATC 20-265). From 1998 to 2004, the taxpayer purchased the products from subsidiaries in France, USA, and China and incurred many years of trading losses from its operations. The taxpayer alluded that the losses were due to a variety of commercial reasons namely intense competition, poor management, fraud by an employee, excessive stock levels, an insufficient level of sales per person and a series of bad debts (Commissioner of Taxation v SNF Australia (2011) ATC 20-265).

The Commissioner disagreed with the taxpayer's reasons for poor profit performance and argued that the losses were due to the fact that the taxpayer paid the supplier more than the arm's length price, thus causing prolonged losses. The taxpayer submitted a Comparable Uncontrolled Price analysis (CUP) which showed that the prices between the suppliers and the arm's length customers were similar to those with the taxpayer. The Commissioner argued that transactions were not comparable because the conditions in the foreign markets of the arm's length customers of the suppliers were not taken into consideration. The Commissioner further argued that the question was to determine what an independent party in the position of the taxpayer would have been willing to pay and contended that if the taxpayer was dealing at arm's length, it would have negotiated a better price that would have allowed it to run profitably. The Commissioner therefore suggested that the appropriate method to determine the arm's length price was the TNMM.

"The Court held that the process [of determining arm's length consideration] is not dissimilar to a valuation, where the relevant task is to price the acquisition, not to focus on special factors of the parties involved in the transaction" (BDO, 2010:3). According to the BDO report, the court accepted the CUP method by the taxpayer by agreeing that there were sufficient volumes of sales to independent third parties for almost every comparable product purchased by the taxpayer. The report further indicated that the court rejected the use of the TNMM method by the taxpayer, citing that the problem is that it inevitably attributes any loss to the pricing.

According to Allen (2010), the court rejected the Commissioner's view that long-term losses are indicative of the shifting of taxable profits out of Australia, even where the taxpayer could demonstrate that the prices paid did not exceed the prices paid by unrelated parties in similar circumstances. Allen further explained that the court was sympathetic and that for one reason or another, or because of the support of a parent company, the loss-making company could still have acquired goods at an arm's length consideration, so the court accepted that the losses were due to commercial reasons cited by the taxpayer.

"Not to be overlooked in this decision is the Court's finding that the determination of the arm's length consideration is not to be unduly coloured by the individual economic circumstances of the parties to the transactions – that is, the analysis must be based on determining the arm's length price of the supply or acquisition in question, rather than hypothesising a different price based on the "position of the taxpayer" (BDO, 2010:4). This case also shows the reluctance of the court to accept the TNMM method where there is sufficient evidence of a comparable to form the basis of the CUP method. More importantly, the decision of the court rejected the inference by the Commissioner that prolonged trading losses are attributable to aggressive transfer pricing practices.

4.3.4 The case of GlaxoSmithKline Inc.

A complex and lengthy battle of nearly 20 years between global drug giant, GlaxoSmithKline Inc. and the Canada Revenue Agency (CRA) is now being weighed by the Supreme Court of Canada. Gray (2012) reported that the court's decision, which is yet to be released, could lay down new ground rules that could make a multibillion dollar difference to the tug-of-war between Canada's tax collectors and multinational companies.

This case of Her Majesty the Queen v. GlaxoSmithKline Inc. as it was reported by KPMG (2012b) involves the determination of a price paid by the Canadian subsidiary of a pharmaceutical Company (Glaxo UK) to a related non-resident Swiss company (Swissco) for ranitidine, the key raw ingredient used in the manufacture of the brand name drug Zantac. According to KPMG (2012b) Glaxo Canada, which had the

license to sell Zantac in Canada, was buying the ranitidine from Swissco at a price that was more than five times higher than that paid by generic manufacturers. The price Glaxo Canada paid Swissco for ranitidine during the relevant period ranged from \$1,512 to \$1,651 per kilogram, which was significantly higher than the amount Canadian generic manufacturers were paying for their purchases of ranitidine from other suppliers (i.e., \$194 to \$304 per kilogram) (KPMG, 2012a:2).

The CRA reassessed Glaxo Canada by increasing its income on the basis that the amount paid to Swissco was not reasonable in the circumstances and that the price should have reflected the price of ranitidine on the open market (i.e. the amount generic drug companies sold on the open market). However, Glaxo Canada argued that the price paid to Swissco was reasonable when assessed together with other relevant factors surrounding the licence agreement and its business of selling branded drugs as opposed to the price of generic drugs on the market.

