

The transfer pricing implications of hard-to-value intangibles: Challenges and recommendations

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DECLARATION

I declare that **“The transfer pricing implications of hard-to-value intangibles: Challenges and recommendations”** is my own work; all sources used or quoted have been indicated and acknowledged by means of complete references and that this mini-dissertation was not previously submitted by me or any other person for degree purposes at this or any other university.

SIGNATURE

DATE

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ABSTRACT

It has been noted with concern that multinational companies (MNC's) have been engaging in base erosion and profit shifting that has resulted in the significant loss of tax revenue. Developing countries are the most affected and as a result there has not been sufficient funding to enable the implementation of poverty-alleviating projects.

This study was conducted based on a literature review that entailed an analysis of specific newspaper, academic and journal articles, textbooks and publications by the Organisation for Economic Co-operation and Development (OECD) and the United Nations (UN), relating to the transfer pricing of hard-to-value intangibles. International case law was also analysed to evaluate some of the factors considered by the courts in deciding the allocation of returns arising from intangible assets as well as the factors considered in the determination of an arm's-length price.

It was noted in this study that MNC's have employed various techniques that have resulted in the shifting of profits from high to low tax jurisdictions. It was also found that there are conflicting views between the OECD and the courts on how allocation of returns arising from hard-to-value intangibles based on ownership should be performed. Several challenges relating to the arm's-length principle were noted. These challenges include comparability of transactions, the lack of resources, and the shortage of appropriate transfer-pricing skills, especially in developing countries.

The following recommendations were put forward as a result of this study: the need for pro-activeness by tax authorities in detecting schemes employed by MNC's, the incorporation of limitation of benefit clauses in South African treaties with other countries, laws that prevent audit firms, specialist tax advisory firms as well as law firms from assisting MNC's in shifting profits by engaging in impermissible avoidance arrangements, amendment of legislation to

impose transfer pricing penalties in addition to understatement penalties, greater co-operation among countries with regard to the exchange of information, as well as the training and up-skilling of the South African Revenue Service (SARS) staff.

KEYWORDS: multinational companies, base erosion and profit shifting, transfer pricing, hard-to-value intangibles, arm's-length, OECD

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List of abbreviations

- AEOI Automatic exchange of information
- BEPS Base erosion and profit shifting
- IRS Internal Revenue Service
- MNC Multinational company
- OECD Organisation for economic co-operation and development
- SARS South African Revenue Service
- UN United Nations

CHAPTER 1: INTRODUCTION

1.1 Introduction and background

Tax authorities worldwide are facing the problem of multinational companies exploiting the gaps in international tax laws to shift profits from high tax jurisdictions to low tax jurisdictions thus avoiding paying tax. This has resulted in a reduction of the contributions by multinational companies (hereafter referred to as MNC's) to the national tax bases of the countries in which they operate (Fasset, 2015).

One of the ways in which MNC's shift profits is through transfer pricing of goods and services at non-arm's-length prices. According to SARS (1999:5) "the term transfer pricing describes the process by which entities set the prices at which they transfer goods or services between each other". Even though most transfer pricing does not result in money being transferred from one hand to another but is noted in the accounting records of the MNC, it can have detrimental effects on developing countries because they normally do not have the due diligence that enables them to determine if they are being cheated in terms of revenue (Fletcher, 2014). According to the Tax Justice Network (not dated) "Transfer pricing is not in itself illegal or necessarily abusive. What is illegal or abusive is transfer mispricing, also known as transfer-pricing manipulation or abusive transfer pricing."

The arm's-length concept is the international transfer-pricing standard that has been agreed to by countries that are members of the Organisation for Economic Co-operation and Development (OECD). These countries have agreed that the concept be used for tax purposes by tax authorities and MNC's (OECD, 2010a:31). Even though South Africa is not a member of the OECD, it has acknowledged the importance of the OECD guidelines as they are followed by many other countries trading with South Africa that are also not

members of the OECD and this shows that the guidelines have been globally accepted (SARS, 1999:6).

The term “arm’s-length” price means the price at which independent non-connected persons transact (SARS, 1999:8). Article 9 of the OECD model tax convention requires that where commercial and financial conditions imposed between connected entities are different from those that would have been imposed between independent persons, any profits that would have arisen from such transactions should be included in the profits of the entities and subsequently be taxed (OECD, 2014a:29-30).

Multinational companies have been accused of using intangible assets to manipulate their profits and hence pay less tax in the countries of operation (Anon, 2013). The G20, in its response to the 2014 reports on base erosion and profit shifting (BEPS) and automatic exchange of tax information (AEOI) for developing economies, reiterated the importance of profits being taxed in the countries where the economic activities responsible for generating the profits are performed and where value creation activities are performed (G20, 2014:2).

As more than 60% of the world’s trade is conducted via multinational companies, transfer pricing has become the most important tax issue in the world (UN Secretariat, 2001:2). Most importantly, the transfer pricing of intangible assets has become an important topic among the various countries of the world. This is because most of the difficult issues in transfer pricing are related to intangible assets and as a result the tax treatment of intangible assets has warranted significant attention by tax authorities worldwide (Markham, 2004).

The SARS compliance programme, which was launched by the then Minister of Finance, Pravin Gordhan, on 1 April 2012, identified large businesses and transfer pricing as one of the priority areas for SARS for the tax periods 2012-2017 (SARS, 2012:9). In its statement on the update of the SARS compliance programme in April 2013, the revenue authority noted that the focus during the 2013/2014 tax period with regards to transfer pricing would

include, among other things, the transactions in which multinational companies sell or transfer intangible assets (SARS, 2013:2). This has resulted in the erosion of the South African tax base and the Minister of Finance, Nhlanhla Nene, in his budget speech, indicated that there is a need for South Africa to prevent financial leakages through base erosion and profit shifting (National Treasury, 2015:20).

1.2 Literature review of the research area

Nowadays, a growing proportion of the assets of companies are made up of intellectual property (Stillwell, 2011). The spiralling of cross-border transactions dealing with intangible assets has resulted in a realisation by tax authorities that the application of traditional tax practices to such transactions may be problematic as the tax rules in most countries were largely designed for the exchange of physical goods (Davis Tax Committee, 2014a:2). The tax rules were not developed with the modern value chains that now exist worldwide in mind and as a result there has been growing concern among many countries with regard to whether adequate compensation for those intangibles that developed and gained value from the economic activities conducted in their jurisdictions is being received (Ffdo/Desa, 2015).

In South Africa, the exportation of intellectual property was considered to be posing a threat to the foreign exchange reserves of the country. This was as a result of the judgment in the *Oilwell v Protec* case (2011), which ruled that intellectual property was not capital for exchange control purposes. This resulted in a major outflow of intellectual property from South Africa, which the National Treasury deemed to be unacceptable (Stark, 2014:1). Not only did the National Treasury have the exchange control regulations tightened by way of an amendment to Regulation 10, which deals with capital, it took a further step by introducing section 23I into the Income Tax Act (58 of 1962). It was perceived that the South African tax base was being eroded because the Income Tax Act (58 of 1962) lacked an anti-avoidance provision that prevented tax arbitrage through denying a deduction for expenditure incurred

for the right of use of tainted intellectual property in instances where a royalty is paid to a recipient who is not liable to South African tax hence the introduction of section 23I (SAICA, 2012).

Intangibles are unique in nature and are extremely valuable assets that are often difficult to price correctly as a result of a lack of comparable transactions, especially as they increase in value and in complexity. Of particular concern are mixed contracts involving intangible assets and goods/services, which make it difficult to identify and attach a value to the component of the transaction made up of the intangible assets (Ffdo/DESA, 2015).

The OECD has identified the transfer pricing of intangibles as an important area of concern to both government and taxpayers as a result of insufficient guidance internationally, especially with regard to the valuation of intangibles (OECD, 2013a:paragraph 35). Multinational companies have taken advantage of the fact that there is insufficient guidance with regard to the definition, identification and valuation of hard-to-value intangible assets for transfer pricing purposes and are continually devising schemes of profit shifting using intangible assets (IMF Academy, not dated).

To this end, in 2014 the OECD issued guidelines in relation to the transfer pricing aspects of intangibles. The main aim of the guidelines was to assist in the identification of transactions that involve intangibles and also to provide guidance in the determination of arm's-length prices with regard to such transactions (OECD, 2014b:9). The OECD believes that the implementation of the guidance provided to national governments will result in the minimisation of the abuse of transfer-pricing rules in relation to intangible assets (OECD, 2014b:4). SARS (1999:6) states that "the OECD guidelines should be followed in the absence of specific guidance in terms of this Practice Note, the provisions of section 31 or the tax treaties entered into by South Africa".