According to KPMG (2012a:2), the Tax Court of Canada (TCC) upheld the CRA's assessments by ruling that one must look at the transaction in issue and not the surrounding circumstances in the determination of the price charged for ranitidine. The KPMG report further states that the Federal Court of Appeal dissented from the TCC's ruling by arguing that to determine the transfer price, it was necessary to consider the licence agreement and to apply the reasonable business person test. As mentioned in the report, the FCA further contends that the relevant circumstances included the business reality that an arm's length purchaser was bound to consider if it intended to sell ranitidine under the Zantac trademark.

According to KPMG (2012b), The Supreme Court of Canada's (SCC) long awaited ruling will provide guidance on how an arm's length transfer price is determined, specifically by looking at the following:

1. Does one consider all circumstances and apply the reasonable business person test, from the perspective of the taxpayer (i.e., the Glaxo Canada Position)?; or
2. Does one ignore the surrounding circumstances of the transaction, and essentially evaluate the transaction on a standalone basis and establish the price to be the open market price (i.e., the CRA Position)?

Further questions that would arise with the Glaxo Canada's position include the economically significant factors and circumstances that would need to be taken into consideration for determining the arm's length price. Secondly, the other question would be what price parties dealing at arm's length would agree to given these factors. Canadian taxpayers engaging in cross border related party transactions and international transfer pricing specialists are eagerly awaiting the SCC's decision.

The OECD transfer pricing guidelines emphasise the importance of factoring in surrounding circumstances in determining an arm's length price, even though the emphasis does not include a reasonable business person test as argued by Glaxo Canada (KPMG, 2012b). The SCC will probably still need to reconcile the OECD guidelines with this reasonable business person test. It therefore becomes important to determine the economically relevant factors to consider in determining and assessing comparability and pricing.

One must, however, also consider the CRA's argument as reported by Gray (2012) that the OECD's rules mean only the comparable generic price must be taken into account for this crucial "arm's length" test, not all of the other provisions of the subsidiary's arrangements with its corporate parent. According to the OECD (2010a:11), the economically relevant characteristics of the situations being compared must be sufficiently comparable. The OECD further suggests that to be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. In determining the degree of comparability, including what adjustments are necessary to establish it, an understanding of how independent enterprises evaluate potential transactions is required.

In this case, one must therefore consider whether first of all the branded and generic drugs are comparable and whether the circumstances relating to the licence agreement could materially affect the price of ranitidine. If so, can reasonably accurate adjustments be made to eliminate the effect of such differences? This case

goes to show that more guidance is still required and that there is controversy surrounding the arm's length principle.

4.4 CONCLUSION

In terms of applying the substance over form principle in the South African context, "SARS will apply more of a substance over form approach in evaluating transfer pricing practices. For example, with limited risk arrangements, taxpayers will be required to show not only that the relevant risks are limited contractually. It will be necessary, in addition, to show that the actual management of those risks is done by the party which purports to carry them" (Kader, 2011).

The case law relating to the substance over form and arm's length principles analysed above does not provide prescriptive guidance on how these two principles should be handled by taxpayers and administrators all around the world. However, it does give some guidance in terms of some considerations that should be taken into account in specific circumstance that can provide useful reference points for both taxpayers and administrators in transfer pricing contentious issues.

CHAPTER 5

CRITICAL ANALYSIS OF THE OECD TRANSFER PRICING GUIDELINES

5.1 INTRODUCTION

The OECD guidelines are generally accepted by both member countries and non-member countries as useful guidelines in addressing transfer pricing issues across the globe. According to Shaheen (2012b), the arm's length principle has been adopted by more than 100 developed, emerging and developing countries and is continuously revised and updated with new guidance to cope with the significant changes and challenges posed by an increasingly globalised economy. However, the arm's length principle in particular has come under immense scrutiny from various parties in the international community, especially the Tax Justice Network (TJN) and other tax specialists.

5.2 CRITICAL ANALYSIS OF THE ARM'S LENGTH PRINCIPLE IN BUSINESS RESTRUCTURINGS

One of the tax analysts against the arm's length principle is Michael Durst, a tax lawyer who is also a former director of the U.S. Internal Revenue Services' (IRS) Advanced Transfer Pricing Program. Durst (2010:2) asserts that the problem lies in the assumptions on which the entire system is based. The tax results of multinational groups can be evaluated as if they were aggregations of unrelated, independent companies transacting with one another at arm's length. Durst argues that until this view is finally abandoned and replaced by one that is more attuned to practical realities, the international corporate tax system will remain unenforceable.

“A second fundamental flaw in the arm's-length system, which has become increasingly evident over the past decade, is that by treating different affiliates within the same group as if they were free-standing entities, the system respects the results of written contracts between these related entities” (Durst, 2010:3). Durst argues here that these contracts do not have any economic substance as they involve the same shareholders, but are given effect under the arm's length principle. The

arguments he puts across here were discussed in Chapter 4 where the substance over form principle was analysed. In as much as Durst's argument is valid to some extent, it must also be noted that intertwined with the arm's length principle is the substance over form principle, which compares the legal form of the contract with its substance so that if the two do not match, the transaction can be challenged as not being arm's length.

Part of Durst's argument emanates from the fact that the arm's length principle requires an analysis of whether the contracts are similar to those that unrelated parties would enter into. However, Durst (2010:3) contends that unrelated party activities are normally organised in a manner that is different from those of commonly controlled groups. As a result of this, it's difficult to find any similar acceptable contracts to use to evaluate related party contracts. As a result it becomes impractical for tax administrators to apply the arm's length principle.

Durst further raises questions regarding the wide range of arm's length prices that result from the use of some of the arm's length methods. Durst (2010: 5) illustrates that for example, a typical transfer pricing analysis conducted according to best practices under the U.S. regulations, might conclude for a given manufacturer that a net operating margin within the range of, say, 2 to 6 percent should be accepted as arm's length. That means, for example, that a net income for tax purposes anywhere between \$200 million and \$600 million should be considered acceptable. This clearly illustrates that such a wide range is admittedly hardly acceptable for purposes of effective tax administration.

According to Durst (2010:6) the practical costs of the enforceability of arm's length transfer pricing rules are enormous. He argues that the costs of government attempts to administer the system, which generally appear to be futile in any case, must amount to at least hundreds of millions of dollars per year. From the perspective of developing countries, Durst indicates that to the extent that developing countries follow the international consensus and adopt arm's-length transfer pricing rules, their corporate tax systems will be hobbled in unintended and unpredictable ways. The recommendation from Durst was for the OECD, as the guardian of the international consensus, to design an alternative. Durst proposes the

use of the formulary apportionment as an alternative to the arm's length. This is discussed in more detail in the subsequent sections.

The OECD (2010b:7) has acknowledged that the arm's length principle is viewed by some as inherently flawed because the separate entity approach may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses. However, the OECD argues that there are no widely accepted objective criteria for allocating economies of scale or benefits of integration between associated entities.

Shaheen (2012a), in his article entitled "OECD's Marlies De Ruiters admits need to improve Transfer Pricing Guidelines (TPGs) but stands by the arm's length principle", reports that De Ruiters accepted that TPGs are too complex and need to be simplified. Marlies De Ruiters reportedly admitted that the arm's length principle is not the end of the story. Marlies De Ruiters is the head of the tax treaty, transfer pricing and financial transactions division at the OECD.

Shaheen further reports that De Ruiters stated that the arm's length principle provides a tool to counteract base erosion and profit shifting, but would not be effective alone. She mentioned that one particular criticism of the TPGs is that they do not serve the interests of developing countries, which often lack the capacity to develop them. Shaheen (2012a) further reports that De Ruiters was keen to point out that the Global Forum, which has 12 non-OECD countries on its Steering Committee, and the Task Force on Tax and Development (which also includes non-OECD countries), are both working on capacity development in developing countries.

All the criticism above relating to the arm's length principle is applicable to all nations across the globe, but more so to developing countries as per the arguments already put forward. In his other 2012 report, Shaheen reports on a conference organised by the tax justice network in Helsinki. The conference was centred on how the arm's length principle is failing developing countries and how it must be redeemed or replaced. The overwhelming response among delegates and speakers at this conference was that the arm's length principle is dead, and that unitary taxation and

formulary apportionment is the future. The concepts of unitary taxation and formulary apportionment will now be discussed in more detail.

5.3 UNITARY TAXATION

Sheppard (2012a) defines unitary taxation as an approach that involves taxing the various parts of an MNE based on what it does in the real world. Sheppard further explains that unitary taxation originated in the U.S. over a century ago as a response to the difficulties that U.S. states had in taxing railroads. The objective of unitary taxation is basically to tax parts of an MNE's income without reference to how the MNE is organised internally.

Sheppard illustrates the concept by way of his example of a company with a one-man booking office in the Cayman Islands, with no local sales. By using the "arm's length" rules, it can shift billions of dollars of profits into this office, and use this to reduce its taxes significantly. Sheppard explains that the unitary taxation (formulary apportionment) would seek to allocate a portion of the income to the Cayman Islands based on sales and payroll. Effectively, only a miniscule portion would then be subjected to tax in the Cayman Islands, leaving the bulk of it to be taxed in the country where the income was produced and where the real activity is happening. Sheppard argues that developing countries should have a particular interest in this approach.