To support the OECD's view mentioned above, it has been noted by the South African Reserve Bank that the monitoring and tracking of physical goods does not pose a challenge as such goods are easily classifiable and the value of such goods is easily determinable. This is not the same with intangible assets because of the high level of complexity of such transactions and this results in valuation problems (Davis Tax Committee, 2014a:16.)

It has also been noted that MNC's in their valuation of intangible assets are using numerous advanced valuation methodologies that are constantly evolving, hence further complicating the application of the arm's-length principle as most tax authorities rely on statistical methods such as cost-plus and profit-split methods, which are based on approximations. To this end tax authorities have been criticised for attempting to fulfil their tasks without the required support of a logical and consistent set of rules that is practical. Governments around the world are therefore continually attacking such practices by issuing or modifying existing transfer pricing rules (Brauner, 2008).

As a result of transfer pricing not being an exact science and because of the complexities highlighted above, it is easy for parties (MNC's and tax authorities) to reach different conclusions with regard to the arm's-length price relating to an intangible asset. Double taxation may occur in instances where the tax jurisdictions in which the MNC operates do not agree on the transfer price. The imposing of double taxation is a barrier to trade as it does not result in economic efficiencies (Markham, 2005a).

It has also been noted that high value intellectual property is being used by MNC's to shift profits to low tax jurisdictions even though the pricing is at arm's-length. In most countries the domestic systems, as well as the systems in the international arena, do not provide sufficient ways of countering those structures that are legal but result in the reduction or elimination of profits (Sweidan, 2013).

The lower a subsidiary's tax rate in a country of operation in relation to its fellow subsidiaries, the higher the level of the intangible assets it holds. The resultant opportunity to shift profits by MNC's also means that not only do MNC's have to shift their intangible assets to low tax jurisdictions but they also have to shift their research and development departments and marketing departments to low tax jurisdictions. As the personnel in these departments are often highly skilled, this means that the low tax jurisdictions not only gain from the profits of the MNC's but they also gain from the expertise of these skilled workers and this may in turn spill over to local firms and hence improve their productivity (Dischinger & Riedel, 2011).

1.3 Motivation of topic

It has been noted with concern that MNC's operating in African countries have been exploiting the profits of developing countries and South Africa has not been spared from this. Such exploitation has resulted in the erosion of the tax bases of these countries, hence hampering the initiatives taken by the countries' leaders to improve the standards of living of their citizens (SAICA, 2014).

In the United States of America (USA) it was found that the major cause of most of the differences in profitability between low-tax and high-tax countries arising from artificial income shifting was as a result of transfers of hard-to-value intangibles. Multinational companies are taking advantage of the fact that hard-to-value intangibles tend not to have comparables and as such it is very difficult to know the arm's-length price of any royalties paid (Gravelle, 2015).

It is imperative to ensure that profits derived from intangibles are linked to the value created and to ensure that there are special measures in place for hard-to-value intangibles. In instances where the owner of the intangible asset, for example, the parent company, outsources key operational substance to related parties and those parties have significant

control over their activities, the entity performing the outsourced activity is entitled to a portion of the profits attributable to the intangible assets (Deloitte, 2014a).

Currently in South Africa there are no court cases, binding general rulings, interpretation notes or any other guidance with regards to the tax treatment of hard-to-value intangible assets for transfer-pricing purposes. The existing legislation does not cater for the instances where MNC's are dealing with intangible assets.

South African taxpayers who are involved in cross-border transactions with other companies in the same group of companies as they are face a number of challenges. As a result transfer pricing has become an increasingly important area for such companies. On the other hand, there has been growing interest from tax administrations worldwide to such an extent that the practical aspects of transfer pricing are ever changing (Wolff & Verhoosel, 2014).

As a result of the growing interest from tax administrators internationally, aggressive audit teams have been established to review compliance with the various transfer-pricing laws of the relevant countries by MNC's. Non-compliance by MNC's now comes at a huge cost of significant adjustments to tax payable as well as hefty penalties. Previously MNC's were content with nominal transfer-pricing adjustments as this was viewed as a small payment to get rid of the tax auditor. However, nowadays transfer-pricing adjustments have become so hefty that they cannot just be written off by companies. In this regard MNC's also encounter challenges in the process of striving to be compliant (PwC, 2013:4.)

It has been noted that nowadays the more common abuse of transfer pricing by MNC's is that of intangible assets that are being licensed to offshore companies situated in low-tax jurisdictions. These are then used to facilitate the payments of large sums of royalties to countries where they will be taxed at a lower rate (Fletcher, 2014). This has resulted in the

shifting of intellectual property being a problematic area with regards to transfer pricing (Ffdo/DESA, 2015).

As a result of the above there is therefore a need to investigate how the resultant base erosion due to the shifting of profits to low-tax jurisdictions can be avoided. It is also important to establish if there are other measures in addition to transfer-pricing legislation that tax authorities can rely on to restrict further losses to the fiscus (Stark, 2014:101).

1.4 Problem statement

As a result of the above, the research problem that will be addressed in this study is as follows: The challenges and recommendations arising from the transfer-pricing implications of hard-to-value intangibles.

1.5 Objectives

1.5.1 Main objective

The main objective of this study is to analyse the challenges that the transfer pricing of hard-to-value intangibles poses within a South African context and to provide recommendations on how they can be overcome.

1.5.2 Secondary objectives include the following:

1. To outline the various strategies employed by MNC's to avoid tax using hard-to-value intangible assets (Chapter 2)

2. To identify challenges posed by the concepts of legal and economic ownership in relation to the allocation of returns from hard-to-value intangible assets (Chapter 3)
3. To analyse the current international guidance (court cases, OECD and United Nations guidance) relating to the arm's-length principle with a view to identifying any differences and shortcomings (Chapter 4)
4. To conclude and make recommendations on how the transfer pricing of hard-to-value intangibles can be approached within a South African context (Chapter 5)

1.6 Research design/method

The research design to be followed is that of a non-empirical classification and a descriptive research design. Descriptive research seeks to answer the question "What is going on?" (De Vaus, 2001:1). In order to answer the question of what is going on pertaining to the challenges faced by tax authorities and MNC's with regard to the transfer pricing of hard-to-value intangibles, a qualitative study will be conducted via a literature review. Kumar (2011:104) states that "the main focus in qualitative research is to understand, explain, explore, discover and clarify situations, feelings, perceptions, attitudes, values, beliefs and experiences of people".

The purpose and objectives of the literature review will be to provide an overview of existing scholarship so as to gain a proper understanding of the domain of transfer pricing and hard-to-value intangible assets. The sources that will be accessed during the course of the review in order to answer the research problem include journals, academic articles, newspapers, textbooks, publications by the OECD and publications by the United Nations (UN). The doctrinal research concept will be applied so as to analyse the law relating to transfer pricing

in terms of acts such as the South African Income Tax Act (58 of 1962), interpretations of the law such as SARS Practice Note: No.7 (1999) and case law from other countries. According to Singhal and Malik (2012:252) “doctrinal research asks what the law is on a particular issue. It is concerned with the analysis of the legal doctrine and how it has been developed and applied.” International law in countries such as Canada and the USA will be considered. These countries have been selected as they are the leading tax authorities in terms of transfer-pricing issues.

1.7 Overview

Listed below are the various chapters that will form part of this study:

Chapter 1 gives a brief background to the research topic, the literature reviewed and the motivation for the chosen topic. It also highlights the problem statement, the primary and secondary objectives of the research and the research design.

Chapter 2 outlines the various strategies used by MNC’s to avoid taxes using hard-to-value intangible assets.

The aim of Chapter 3 is to analyse in detail the concepts of legal and economic ownership in and the challenges posed by the concepts in South Africa.

Chapter 4 analyses the current international guidance relating to the arm’s-length principle (international court cases, OECD and UN guidance) with a view to identifying any differences and shortcomings.

Chapter 5 seeks to conclude the research and make recommendations on how the transfer pricing of hard-to-value intangibles can be approached within a South African context.

CHAPTER 2: THE USE OF HARD-TO-VALUE INTANGIBLE ASSETS IN TAX AVOIDANCE SCHEMES

2.1 Introduction

The objective of this chapter is to discuss the various strategies used by MNC's internationally to avoid taxes using hard-to-value intangible assets. The chapter focuses on secondary objective number 1 (paragraph 1.5.2). The chapter will begin by explaining/defining the term "hard-to-value intangibles" and discussing its characteristics. The meaning of the terms "tax avoidance", "tax resistance" and "tax evasion" will be considered and the various schemes/strategies that MNC's use to avoid taxes using hard-to-value intangible assets will then be examined. The chapter will conclude with a summary of the challenges arising from such schemes.