However, Sheppard (2012a) acknowledges that there are three main obstacles to unitary taxation, namely vested interests, path dependency and technical issues. Sheppard describes vested interest as a result of MNEs with an interest in maintaining the status quo (arm's length principle) as a form of leeway to manipulate transfer pricing. Sheppard points out that the arm's length principle is how the international tax system emerged and henceforth describes path dependency as the resistance to change established practices. Finally, technical issues relate to potential technical complexities in terms of the adopting, designing and applying the formula (Sheppard (2012a)).

The OECD (2010b:9) argues that the global formulary apportionment is difficult to implement in a manner that protects against double taxation and ensures single taxation. Countries would need to agree on the use of the method, the use of a predetermined formula, as well as the factors that will be used to apportion the tax base and how to measure and weigh these factors. The OECD argues that reaching such an agreement will be time consuming and extremely difficult. The transition to a global formulary apportionment system would present enormous political and administrative complexity and require a level of international cooperation that is unrealistic to expect in the field of international taxation (OECD, 2010b:10). Effectively, if some of the countries refuse to adopt the global formulary apportionment approach, two totally different systems would be in operation. This could result in either double taxation or under taxation as two different standards would end up being used for the same transaction.

The OECD (2010b:10) further argues that “a formula based on a combination of cost, assets, payroll, and sales implicitly imputes a fixed rate of profit per currency unit (e.g. dollar, euro, yen) of each component to every member of the group and in every tax jurisdiction, regardless of differences in functions, assets, risks, and efficiencies and among members of the MNE group”. Due to the fact that the formula relies on the cost, exchange rate movements can easily distort the profits of an associated entity as there are no adjustments or considerations that take this into account. The argument here is that the arm’s length principle is better equipped to deal with the economic consequences of exchange rate movements as it requires a specific analysis of the facts and circumstances of the taxpayer.

According to the OECD (2010b:10), documentation and compliance requirements for the application of the global formulary apportionment is more cumbersome than under the arm’s length principle because data collection would involve the entire MNE. The OECD argues that data would have to be analysed per jurisdiction while including the tax and accounting principles of each jurisdiction as well as the basis of the currency. The OECD concluded that the different accounting standards and multiple currencies would pose problems in the valuation of assets, especially intangibles. These challenges with valuation of course also exist under the arm’s length principle.

The global formulary apportionment has also generally been criticised for having the effect of taxing the MNE group on a consolidated basis. It does not take into consideration important factors such as geographical differences, separate company inefficiencies, competition and other specific factors that may be applicable to a specific associated company of an MNE. These factors may have a significant impact on the profitability of these entities. The OECD (2010b:11) argues that the arm's length principle takes into cognisance the fact that the different associated entities within an MNE have various unique economic characteristics. This means that one entity in the group may be making a profit while the rest of the MNE makes a loss even though it for example has significant sales. The argument here is that the global formulary apportionment does not take such factors into consideration in the apportionment process, which means that some entities will end up paying significant taxes based on for example sales apportionment, when in fact they are making losses and should not be paying any taxes.

Evidently, both the arm's length principle and the formulary apportionment have their own flaws. Unfortunately the global community would have to agree on the best method. The double tax and double non-tax effects make it unenforceable to have different jurisdictions choose the best method between these two. According to Sheppard (2012a) "unitary taxation is entirely compatible with country by country reporting, a concept developed by TJN's senior adviser Richard Murphy. More precisely, country by country reporting could serve as the accounting basis for formulary apportionment and unitary taxation."

5.4 COUNTRY BY COUNTRY REPORTING

Country by country reporting (CbC) is a relatively new concept of accounting for MNEs. It was developed by Richard Murphy, who is the founder of the Tax Justice Network and director of the Tax Research LLP. Country by country reporting would require detailed information disclosures by each MNE in its annual financial statements. CbC would benefit the developing nations. Murphy (2009:7) argues that "CbC would enable citizens of developing nations to determine who owns the

companies that are trading in their countries, what tax is being paid, and whether that appears reasonable in relation to the tax rates in the country in question”.

In his report, Murphy (2012:11) puts forward that MNEs would have to disclose the following information in their annual financial statements:

1. The name of each country in which it operates;
2. The names of all its companies trading in each country in which it operates;
3. What its financial performance is in every country, in which it operates, without exception, including:
 - Sales, both third party and with other group companies;
 - Purchases split between third parties and intra-group transactions;
 - Labour costs and employee numbers;
 - Financing costs split between those paid to third parties and to other group members;
 - Pre-tax profit;
4. The tax charge included in its accounts for the country in question split as noted in more detail below;
5. Details of the cost and net book value of its physical fixed assets located in each country;
6. Details of its gross and net assets in total for each country in which it operates.

Murphy further explains that tax information would need to be analysed by each country in more depth. This would require disclosure of the following for each country in which the corporation operates:

1. The tax charge for the year split between current and deferred tax;
2. The actual tax payments made to the government of the country in the period;
3. The liabilities (and assets, if relevant) owing for tax and equivalent charges at the beginning and end of each accounting period;
4. Deferred taxation liabilities for the country at the start and close of each accounting period (Murphy, 2009:11).

CbC will definitely provide useful information for tax authorities for risk profiling and for determining which entities pose a high risk and would require an audit. This is so especially given the current challenges of lack of availability of information. Tax

authorities can therefore much more easily determine whether they should initiate an inquiry into a group of companies. The time and cost saved will be significant and the probability that each inquiry launched will give rise to a positive outcome will rise substantially. Sheppard (2012b:3) asserts that CbC would prevent multinationals from telling different stories to different governments.

Murphy also believes that CbC will provide data that the tax departments in question can use to assess the likely risk within the accounts of a multinational corporation. Murphy further explains that this can be achieved by doing the following: assessing the likelihood of risk within the group structure, reviewing the overall allocation of profits to countries within the group to see if there is an indication of systemic bias towards low tax jurisdictions, assessing whether the volume and flows of intra-group trading disclosed by country by country reporting suggest that this outcome is achieved as a result of mispricing of that trade, and finally, using that information to assess where that abuse is most likely to occur so that an appropriate challenge can be raised (Murphy, 2009:21).

Sikka (2009) similarly points out that governments should mobilise the public to require companies to publish a table showing their sales, purchases, profits, assets, liabilities, taxes and employees in each country of operation. He further states that corporate returns should be made publicly available and that companies should publish the transfer prices actually used. “The public may be horrified to learn that companies have priced flash bulbs at \$321.90 each, pillow cases at \$909.29 each and a ton of sand at \$1993.67, when the average world trade price was 66 cents, 62 cents and \$11.20 respectively” (Sikka,2009). Sikka’s contentions are akin to the country by country reporting analysed above.

However, Murphy (2012:41) acknowledges that CbC has been criticised for the following self-explanatory reasons:

- It will destroy company’s competitive advantages and so harm markets;
- It will be hard to put in place and to make it work properly;
- Companies do not have or may not calculate the necessary data;

- It will not decrease tax avoidance / evasion because firms will use other devices;
- Developing countries do not have enough people or qualified people to look at country by country based accounts and as a result they will not increase their tax revenues;
- The determination of the “right” level of transfer pricing is far from obvious, especially on intangibles;
- Consolidated accounts are based on information provided by subsidiary companies, but additional entries are made during the consolidation process, so it will not be possible to reconcile country-by-country reporting with the published accounts;
- It will be difficult to audit country by country information;
- In some countries this information is already available, even for subsidiaries located elsewhere;
- Lastly, each country already requires that all companies submit their accounts for taxation purposes and so no additional information will be secured by those authorities as a result of country by country reporting. A huge flow of information will be published that will be difficult to interpret.

Murphy addresses the above issues one by one in his report. Based on the counter arguments in his report and the analysis of the arguments put forward above, one can conclude that the criticism raised is not strong enough when weighed against the benefits of CbC. This is especially true for developing countries, as CbC will improve transparency in their reporting. PwC (2012:26) reports that the status of country by country proposals is that the proponents of country by country have been and continue to be part of the debate urging institutions to introduce these reporting requirements to MNEs. PwC further states that the institutions targeted include the G-20, European Parliament and European Commission, International Accounting Standards Board (IASB) and the OECD. Generally it seems that country by country reporting is gaining popularity from different bodies and will eventually be implemented all across the globe.

5.5 CONCLUSION

According to Durst (2011:3), the main aim of drawing up and revising transfer pricing guidelines by the OECD is to assist in the creation of a system of tax compliance and enforcement that is administratively workable. Those who are in favour of the current approach (arm's length principle) have the perception that there is no alternative method that has been practically tried and tested on a global scale. As a result there is in their opinion the risk that significant unforeseen costs would have to be incurred with the use of a new alternative system. Such costs will only be unveiled as practical difficulties are encountered and corrective action is taken. Durst further argues that many advocates of the current approach take the view that the arm's length method has been used in practice for decades around the world, even though it has its practical and theoretical shortcomings. They would rather stick to this method due to the large transitional costs that are likely if a new system was to be implemented. For this reason some parties do not even entertain the unitary taxation method and they will not give it a chance.

Sheppard (2012a) argues that the activists that are in support of the unitary taxation method are convinced that MNEs will simplify their corporate structures as the need for highly complex multi-jurisdictional structures will be defeated. This could result in billions being saved on tax enforcement. Sheppard further argues that the big losers, apart from multinationals, would be accountancy and legal firms and economic consultants, as they derive significant amounts of income from setting up and servicing complex tax-driven corporate structures. The unitary taxation method definitely has its benefits and should perhaps be given a trial to assess the practical applicability of this method.