2.2 Meaning of hard-to-value intangibles and their characteristics

The term "hard-to-value intangibles" means:

"intangibles or rights in intangibles for which, at the time of their transfer in a transaction between associated enterprises, (i) no sufficiently reliable comparables exist, and (ii) there is a lack of reliable projections of future cashflows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain" (OECD, 2015a:4).

Hard-to-value intangible assets exhibit the following characteristics: (1) they are partially developed at the time at which they are transferred; (2) it is not anticipated that the hard-to-value intangibles will be exploited for commercial purposes for quite a number of years following the transaction; (3) they also comprise of intangibles that are not necessarily hard-

to-value but are linked with the development of those intangibles that are hard-to-value intangibles as defined; (4) at the time of transfer they are anticipated to be exploited in a novel manner (Ernst & Young, 2015).

2.3 What is tax avoidance, tax resistance and tax evasion?

According to Stiglingh *et al.* (2014:811) tax avoidance “usually denotes a situation in which the taxpayer has arranged his affairs in a perfectly legal manner, with the result that he has either reduced his income or has no income on which tax is payable”. Oguttu (2006:138) defines tax avoidance as the use of legal methods to arrange one’s tax affairs so as to pay less tax by taking advantage of loopholes in the law of tax and utilising those loopholes in parameters that are legal.

The taxpayer attempts to lawfully reduce their tax liability while at the same time fully disclosing to tax authorities all the information that is deemed to be material. Examples of tax avoidance are as follows: (1) utilising tax deductions as provided for by the various tax acts and (2) the changing of a company’s business structure by way of establishing or incorporating an off-shore subsidiary in a tax haven. Tax avoidance is considered to be the amoral dodging of a taxpayer’s duty to society or merely the right of every citizen to find legal ways that will assist them to avoid paying too much tax (Musviba, not dated).

The Business Dictionary online (2015) defines tax evasion as an “unlawful attempt to minimize tax liability through fraudulent techniques to circumvent or frustrate tax laws, such as deliberate under-statement of taxable income or wilful non-payment of due taxes”. Musviba (not dated) notes that tax evasion is a crime in almost every country in the world with the exception of Switzerland, where tax fraud such as the forging of documents is considered a crime whereas the under-declaration of assets, which in essence is tax evasion, is not a crime.

The term “tax resistance” refers to the refusal by taxpayers to pay tax for conscientious reasons (such as not supporting the corrupt activities of a government) while at the same time breaking the law in refusing to pay tax. Some taxpayers end up donating their money to charity organisations. In the USA some taxpayers take creative deductions such as refusing to pay a percentage of tax which is equal to the defence budget (Emikamanzi, 2015.)

According to Knights Lowe Chartered Accountants (not dated) “[t]ax avoidance schemes are a very aggressive form of tax planning and avoidance”. As highlighted in the previous chapter, MNC’s use tax avoidance schemes to transfer profits to low tax jurisdictions and avoid taxes in countries where they have substantial trading operations. Most tax authorities are of the view that most multinational companies manipulate the prices of their exports and imports so as to avoid taxes (Sikka, 2009).

2.4 Tax avoidance schemes using hard-to-value intangible assets

2.4.1 The use of planned licensing structures and tax havens

According to Olivier and Honiball (2011:667), a tax haven is a country that is capable of financing its public services with little or no income taxes and that makes itself available to non-residents for the purposes of tax avoidance. Tax havens are also known as low tax jurisdictions or offshore finance centres. The OECD further describes tax havens as those countries where there are laws that prevent the government-to-government exchange of information with regards to those taxpayers who are benefiting from the low tax rates as well as those countries where there is no transparency with regard to how the legislation, legal or administrative provisions work (OECD, 1998:20- 21). There are three different classes of tax havens namely: (1) countries such as the Bahamas, Bermuda and Cayman Islands where there are no taxes; (2) countries such as the British Virgin Islands where taxes are levied at

very low rates; (3) countries such as the Isle of Man, Channel Islands, Liechtenstein and Monaco where special tax privileges are granted to certain types of companies or operations (Excellent Consultants Ltd, 2001).

In its first interim report on base erosion and profit shifting, the Davis Tax Committee (2014a:2) noted that an MNC will, for example, establish a licensing and intellectual property holding company in a tax haven for purposes of acquiring, exploiting, licensing and sublicensing the intellectual property rights for its other foreign subsidiaries located in different countries. The royalties received by the foreign offshore company will end up not being taxed at all or being taxed at a low tax rate in the tax-haven.

As indicated in Chapter 1 (paragraph 1.3), the major cause of most of the differences in profitability between low-tax and high-tax countries arising from artificial income shifting in the United States of America was as a result of transfers of hard-to-value intangibles. Multinational companies are taking advantage of the fact that hard-to-value intangibles tend not to have comparables and as such it is very difficult to know the arms-length price of any royalties paid (Gravelle, 2015).

2.4.2 The use of double tax agreements/treaty shopping and conduit companies

Haupt (2014:31) defines a double tax agreement as “an agreement between two states (countries) aimed at regulating the taxation of income which is earned in one state and subject to tax in the other state.” According to Acca (2012:1), a double tax agreement is an “agreement or a contract regarding double taxation or, more correctly, the avoidance of double taxation”. Acca (2012:1) further states that a double tax agreement is an agreement between two sovereign states that is normally signed by a cabinet minister or a prime minister of a country to prevent the double taxation of the same income in two countries. It is also referred to as a treaty between two countries and any further amendments or additions

to the treaty are referred to as protocols. To date more than 2 500 double tax agreements exist between countries worldwide (Obaro, 2012).

The Davis Tax Committee (2014a:3) notes that most MNC's have implemented a wide range of strategies to avoid paying exorbitant withholding taxes, which are usually charged upon remittance of royalties from the foreign countries in which the royalties are derived. In most instances double tax agreements are utilised in order for the MNC's to benefit from the reduced rates of withholding taxes that are usually contained in such agreements. In order to benefit from the reduced rates, MNC's usually enter into a conduit agreement and establish a royalty conduit company in a tax haven/low-tax jurisdiction.

A conduit agreement is defined by Olivier and Honiball (2011:840) as "an arrangement through which taxpayers operating in an international environment attempt to obtain undue treaty benefits often by utilising a tax haven". Olivier and Honiball (2011:840) further state that a conduit company is "an entity that is used in a conduit arrangement". This conduit company will be used as a licence rights owning company, which will then sub-license the rights to another company that is situated in a country with a favourable double tax treaty with the country in which the conduit company is located. The other company will exploit the license rights and earn a margin on the royalties. This amount will be subject to the local company income tax with the remaining amount being paid to the ultimate licensing company. These fees that are paid for the use of the intellectual property are hard-to-value for tax authorities. The Netherlands is one of the countries where such strategies of establishing sub-licensing companies have mainly been utilised (Davis Tax Committee, 2014a:3).

2.4.3 Globalisation

Globalisation is also a motive for tax avoidance schemes by MNC's. As a result of globalisation, most MNC's are now able to design their products in country A, manufacture their products in country B, test the product in country C, hold hard-to-value intangible assets, for example, patents, in country D, and also assign marketing rights to a subsidiary in another country. Structures such as the above provide MNC's with a great deal of discretion in allocating costs to each country and also allow MNC's to shift profits through internal trade (Sikka, 2009).

2.4.4 Cost sharing agreements

A cost sharing agreement is an agreement between companies who form part of the same multinational group, which allows them to share the costs as well as the risks of developing, producing or obtaining intangible assets. The costs to be paid by the companies are dependent on the relative benefits to be derived from using the intangible assets (Valuation Research, 2013). The Business Dictionary online (2015) defines a cost sharing agreement as "an agreement between two parties to share the cost of developing an intangible asset, such as computer code, production methods, or patents".

Cost sharing agreements normally work in the following manner: The parent company will develop an intangible asset, for example, a patent on a product that can be sold by both the parent company and the subsidiary. Given the cost sharing agreement entered into by the two companies, the subsidiary will have to pay the parent company a fraction of the costs relating to the development of the patent. The fraction of the costs paid by the subsidiary is known as a buy-in payment and is meant to compensate the parent for the costs/risks associated with the development of the patent (Internal Revenue Service (IRS), 2002).

Such cost sharing agreements are especially beneficial for an MNC in instances where, had it not been for a cost sharing agreement, the global development activities of the MNC would have required global cross-licensing arrangements. Such licensing arrangements are particularly difficult to administer and can result in a huge additional tax burden in the form of withholding taxes (Valuation Research, 2013). According to Dye (2008), in instances where no cost sharing agreements exist, the subsidiary would have to pay the parent company a royalty for each item of the patented product that is sold by the subsidiary, which will be equal to the market value of the license to sell the patented product. The royalty payments by the subsidiary to the parent comprise gross income in the hands of the parent and are also deductible for tax purposes in the hands of the subsidiary. Similarly, under a cost sharing agreement, the subsidiary's cost sharing payment to the parent comprises gross income in the hands of the parent and is tax deductible in the hands of the subsidiary. In instances where the parent is operating in a higher tax jurisdiction than the subsidiary and the cost of developing the patent is lower than the market related royalty payments, the MNC can reduce its worldwide tax liability by implementing a cost sharing agreement rather than by adopting royalty-based transfer prices. The major tax advantage of cost sharing agreements is that market prices end up being replaced by internal costs. Most MNC's are therefore substituting their transfer pricing policies with cost sharing agreements in a bid to avoid paying exorbitant amounts in tax.

Cost sharing agreements have become one of the mechanisms being used by MNC's to shift valuable intellectual property/hard-to-value intangible assets off-shore to tax havens/low tax jurisdictions. They are also being used by MNC's as vehicles to split the benefits and costs of research and development between group companies (De Simone & Sasing, 2015).

Many MNC's are entering into cost sharing agreements as opposed to outright sales of intellectual property, as such agreements are useful to MNC's especially when the existing intellectual property must be further developed in order to attain or maintain its potential

future value (Alvarez & Marsal, 2015). Cost sharing agreements permit all foreign profits that are derived from the exploitation of the intangible assets to be earned by foreign subsidiaries. This can provide significant tax savings especially in those instances where the foreign tax rates are materially lower than the tax rate prevailing in the country of operation of the parent company (Yoder, 2012).

Another motive other than tax avoidance for entering into cost sharing agreements by MNC's is the fact that some of the activities undertaken under a cost sharing agreement, such as research and development as well as mining exploration, involve a significant amount of risk of commercial failure which in turn results in financial loss. Therefore a commercial rationale for a cost sharing agreement is the fact that risk is shared or spread among the various entities that are part of the agreement. Another likely benefit is the ability of an entity to exploit potentially profitable business opportunities that would not have been financially or commercially viable had they been exploited by a single entity alone. As a result of the joint effort, the participants to the cost sharing agreement may contribute various assets, resources and expertise that together make the venture a success (Australian Taxation Office, 2004:4).

The challenge with cost sharing agreements is that it is problematic to determine an arm's length price of the payment made by the subsidiary, hence firms with cost sharing arrangements are more likely to engage in tax avoidance schemes (Gravelle, 2015). In the United States of America, the treasury regulations require that the costs should be shared in proportion to the future benefits that each company is expected to receive from the intangibles. However, the challenge is that there is some vagueness with regard to how such benefits are to be determined (Dye, 2008).

2.4.5 The Double Irish Dutch Sandwich

2.4.5.1 Background to the Double Irish Dutch Sandwich

Strategies such as the Double Irish Dutch Sandwich are mainly used by MNC's that have a large number of intangible assets in order to avoid paying income tax. This is a structure that was pioneered by Apple Inc and has become common among other US companies such as Facebook and Google (Peacock, 2013). Ireland is a favoured destination for investment as it has a low company income tax rate (12.5% as compared to South Africa's 28%), tax treaties that are favourable, and a well-educated English speaking workforce (Badenhausen, 2013).

According to Thorne (2013:8), there are two fundamental income tax concepts that are often exploited by MNC's in the implementation of their tax avoidance strategies. The first concept relates to the basis of taxation. Income tax systems are either based on the residency of the taxpayer (residence-based taxation) or on the source of income (source-based taxation).

Under a residence-based taxation system, once a taxpayer is deemed to be resident in a certain country, they become liable for tax on their worldwide income. In a source-based taxation system the taxpayer will be liable for tax on income that has been earned within the jurisdiction of the taxing state. Most countries have adopted a combination of both the residency- and source-based taxation systems. The second concept being exploited by MNC's relates to the manner in which different countries determine the residency status of companies for tax purposes. Most countries such as the United States of America determine the residency of a company based on where the company is incorporated, and some countries, for example Ireland, determine the residency status of a company based on where the place of management and control of the company is located. The two concepts discussed above (residence-/source-based taxation and the rules used in the determination of where a company is tax resident) are vital in the explanation of the Double Irish Dutch

Sandwich structure. The differences in the residency rules between countries are of fundamental importance to the effective functioning of the structure, hence MNC's are taking advantage of these differences to engage in tax avoidance (Out-Law.com, 2014) as will be illustrated below.

2.4.5.2 How the Double Irish Dutch Sandwich works

The Double Irish Dutch Sandwich works by taking advantage of Irish Laws, which allow companies based outside of Ireland to be registered as Irish Companies. For example, a company that is based in a tax haven can register as an Irish Company for tax purposes (Flanagan, 2013).

The structure works as follows: a USA parent company will set up an Irish subsidiary (IrishCo1) which will have its place of management and control (tax home) in a tax haven such as Bermuda and as such will be taxed in Bermuda and not in Ireland. Under US law IrishCo1 will not be a tax resident because it is incorporated outside the US. IrishCo1 will then set up a wholly owned Irish subsidiary (IrishCo2) that will be managed and controlled in Ireland, hence making it an Irish resident for tax purposes. Even though both IrishCo1 and IrishCo2 will be Irish companies they will be treated differently for Irish tax purposes with Irish Co1 being treated as a resident of Bermuda, which has an Irish subsidiary (IrishCo2) (Ting, 2014).

IrishCo1 will be provided with a licence by the US company, which allows it to exploit its intellectual property outside the US and will be liable to pay royalties in return for the right to exploit the US company's intellectual property. IrishCo1 will then sublicense the intellectual property to IrishCo2 and using its licence. IrishCo2 will gather most of the non-US revenue for the US company. The revenue collected will be paid to IrishCo1 as royalties. The royalties paid by IrishCo2 to IrishCo1 will be treated under Irish tax law as royalties paid by an Irish company (IrishCo2) to a company in Bermuda (IrishCo1) for the use of its intellectual

property in Ireland. Such royalties will be deductible by IrishCo2 for tax purposes resulting in a reduction of its tax burden in Ireland. As there is no tax in Bermuda, the royalty payments made to IrishCo1 will be tax free. Withholding tax may be levied in Ireland on the royalties paid by IrishCo2 to IrishCo1. To avoid this, the US company will set up another subsidiary in the Netherlands (DutchCo) which will be interposed between IrishCo1 and IrishCo2. As a result of this, IrishCo1 will sublicense the intellectual property to DutchCo, which will in turn sublicense the intellectual property to IrishCo2 (Rubinger & Lepree, 2014).

According to the European Commission (not dated), royalty payments between European Union countries are not subject to withholding tax. The effect of this is that the payments from IrishCo2 to DutchCo are not subject to Irish withholding tax because the two countries (Ireland and the Netherlands) form part of the European Union. DutchCo will subsequently transfer the payments received from IrishCo2 to IrishCo1 and will not be subjected to withholding tax under Dutch law. The Dutch law does not provide for the withholding of tax on outbound royalty payments. Moreover DutchCo will be subjected to minimal income tax in the Netherlands as the royalty income received from IrishCo2 will be offset by the outbound payment made to IrishCo1 (De Looze, 2013).

In his 2015 budget speech, the Irish Minister of Finance announced measures that would cause all Irish incorporated non-resident companies to be treated as Irish tax residents from 1 January 2015. The purpose of this was to bring to an end the Double Irish Dutch Sandwich structures (Phillips, 2014). However, even though the proposals came into effect on 1 January 2015, they contained a grandfathering rule for current Irish incorporated non-resident companies (Deloitte, 2014c). This rule allowed them to keep their structures until 31 December 2020, giving them a five-year window period to wind down (Wood, 2014). According to the Oxford Dictionary online (2015), a grandfathering rule is “a clause exempting certain pre-existing classes of people or things from the requirements of a piece of legislation”. The result of the above is that until 2020 there will be billions of revenue lost

as a result of the Double Irish Dutch Sandwich structures. The five-year window period also gives MNC's a lot of time to devise other schemes on how to avoid taxes, which will be exploited come 2020 and beyond.