Developing countries have more to lose than anyone else when it comes to transfer pricing abuse. Murphy (2012) reports that Nishana Gosai, transfer pricing manager at the South African Revenue Service's (SARS) Large Business Centre, spoke strongly in favour of CbC reporting to help tackle the problem. At the International Tax Review Global Transfer Pricing Forum held in Paris at the end of September 2012 Gosai stated: "We strongly support CbC. It would help with a lot of the challenges developing countries face." Murphy reiterates in his report that four tax

authorities spoke of the benefits of CbC and of greater transparency. However, these speakers indicated that CbC would not be sufficient on its own to prevent transfer pricing abuse. It will definitely have some benefits, as it improves transparency reporting and it seems to be slowly gaining popularity with various bodies.

CHAPTER 6

CONCLUSION AND RECOMMENDATIONS

6.1 INTRODUCTION

Most MNEs are constantly aspiring, some legally and some illegally, to reduce their tax liabilities, hence the use of aggressive tax planning schemes. The major concern for most tax administrators is the loss of revenue by the fiscus due to these schemes used by MNEs to avoid tax. There is an increasing focus on how to deter and detect these schemes. Part of the focus for most tax administrators should be to curb the revenue losses by addressing the practical challenges they face in an effort to minimise such non-compliance by MNEs.

The issue of transfer pricing, especially in relation to business restructurings, is and has been a concern for tax administrators all across the globe. This study has confirmed that MNEs have devised various forms of schemes that they use as aggressive tax planning tools as discussed in Chapter 2. These schemes generally manipulate the transactions between associated entities by effecting them at prices below the arm's length price, thus shifting profits between jurisdictions in the process. The practical challenges surrounding the determination of the arm's length price make it difficult for tax administrators to effectively curb this problem.

Some of the tax administrators have relied upon decisions taken in courts as guidance with regard to the factors they have to consider in determining the arm's length price. The OECD has also considered this issue to be one of its key priorities in terms of giving guidance and ensuring international cooperation on the matter, as evidenced by the continuous revised guidelines it releases. This has assisted tax administrators in terms of consistency in the application of certain principles, particularly the arm's length principle. However, because the arm's length principle has its own shortcomings, other international tax specialists have come up with alternative methods that can be used in place of the arm's length principle. These

include the unitary taxation method as well as the country by country concept, both of which were discussed in this study.

The problem that this dissertation sought to investigate is ways to address the practical challenges for SARS in the application of the arm's length principle. In order to comprehensively answer this problem statement, certain objectives were set. This chapter will revisit each of these research objectives in order to determine if they have been adequately addressed.

6.2. ACHIEVEMENT OF RESEARCH OBJECTIVES

A qualitative approach was used to achieve the objectives of the research and in an effort to get a better understanding of the practical challenges of the application of transfer pricing in business restructurings specifically the arm's length principle. International case law was consulted to see what considerations courts take into account in determining whether the arm's length principle has been adhered to. Specific examples reported in newsletters and newspaper articles and analysed in technical articles were also used for illustration purposes.

6.2.1. Objective 1: To critically analyse how the arm's length principle can be used by MNEs as an aggressive tax planning tool

This objective was tackled in Chapter 2. The study aimed to evaluate how MNEs use non-arm's length transactions to shift profits from high tax jurisdictions to tax havens that are low tax jurisdictions. The use of complex financial structures by MNEs to evade the payment of taxes was also scrutinized. This involves MNEs taking advantage of differences in tax treatment of transactions in the different jurisdictions where they operate. The effect of these transactions on certain countries was also reported. In such cases only one leg of the transaction is considered and if the other side of the transaction is in a developing country, it most probably was not picked up due to scarce resources in this field. This chapter also considered some specific examples reported in the press and other reports to illustrate how MNEs evade paying tax.

The results of the study indicate that MNEs definitely use aggressive tax planning schemes through the development of complex financial structures in order to avoid or evade paying tax. MNEs also shift profits through payment of management fees to sister companies in tax havens, lending of money between subsidiaries to maximise on tax efficiencies, as well as transfer of intangibles invented in developing countries to tax havens at a very low cost and the subsequent payment of royalties by the developing countries for the same intangibles.

6.2.2. Objective 2: To identify the practical challenges relating to the arm's length principle, including uncertainties regarding the principle despite the "new guidelines" that have been issued by the OECD in this regard

This objective was addressed in Chapter 3. This chapter initially investigated the principles that should be considered in determining an arm's length of a transaction. It consequently analysed the practical issues that are encountered in applying the principle and how this applies specifically to developing nations. It also examined the practical challenges of applying the different transfer pricing methods that are used to determine the arm's length price.

The results of the study indicated that the arm's length principle is often too complex and resource intensive to administer, especially for developing nations where resources are limited. The other challenge is the complexity and uniqueness of transactions of MNEs that make it difficult to find similar transactions on the market. It was also noted that each of the transfer pricing methods has its practical challenges in terms of its application and these are detailed in this chapter. Recommendations for addressing these challenges have been included in 6.3 below.

Chapter 5 also partly addresses the same objective that was broadly addressed in Chapter 3. Chapter 5 critically analyses the principle as it scrutinises the critique of the arm's length principle, as well as the other schools of thought that have been brought forward as either alternatives or supplemental to the arm's length principle. Chapter 5 further considered the advantages and shortcomings of using the alternative methods.

It was noted that the unitary taxation method has some benefits and should be given a trial to assess its practical applicability. Country by country reporting was also seen as a beneficial concept that could be used concurrently with either the arm's length principle or the unitary taxation method, as it requires detailed information disclosures that can be used by tax administrators.

6.2.3. Objective 3: To critically analyse the substance over form principle in the context of business restructurings – allocation of risk in connection with the economic substance of the transaction

This objective was addressed in Chapter 4. This chapter mainly looked at the consistency of the allocation of the risk with the economic substance of the transaction. It also considered how the substance and the form of the transaction can be inconsistent and how this can be used to manipulate transactions. This Chapter also examined international case law from Australia, Canada and the U.S. to evaluate some of the factors that are considered by the courts in the determination of whether transactions are carried out at arm's length, as well as the substance over form considerations. Where the substance of the transaction is different from its form, tax administrators will disregard the legal form as sham transactions and re-characterise the transaction to match its substance in determining the arm's length price of the transaction.

6.2.4. To clarify if long term losses as a result of business restructurings necessarily evidence inflated non-arm's length prices that result in the tax revenue losses

This objective was also dealt with in Chapter 4. This is with specific reference to the SNF case, which provided guidance on this issue. Here the decision of the court rejected the inference by the Commissioner that prolonged trading losses are attributable to aggressive transfer pricing practices as there are many other factors that could influence trading losses. Thus long term losses as a result of business restructurings do not necessarily evidence non-arm's length prices that result in tax revenue losses.

6.3 RECOMMENDATIONS

There are clearly many issues surrounding transfer pricing in business restructurings, not only for SARS, but for all tax administrators around the world. As demonstrated in some of the case law analysed in Chapter 4, the arm's length principle is one of the challenges in the transfer pricing arena that has caused much debate. Developing countries are the most affected due to the lack of skills, knowledge, resources and expertise on how the principle should be applied. However, the principle itself has its own additional challenges as highlighted in this study.

In order to address the issues that have been raised in this dissertation, especially the challenges of applying the arm's length principle, the following recommendations are put forward to SARS:

- The Commissioner should further pursue the initiatives that seem to already be underway in the area of getting assistance from the OECD member countries in the form of tax experts that will assist with auditing of complex international tax audits (OECD, 2012b). This is in view of the fact that the Commissioner has admitted that the transfer pricing section needs to be up-skilled (SARS, 2012:11). Such assistance will help with the transfer of skills and expertise from other developed countries that have advanced tax systems and legislation and thus more experience in this field.
- The OECD has made recommendations to developing countries, as detailed in the conclusion of Chapter 3, that one key to success to addressing the challenges may be to tailor legislative measures and the deployment of administrative capacities to the strategic needs and administrative resources of each particular country. This typically means that SARS will have to prioritise transfer pricing enforcement activities, taking into consideration the resources available (which may need to be improved) and designing compliance requirements that are more aligned to the risk factors.
- Special reporting obligations on losses – this mainly relates to placing an obligation on MNEs operating in South Africa to report on any losses made

from their South African operations. This will assist SARS to follow up where they consider the risk of aggressive tax planning by shifting profits to be significant.