2.4.5.3 Practical examples of instances where MNC's have used the Double Irish Dutch Sandwich to avoid tax

2.4.5.3.1 The case of Google

In 2012, Google channeled £8.8 billion of its royalty payments to Bermuda using the Double Irish Dutch Sandwich, a strategy that has saved the company billions of dollars in tax. By channeling the payments to Bermuda, Google managed to reduce its effective tax rate overseas to by about 5%, which is less than half the tax rate in Ireland, where the majority of the company's international sales are booked. The company holds its non-US intellectual property in Bermuda and it is reported that between 2009 and 2012 the royalty payments paid to Bermuda doubled. Google has been at the centre of worldwide controversy with regards to tax avoidance as a result of the fact that most of its foreign earnings are made in Ireland and the company pays little tax in those countries where most of its customers are based (Houlder, 2013).

In the case of Google, the Double Irish Dutch Sandwich works as follows: When a company in Europe, Africa or the Middle East concludes an agreement to buy a search advertisement from Google, the payments are made to Google Ireland Ltd, an Irish company that is wholly owned by Google Ireland Holdings, which is also an Irish company with its centre of management and control located in Bermuda (Farivar, 2013). The tax home for Google Ireland Holdings is therefore in Bermuda. Google Ireland Holdings holds Google's intellectual property rights, which it licenses to Google Netherlands Holdings B.V. The rights in intellectual property are sub-licensed by Google Netherlands Holdings B.V. to Google

Ireland Ltd in return for royalties. The royalties paid are not subject to withholding taxes. This is because payments made to certain European Union (EU) countries are not subject to withholding tax in accordance with an EU directive, which was discussed in section 2.4.5.2 above. Once the money is in the Netherlands, Google Netherlands Holdings B.V. transfers 99.8% of what it collects to Bermuda as royalties and no withholding taxes are levied, as the Netherlands does not withhold tax on outbound royalty payments. The above-mentioned tax strategy is perfectly legal and it has allowed the company to save on its overseas tax bill. However, the downside of the strategy is that the US tax base is eroded as the company does not pay any tax in the USA at a time when the US government is trying to close a projected \$1.4 trillion budget deficit (Drucker, 2010).

2.4.5.3.2 The case of Apple Inc

Using the Double Irish Dutch Sandwich, the company paid taxes at an effective tax rate of 9.8% by routing its profits through Irish subsidiaries and the Netherlands and then to the Caribbean Islands (Hickey, 2012). In an investigation conducted by the US senate it was concluded that the tax arrangements of Apple Inc were not a true reflection of its business and has resulted in the US treasury losing \$100 billion of revenue each year (Sikka, 2013).

2.4.6 The Intellectual Property Holding Structure using the IP Box regime

According to Evers *et al.* (2013:1) “the most significant policy innovation in recent years has been the introduction of Intellectual Property (IP) Box regimes that offer a substantially reduced rate of corporate tax on the income derived from patents and in some cases other forms of intellectual property”. The first countries to operate such policies were Ireland, France and Belgium and to date nine other European countries have implemented their own IP Box regimes. However, such regimes first received widespread attention when they were implemented by Luxembourg and the Netherlands in 2007. Evers *et al.* (2013:6) further note

that under such regimes the tax rates on the qualifying income range from 0% in Malta to a tax rate of 15.5% in France. As a result of the above tax rates, the attractiveness of a country as a location in which MNC's can hold their intellectual property increases drastically.

Under this structure, a MNC will transfer intellectual property to an intellectual property holding company that is resident in one of the countries in Europe and that offers an intellectual property box regime. Normally the operating company will be resident in another EU member country and in order to derive the most benefit, the operating company will be located in a country that does not apply the arms-length principle strictly, hence making it easy for the MNC's to shift profits. Another factor that is required for the structure to work effectively is that there must be no Controlled Foreign Corporation (CFC) rules in the country of the parent company and there must also be low exit taxes relating to the transfer of intellectual property (Davis Tax Committee, 2014a:6).

Adopting the above structure results in the avoidance of withholding tax on royalties as a result of the EU interest and royalties directive. The directive will apply to waive any withholding taxes because the intellectual property holding company will be located in an EU member country and, provided that the beneficial owner of the royalty payments is a company or a permanent establishment in another member state, the royalty payments shall be exempt from any taxes (European Commission, not dated). There is therefore no need for a conduit company to be interposed in order to avoid withholding taxes (Davis Tax Committee, 2014a:7).

2.5 Challenges arising from the schemes used by MNC's to avoid taxes

As is evident from the above, MNC's employ various strategies involving hard-to-value intangible assets in order to avoid paying their fair share of tax in the countries in which they

are operating. Tax authorities around the world have become more prepared and informed than before and they are under immense pressure to deliver revenue as a result of their efforts to curb aggressive anti-avoidance practices by MNC's (Moneyweb, 2006).

It is, however, also important to note that one of the challenges in relation to hard-to-value intangible assets is that in most instances large audit and law firms are helping MNC's to avoid tax. Aniket (2013) considers this not to be good practice. However, since tax avoidance is legal, many MNC's are prepared to pay large sums of money to lawyers and accountants so that they can assist them to avoid tax.

According to Needham (2013) the extent to which tax administrations are losing revenue as a result of the tax avoidance strategies highlighted above is difficult to estimate but it is considered to be of a serious nature. Even though in the end the MNC's benefit, the domestic competitor firms are unable to obtain similar tax advantages. Another challenge that most governments are facing is that the local and international tax environment for corporates has become more and more complex, hence effective solutions to the above tax avoidance will be difficult to achieve. Needham (2013) further notes that the other challenge being faced is that countries all over the world are offering varying tax advantages and different rules in relation to tax. MNC's are aware of this and are constantly devising strategies to take advantage of it. The ability of MNC's to separate their functions (for example, between sales and research and development) as well as the fact that the digital economy enables MNC's to operate various remote internet business processes has given more value to hard-to-value intangible assets. The different tax rules result in no or low taxation and the shifting of profits from where the economic activities of the MNC are taking place to other countries.

Another challenge that has been noted by the OECD is that the anti-avoidance measures put in place by various countries, such as the general anti-avoidance rules, controlled foreign

company rules and thin capitalisation rules, are far too complex and costly to implement. The OECD has found that these rules are in most instances ineffective. Even though the OECD went on to devise action plans to curb base erosion and profit shifting, it has highlighted the fact that countries will not be able to act in isolation without the assistance of other countries. Given the fact that tax avoidance by MNC's is of a cross-border nature, the OECD has encouraged countries to apply a holistic and comprehensive approach to dealing with the effects of tax avoidance (OECD, 2013b:11-16).

In this regard the battle against tax avoidance is an international issue requiring a coordinated effort between the various countries (Jolly, 2013). On the other hand, MNC's are being challenged to balance the pressures of being good corporate citizens as well as paying up their fair share of taxes with the pressures of catching up with their competitors and providing their shareholders with an appropriate return on their capital (Needham, 2013:5).

Another issue currently being faced by South Africa that leads to erosion of the tax base is the lack of country-by-country reporting. Under country-by-country reporting, MNC's will be required to name the countries that they operate in, name all subsidiaries and associates in those countries of operations, indicate the performance of each subsidiary and associates, and detail the cost and net book values of their fixed assets (Tax Justice Network, not dated b). In this way it is then easy to keep track of the activities of MNC's and their effect on base erosion and profit shifting.

2.6 Conclusion

In this chapter the various strategies employed by MNC's to avoid tax using hard-to-value intangibles as well as the related challenges were considered as per secondary objective number 1 (paragraph 1.5.2). It was noted that MNC's are continuously devising strategies of

tax avoidance resulting in tax savings of large amounts. It is important that tax authorities worldwide keep up-to-date with such schemes in order to avoid further base erosion and profit shifting taking place.

CHAPTER 3: CHALLENGES ARISING FROM THE CONCEPTS OF LEGAL AND ECONOMIC OWNERSHIP

3.1 Introduction

The previous chapter focused on tax avoidance strategies employed by MNC's using hard-to-value intangible assets. In this chapter, the focus will be on secondary objective number 2 (paragraph 1.5.2). The meaning of legal ownership and economic ownership in relation to hard-to-value intangibles and royalties is explored in order to determine whether returns on the exploitation of hard-to-value intangibles should be allocated on the basis of legal ownership, economic ownership or both. A review of the court cases that have been decided on in this matter in Canada and in the USA will also be performed. The OECD's view and guidance with regard to ownership of intangible assets will be considered. The chapter will conclude by outlining the challenges that the application of these concepts poses in South Africa with regard to transfer pricing and this is in line with the main objective of this research as indicated in paragraph 1.5.1.

It has been noted by the United Nations (2015:2-3) that an issue of special concern to many developing countries is that of intellectual property rights and other intangibles such as hard-to-value intangibles. The United Nations (2015:2-3) has also noted that the current rules (OECD guidance) relating to intangibles have not been developed with global taxpayers in mind. A cause for concern among developing countries is the fact that they do not seem to be receiving compensation for those intangibles that were developed and that received their value from economic and value-creation activities that took place within their jurisdictions. Of particular concern is the fact that legal ownership can be transferred to other jurisdictions resulting in an erosion of the tax base through royalty payments.

3.2 Legal ownership versus economic ownership of an intangible asset

There are two types of ownership: (1) legal ownership and (2) economic ownership (Harrison, 2006). Hundred percent legal ownership plus hundred percent economic ownership equals full ownership. The term legal owner of an asset means that the person (natural or juristic) is the owner of the asset under the civil laws of the country in which the person is resident or under the civil laws of the country in which the asset is located. Under the civil laws of most countries, the legal owner of an asset refers to the person who has possession of the asset. The term “possession of the asset” means that the person has physical possession of the asset or the asset is officially registered in the name of the person. Initially, the legal owner also has full economic ownership of an asset (Van Bladel, 2013:3). In some instances economic ownership occurs when legal ownership cannot be established, for example, in cases where there are embedded intangibles such as knowhow, as it is often difficult to use the legal system to protect them (IPR Plaza, not dated).

3.3 Is beneficial ownership the same as economic ownership?

The concept of beneficial ownership has been a point of debate recently when it comes to tax treaties. According to the Tax and Asia Senior School (2014:2), a beneficial owner is the “owner who enjoys the benefits of ownership” or the “one who is entitled to receive the income of an estate without its title, custody, or control” or the “one who is recognized in equity as the owner of something because use and title belong to that person, even though legal title may belong to someone else”. The Tax and Asia Senior School (2014:2) also notes that the concept of beneficial ownership is based on the principle of substance over form.

According to PwC (2010:1), since the very inception of tax laws there has been much debate with regard to whether a transaction should be analysed based on its legal form or on its

economic substance for tax purposes. The application of the concept “substance over form” may be mandated by a legislative provision even though in most tax jurisdictions it is more often a rule of interpretation developed by the judiciary. In either case, the effect is to determine the tax consequences of a transaction or arrangement by determining its economic substance rather than its legal form. The Davis Tax Committee (2014b:23) notes that the substance over form concept is used by tax authorities to overcome the abuse of or improper use of double tax agreements with the aim of preserving their taxing rights as well as in the prevention of tax avoidance. To this effect some tax jurisdictions within the EU have incorporated legislative provisions in their domestic law in order to give effect to the doctrine of economic substance over legal form (Kolesnikovas, 2014:4). From the above definition as well as the comments made thereafter it is clear that the concept of beneficial ownership is the same as economic ownership of an asset.

3.4 The importance of the concepts of legal ownership and economic ownership in relation to hard-to-value intangibles

The arm’s-length character of the consideration paid for the use (royalties) or transfer of a hard-to-value intangible between group companies is evaluated using certain prescribed transfer pricing methods, such as the residual profit split method. Such an evaluation can, however, not be performed until ownership of the intangible asset has been ascertained (Markham, 2005b:48). In establishing the ownership of such assets, the terms and conditions of all contracts should be carefully analysed. The functions performed, risks assumed, assets held and costs incurred by the related parties should be examined in order to determine whether they are aligned to the compensation received by each party. In the case that the above activities are aligned to the conduct of a certain party, that party is the one entitled to the compensation received on the intangible asset (KPMG, 2012).

In instances where another company within a group of companies assists the owner of the hard-to-value intangible asset to develop or enhance the value of the intangible, the assisting group company must receive an arm's-length consideration from the owner of the hard-to-value intangible asset for the assistance granted. It is therefore important to distinguish between the owner of the intangible asset and the assister in this regard (Markham, 2005c:48). According to Phatarphekar (2013) "ownership of legally registered intangibles such as trademarks is determined first by registered ownership; the developer assistance rules are confined to intangibles that cannot be legally registered".

As a result of the fact that the right to exploitation of an intangible may in various ways be subdivided, a single intangible asset may have multiple owners. This will be the case in instances where, for example, the owner of a patent licenses the exclusive right to the patent in a specific geographical area and for a specified period of time. In such a case, both the licensor and the licensee will be regarded as the owners of the intangible asset. A licensing agreement can, for example, grant the licensee certain rights with regards to the intangible for the duration of the agreement with the licensor retaining some residual rights to the intangible after termination of the agreement (Markham, 2005c:48).

The concept of economic ownership is aimed at eliminating the avoidance of withholding taxes using structured transactions. However, very few countries have adopted the concepts of economic/beneficial ownership in their legislation. Developing countries in particular (South Africa included) are in dire need of the income that comes from withholding taxes for development purposes, but they still do not have the concepts of economic/beneficial ownership in their legislation. The introduction of such concepts would protect such countries from structures that result in the reduction of the income derived from withholding taxes (Van Bladel, 2013).

The concept of legal and economic ownership is mainly used to determine the allocation of returns relating to the hard-to-value intangibles among the different companies within the MNC's group (OECD, 2014b:41). However, a question that still needs to be answered is whether returns should be allocated based on economic ownership or on legal ownership.

To answer this question we will look at the views of the OECD and the views of the courts, with the aim of identifying differences in opinion.

3.5 The view of the OECD

It is the view of the OECD in paragraph 6.42 of the Guidance on Transfer Pricing Aspects of Intangibles (2014b:41) that legal ownership on its own does not necessarily give an entity any right to the residual returns arising from the exploitation of the hard-to-value intangibles. It is merely used as a reference point for the purposes of identifying and analysing transactions involving hard-to-value intangibles within a group of companies, as well as in the determination of the remuneration to be allocated to the group companies with respect to those transactions.

The OECD further asserts that the identification of a legal owner is merely the first step in performing any analysis as to where the returns derived from an intangible should be allocated. Even though the legal owner of the intangible may receive returns from the exploitation of the intangible, other companies within the legal owners' MNC group may have been involved in the performance of certain functions and assumed certain risks that play a contributing factor to the value of the intangible. It is the view of the OECD that such members within the MNC group must receive the appropriate compensation for their contributions in line with the arm's-length principle (OECD, 2014b:38). From the above it is clear that the OECD is more inclined to the allocation of returns based on the concept of economic ownership after first establishing the legal owner.

3.6 The view of the courts

As previously indicated in South Africa there are no transfer-pricing court cases. There have been a few court cases internationally where the concepts of economic and legal ownership were considered. Some of the few countries in which such cases have been dealt with by the courts include Canada and the USA. The court cases will be considered under sections 3.6.1 to 3.6.4.

3.6.1 DHL Corporation and Subsidiaries v Commissioner of Internal Revenue

The case of DHL Corporation and Subsidiaries v Commissioner of Internal Revenue (2002) is a United States of America court case in which the concepts of economic ownership and legal ownership were considered. The facts of the case are as follows: DHL is a worldwide packaging company that was formed in the USA in 1969. In 1972, the company expanded to international services and in that year the company formed DHLI, its subsidiary in Hong Kong. DHLI was responsible for managing the international operations of the company, together with a Netherlands Antilles Company known as Middletown MV, while DHL continued operating in the USA. DHL and DHLI were owned by the same shareholders even though the operations of the two companies were fairly autonomous. Even though DHL and DHLI were operated separately, there were certain structures in place that were meant to manage the operations of the company worldwide. As business opportunities arose, the DHL network expanded, however, without giving much attention to the transfer-pricing implications of such expansion.

A crucial issue in the DHL case was the ownership of the DHL trademark. Both DHL and the Internal Revenue Service agreed that DHL was the owner of the trademark. This is because DHL was incorporated as a US company. It was also clear that the non-US trademark rights were initially US property and from the subsequent events it was not quite clear who the

owner of the trademark rights was. It was, however, noted that a memorandum of understanding was signed between DHL and DHLI giving effect to an agency agreement between the two companies. Under this agreement DHLI's role was to act as a foreign pickup and delivery agent for DHL. DHL then licensed the use of its DHL name to DHLI for no return. The memorandum of agreement was then amended six times, but the agreement never included payment of any royalties by DHLI for the use of the DHL name. There was also no other agreement that addressed the ownership of the intangible asset.

DHLI then identified the need for a standard trademark and logo and went on to design and pay for the first logo, which was to be used by the network of companies. The trademark was registered in countries outside the USA and the cost of registering the trademark, protecting it against infringement of advertising the DHL network outside of the USA was incurred by DHLI. The company also handled all disputes related to the trademark with terminated agents. It is estimated that DHLI spent on average \$150 million on advertising the trademark and its affiliate (Middletown MV) is estimated to have spent \$380 million on advertising the DHL trademark outside the USA.