- Mandatory disclosure rules - currently Practice Note 7 does not have any specific documentation requirements, but just encourages taxpayers to keep contemporaneous transfer pricing documentation. The current Section 31 is also discretionary, so the burden of proof initially rests with SARS. When SARS reaches a view regarding the arm's length price of a transaction, the burden of proof then lies with the taxpayer to prove whether the transactions are arm's length. SARS should consider giving specific reporting requirements in the new interpretation note that will soon be released in light of the changes in the legislation. This could include for example disclosure of details of management fees paid to any related company outside South Africa, related party amounts payable/receivable and the details of the transactions giving rise to such amounts.
- Rulings - presently there are no rulings in relation to transfer pricing. Issuing rulings on specific transfer pricing matters will assist to promote clarity, consistency and certainty in respect of the Commissioner's interpretation and application of transfer pricing legislation.
- Advance Pricing Agreements (APAs) – South Africa does not have an APA program at the moment, although one will hopefully be considered under the new interpretation note that is currently being drafted. Practice Note 7 specifically states that APAs will not be made available to South African taxpayers in the near future (that was at the time the Practice Note was released in 1999). Due to the many changes that have occurred since the release of this Practice Note and considering the benefits of APAs, SARS should implement an APA program as part of the new interpretation note. This will assist in providing clarity and avoiding disputes with taxpayers in future as the transfer prices are agreed in advance between taxpayers and the Commissioner.
- The transfer pricing issues facing SARS are imminent for all developing countries, especially in Africa. SARS should join hands with other African countries to find solutions to the common problems that the continent is

facing. This can be done through tenaciously following up and contributing positively to the ATAF's concerted efforts to build transfer pricing capacity of the revenue authorities on the continent, as highlighted in Chapter 3.

- Some of the recommendations specifically put forward above relate to the arm's length principle challenges. However, it should be pointed out that some of the challenges specifically relating to the determination of the arm's length price by the use of different transfer pricing methods, as detailed in Chapter 3, can only be addressed by choosing the most appropriate transfer pricing method. Each method has inherent challenges, and it's impractical to propose a solution for each of these challenges except for the adoption of another method, such as the unitary taxation method as discussed in detail in Chapter 5.
- The unitary taxation alternative seems to have some benefits, but would require a change in regime as well as consistent application by all the countries. It also has its flaws as detailed in Chapter 5, and the OECD and other bodies have their own criticism as to why this method would not work. Looking at the arm's length principle itself, it must be highlighted that one of its greatest challenges is that market prices for intra-firm transactions rarely exist. Furthermore, to find comparable transactions require data that is usually unavailable, thus the lack of data often means manipulation of transactions by MNEs. All these concerns coupled with the general complexity of the transfer pricing rules and the shortcomings of each of the methods used to determine the arm's length price render the arm's length principle flawed. The recommendation would be to adopt the unitary taxation (formulary apportionment method) concurrently with the arm's length principle so that the two can work mutually exclusively. This means that both methods would be available for use and countries can decide the method to adopt on a specific transaction by transaction basis. This is so because where readily available comparables exist, the arm's length principle usually works well. However, the unitary taxation method might be a good method where there are observable and measurable factors to assess transfer prices and to come up with a formula that apportions and reduces compliance and enforcement costs, as well as double taxation risks. However, this is a recommendation that SARS

cannot implement on its own because it requires global co-operation and agreement on the way forward.

- Country by country reporting, also discussed in detail in Chapter 5 would be a good concept to adopt and can still be used in conjunction with the arm's length principle or the unitary taxation method. The greatest advantage of using country by country reporting is that it assists with detailed information disclosure. The information gathered can then be used by tax administrators in the application of either the arm's length principle or the unitary taxation method. This information can also be used by tax administrators at the risk profiling stage to assess MNEs that probably have a high risk of non-compliance, for example where it seems profits have been shifted through intercompany transactions. Developing countries' tax administrators should therefore be pushing for the adoption of the country by country reporting concept as it will certainly resolve some of the challenges, particularly the unavailability of information that they face in applying the arm's length principle.

6.4 CONCLUSION

Various challenges face SARS relating to the application of transfer pricing in business restructuring. These challenges result from various factors, as discussed in this study. From a SARS perspective, as in many other developing countries, many of the issues result from limited skills, knowledge and expertise. Lack of resources to implement the complex transfer pricing rules adds to the problem. The specific issues surrounding the arm's length principle (which forms the backbone of transfer pricing in business restructurings) should also not go unmentioned, particularly the practical challenges of determining the arm's length price using different transfer pricing methods.

Although recommendations have been highlighted above, it must be noted that the use of the arm's length principle as a method of determining the transfer price between MNEs has come under severe scrutiny. There are more and more advocates for the alternative methods, particularly the unitary taxation method also known as the formula apportionment method. This method also has its own

shortcomings. In addition a debate is on regarding the country by country concept, which many, including SARS, are in support of. It could be used in conjunction with the arm's length principle or the unitary taxation method. Unfortunately the change of regime from the arm's length principle to another method like unitary taxation would require the cooperation of all the countries and the OECD, so SARS cannot decide to use this method on its own. It is unlikely that a consensus will be reached in the near future on the most appropriate method. In the meantime SARS should focus on making improvements with regard to other challenges that also have significant impact on transfer pricing in business restructurings. SARS should advocate for country by country reporting, as this can be used alongside with the current arm's length principle. In addition, they should push for a regime change through OECD commentaries.

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