At some point, DHL experienced a massive cash flow crisis and it engaged the services of Bain and Company to help in the quest to return to profitability. One of the recommendations made by Bain was that DHL should merge with another company in the courier industry. DHL and DHLI then negotiated with UPS³ with regard to a possible merger. The negotiations were, however, unsuccessful. DHL was then approached by a group of investors that included the Japan Airlines Company, whose primary interest was to combine their business with the DHL international network through purchasing a controlling stake in the operations conducted by DHLI. The investors purchased a 12.5% stake in DHLI as well as Middletown MV and an option to purchase another 45% stake in the two companies, which they later exercised and so became the majority shareholders in both companies. DHL was advised during the due diligence activities that the Internal Revenue Service would

potentially seek to tax DHL on possible royalties received from DHLI on the use of the DHL trademark. It was also noted that DHL's activities were critical in the operations of the DHL network and that the cash flow problems that were being experienced by DHL would be detrimental to the network of operations. It was then proposed that DHLI purchase the trademark from DHL for \$20 million as a way of capitalising DHL.

During an audit performed by the Internal Revenue Service the \$20 million valuation was challenged and the value of the trademark was placed at \$600 million. It was also argued by the Internal Revenue Service that DHL owned the worldwide rights to the trademark and that royalties were due for the use of the DHL name by DHLI. DHL, on the other hand, argued that the \$20 million was an arm's-length price and that DHL owned the US rights and not the international rights to the trademark, as DHLI had registered the name outside of the USA and all the advertising costs were incurred outside the USA and were the responsibility of DHLI.

It was held in this case that DHL owned the worldwide rights to the trademark even though the quality and the value of those rights was compromised by the fact that DHLI registered the trademark in various countries under its own name and the fact that there were no precise agreements. The tax court therefore upheld the Internal Revenue Service's allocation of income to DHL.

Upon appeal the decision of the tax court was reversed by the United States Court of Appeals. It was held that the developer of the trademark was DHLI and that the allocation to DHL of the value of the foreign trademark was inappropriate.

Commentary on the court case and its application to the research

In this United States of America court case the concept of economic ownership versus legal ownership was tested. It was evident from the activities performed by DHLI with regards to the trademark that it was the economic owner of the trademark registered outside the USA and not DHL. Initially the lower tax court upheld the allocation of income on the basis of legal ownership rather than on the basis of economic ownership only for this to be reversed by the higher court. This shows that the application of the concepts of economic ownership and legal ownership is not a clear cut and that it is a subjective matter.

The United States of America court of appeals strengthened the principle that advertising and promotional activities result in the further development and strengthening of trademark rights. In this case DHLI incurred all the overseas development and marketing costs resulting in the company being the developer of the overseas trademark and was thus the economic owner. No income could therefore be imputed to DHL for such value. The judgement of the United States of America court of appeals also reinforced the fact that the distinction between economic ownership and legal ownership of intangibles is premised on the principle that reward follows risk and that the development of a marketing intangible is the economic activity that generates value and not the mere registration of the intangible asset. (Patel, 2006.)

3.6.2 Prevost Car Inc. v Canada

Prevost Car Inc. v Canada (2010) is a Canadian court case in which a holding company

(Prevost BV Netherlands) was established in the Netherlands by a British company (Henlys Group) and a Swedish company (Volvo Bussar Corporation). The purpose of forming the holding company was for it to hold shares in Prevost Car Inc., a Canadian taxpayer. A

shareholder agreement was then entered into between Henlys Group and Volvo Bussar Corporation whereby it was agreed that 80% of the profits of the companies that were jointly owned by Henlys Group and Volvo Bussar Corporation, namely, Prevost BV Netherlands and Prevost Car Inc., would be distributed as a dividend, returns of capital or repayment of loans. The distributions to be made were on condition that there would be sufficient financial resources left over in order to meet the working capital requirements of both Prevost BV Netherlands and that of Prevost Car Inc.

It was noted that neither the holding company (Prevost BV Netherlands) nor the Canadian taxpayer (Prevost Car Inc.) were part of the above-mentioned agreement. Prevost BV Netherlands did not have a physical presence in the form of an office and neither did it have any employees in the Netherlands or anywhere else across the world. The board of directors for Prevost Car Inc. was also the board of directors for Prevost BV Netherlands. Prevost Car Inc. paid a dividend to its shareholder Prevost BV Netherlands, which in turn the latter declared as dividend to its two shareholders, namely Henlys Group and Volvo Bussar Corporation. This was done in accordance with the aforementioned agreement with regards to the profits of Prevost BV Netherlands and Prevost Car Inc. In this regard the tax authorities in Canada were of the view that the beneficial owners of the dividend were the UK and Swedish shareholders and not Prevost BV Netherlands. Canada tried to deny Prevost BV Netherlands the treaty benefits in the Canada-Netherlands treaty.

It was noted by the Canadian court that the term “beneficial ownership” was not a term that was recognised in Quebec’s civil law or under Roman-Dutch law. Part of the evidence presented in the court was that the term “beneficial owner” under tax treaties did not stipulate that the beneficial owner of the dividend must be the owner of the share, especially in instances where the entity receiving the dividend is obliged to pass it on to another entity. It was noted that the term was introduced under treaties in order to curb the use of conduit companies for purposes of obtaining treaty benefits. In the absence of clear evidence that

the holding company is merely acting as a conduit, the company is treated as the beneficial owner of the dividend.

It was held by the tax court of Canada that, based on the facts of the case, Prevost BV Netherlands was not a conduit company and it was not in the position of having no discretion with regards to the use or application of the funds that it received from Prevost Car Inc. The tax court of Canada held that it was of major importance that Prevost BV Netherlands was not part of the shareholder's agreement. The court indicated that there was no evidence that the dividend from Prevost was from the beginning meant to be transferred to Volvo and Henlys. A most significant finding of the tax court was that until the board of directors of the holding company declared a dividend, and approval by the shareholders of that dividend was obtained, the dividend remained an asset in the hands of the holding company, which would be available for the payment of the companies' creditors.

Commentary on the court case and its application to the research

This is another case that proves that the concept of beneficial ownership/economic ownership vs legal ownership is a contentious issue. In this case it was evident that the beneficial owners of the dividend were Henlys Group and Volvo. Even though the judgement indicated that Prevost BV Netherlands was not part of the agreement, hence it had discretion with regards to what to do with the dividend, it can also be argued that by virtue of the controlling relationship between Prevost BV Netherlands and the founders of the company (Henlys Group and Volvo Bussar Corporation) Prevost BV Netherlands was obliged to comply with whatever demands were placed on it by the founders of the company, meaning it did not have 100% discretion in dealing with the dividends. Also the fact that Prevost BV Netherlands did not have a physical presence in the form of an office and neither did it have employees in the Netherlands or anywhere across the world proves that its purpose was merely to act as a conduit company and pass on the dividend received to the United

Kingdom (UK) and Swedish shareholders. According to Munting (not dated) the court took a strictly legal approach. Munting further notes that the Prevost court case “gave the necessary comfort” to those who argued that the BO¹ concept in tax should be approached strictly as juridical, not economical.”

3.6.3 Velcro Canada Inc. v the Queen

In the Velcro Canada Inc. v the Queen (2012) case, a company resident in the Netherlands, Velcro BV (Velcro Industries) was the owner of Velcro Brands and Technology. In 1987 the company entered into a licence agreement with Velcro Canada in terms of which Velcro Canada acquired the right to manufacture, sell and distribute the licensed products as well as the right to use the licensed trademark for the purposes of promoting, selling and distribution. In return, Velcro industries received a royalty that was subject to a reduced withholding tax rate of 10% under the Canadian and Netherlands treaty.

As part of a worldwide reorganisation in 1995, Velcro Industries migrated and became a resident in the Netherlands Antilles, a country that did not have a double tax agreement with Canada. Prior to its migration, Velcro Industries assigned its rights and obligations with regards to its intellectual property to Velcro Holdings BV (Velcro Holdings), which was resident in the Netherlands. Velcro Holdings was granted the right to give licences in respect of Velcro Industries’ intellectual property to Velcro Canada. It was also required to collect all royalty payments from Velcro Canada, enforce the terms of the licensing agreement, and take the necessary steps in the event of default by Velcro Canada. Velcro Industries, however, remained with ownership of the intellectual property.

The Canadian Minister of Finance assessed Velcro Canada for taxes for the periods 1995 to

¹ BO stands for beneficial ownership.

2004 for its failure to withhold tax on royalties. This assessment was based on the fact that Velcro Holdings was not the beneficial owner of the royalties and that Velcro Industries, which was resident in the Netherlands Antilles, was the beneficial owner of the royalties. The Minister argued that Velcro Holdings was a conduit company with regards to the royalty income.

However, the taxpayer (Velcro Canada) argued that it had continued withholding tax on royalties paid to Velcro Holdings and had only ceased doing so after 1998 when the treaty rate was reduced to 0% on certain royalties. Velcro Holdings argued that it was not a conduit company as it would deposit the funds in its own account together with other funds. Velcro Holdings further argued that the funds would be used as the company deemed fit and it did not have to ask another entity what to do with the funds and no creditor had priority over another with regard to the funds. The amount of royalty payments made to Velcro Holdings by Velcro Canada was different to the amount that was subsequently paid to Velcro Industries.

It was also argued that although Velcro Holdings had an obligation to pay an amount equivalent to 90% of the royalties received from Velcro Canada, and the funds from which these payments came were intermingled with other funds of the company. This was argued to be different from an automated flow of specific funds, hence Velcro Holdings had met the tests established in the *Prevost* case to be considered the beneficial owner of the dividends.

The tax court agreed with the taxpayer and it was deemed to be the beneficial owner of the royalties. In determining whether Velcro Canada was the beneficial owner of the royalties, the court applied the four tests of possession, use, control and risk. With regard to possession, it was held that Velcro Canada had possession of the royalties because it has the right to receive the royalties that were deposited in its own account and the royalty amounts were mingled with other funds of the company. With regard to use, the court ruled

that there was nothing in the assignment agreement that prevented Velcro Canada from using the royalty funds at its own discretion. The fact that Velcro Holdings assumed the risk of currency fluctuations where the royalties were received as Canadian dollars that were then to be converted to US dollars or the Dutch currency, as well as the fact that the royalties were shown as the assets of Velcro and that they were available for claims by creditors, meant that Velcro assumed risk in terms of the royalties. Lastly, the court held that Velcro Holdings had control over the royalties received based on the same factors considered in the determination of whether the company enjoyed possession and use and had assumed risks in relation to the royalties. It was further held that the company was not an agent or a conduit company as per the Canadian Minister of Finance's assessment because it did not have the capacity to enter into contracts with third parties on behalf of Velcro Industries.

Commentary on the court case and its application to the research

Based on the principle of substance over form it would appear that Velcro Holdings was not the owner of the royalties and that it was set up to pass the royalties to Velcro Industries. However, the court differed from this view. The court also took a juridical/legal view in this case and not an economical view (Munting: not dated).

The above court case only has persuasive influence in South Africa. According to taxEnsign (2012), this court case provides a useful framework for both taxpayers and the courts, to be used in the determination of whether a taxpayer is a beneficial owner of an asset or not.

3.6.4 Coca-Cola

The company recently received a \$3.3 billion assessment from the Internal Revenue Service. The matter will be proceeding to litigation and this could be an interesting case with

regard to intangible assets. It has been indicated by the taxpayer that the dispute with the Internal Revenue Service relates to how the company reports the income that it derives from foreign licensing of manufacturing, sale and distribution, as well as marketing and promotion of its products in overseas markets (Snyder, 2015). Coca-Cola is, however, arguing that it has followed the methodology for the licences that was outlined in a 1996 agreement with the Internal Revenue Service. The company further argues that its compliance with the agreement had been confirmed by five audits covering the subsequent years through 2006, with the most recent audit ending in 2009 (Delaney & Esterl, 2015). The above case will again bring the issue of legal and economic ownership to the test, proving that the determination of the owner of an asset is still not a clear cut issue despite the guidance provided by the court cases discussed above. As a result of this, there are still disputes between tax authorities and taxpayers.

3.7 Challenges anticipated in South Africa

The sale of intangible assets developed in South Africa presents a somewhat exceptional situation in comparison to the rest of the world. This is because of the exchange control regulations, which prevent the relicensing of intellectual property back into South Africa (Exchange Control Regulations, 1961). Also, in South Africa Section 23I of the Income Tax Act (58 of 1962) prohibits the deduction of royalties paid with regard to intellectual property that was developed in South Africa and sold to a foreign company and that is then licensed back to a South African company. Such intellectual property is said to be tainted. When the intangible asset is sold to a foreign-related party, that foreign-related party becomes the legal owner of the intangible. The terms and conditions of the sale may dictate that the South African entity will continue performing certain functions that contribute to the enhancement of the intangible asset as well as the further development of the intangible asset for which it receives a return. From the perspective of the SARS there is merit in the argument that the

South African entity is the economic owner of the intangible asset and that the South African entity should be earning a commensurate return (United Nations, 2013:414).

Under South African law there are no ownership rules pertaining to hard-to-value intangible assets that provide guidance in identifying the group company that should recognise the income attributable to the hard-to-value intangible asset. The above court cases seem to suggest that the courts tend to place more emphasis on the legal owner of an asset. This creates problems particularly with regards to the OECD's emphasis on economic ownership of assets. As a result of the fact that there is no local guidance in South Africa, as previously mentioned, a challenge that South Africa is likely to face is whether to follow the OECD guidance, which seems to favour economic ownership over legal ownership, or to follow the international court cases discussed above, which seem to favour legal ownership.

In terms of the OECD, South Africa has observer status and is not a member. According to Eriksson (2010), the OECD guidelines are not legally binding and as a result the national legislation that prevails at that time will be considered first. South Africa does not have national legislation with regard to the concepts of economic and legal ownership of intangible assets. The only legislation is section 31 of the Income Tax Act (58 of 1962), which is silent on the concepts of legal and economic ownership. Foreign court cases, however, have persuasive influence on our courts and are likely to persuade the local courts. It is, however, important to note that the OECD transfer pricing guidelines are a commentary to Article 9 of the OECD model tax convention, hence they also have higher value as an authoritative source of information because of the value they have in interpreting double tax agreements concluded under the OECD model tax convention.

There would, however, be no point in SARS conducting its audits based on the OECD guidelines and guidance only for the tax court to rule in favour of the taxpayer when it comes to litigation. This shows that there is a need for legislation in South Africa that clearly

articulates how returns arising from intangible assets should be allocated. Taxpayers may view the current lack of clarity/differing opinions with regards to economic and legal ownership as an opportunity to continue profit shifting by setting up structures in foreign countries that they can use to their advantage and this will further exacerbate the problem of base erosion and profit shifting currently being experienced in South Africa.

3.8 Conclusion

The objective of this chapter was to analyse in detail the meaning of the terms legal ownership and economic ownership in relation to hard-to-value intangibles and royalties. A review of the court cases that have been decided on this matter in Canada and in the USA was also performed and the OECD's view and guidance with regards to ownership of intangible assets was also considered. Differences were noted between the application of the terms by the OECD and the courts. It was noted that the OECD emphasises economic ownership whereas the court cases from Canada and the USA highlighted above seem to emphasise the concept of legal ownership. The chapter concluded by outlining the challenges that the application of this concept poses in South Africa with regard to transfer pricing. Secondary objective number 2 (paragraph 1.5.2) and the main objective of this research (paragraph 1.5.1) have therefore been met with regards to this chapter.

CHAPTER 4: CURRENT INTERNATIONAL GUIDANCE RELATING TO THE ARM'S-LENGTH PRINCIPLE

4.1 Introduction

The previous chapter focused on an analysis of the concepts of economic ownership and legal ownership and the challenges these pose within a South African context. It was highlighted in the chapter that before an arm's-length price can be determined it is first of all important to determine the owner of the hard-to-value intangible asset. In this chapter, the focus will be on secondary objective number 3 (paragraph 1.5.2). The purpose of this objective is to analyse the current guidance (international court cases as well as the OECD and UN guidance) with a view to identifying any shortcomings. A critical analysis of the OECD and UN guidance with regard to the application of the arm's-length principle will be performed. The guidelines will then be compared and contrasted for differences, if any. The chapter will conclude by outlining the applicability of the guidelines within a South African context and highlighting the possible challenges that South Africa may encounter in applying the guidelines in relation to hard-to-value intangibles. The identification of possible challenges is in line with the main objective (paragraph 1.5.1) of this research.

4.2 The arm's-length principle

In developing transfer pricing legislation, both developing and developed countries are faced with the objective of trying to protect their tax bases while also not creating the problem of double taxation or uncertainties that would likely hamper foreign direct investment as well as cross border trade. The embodying of the arm's-length principle in the transfer pricing legislation of various countries can be instrumental in attaining this objective (OECD, 2011:2).

The arm's-length principle is embodied in Article 9 of both the OECD Model Convention (2014a), also referred to as the OECD model, and the United Nations Model Double Taxation Convention between Developed and Developing Countries (2011), referred to as the UN model hereafter. The OECD guidelines have, however, elaborated on this principle and many countries around the world have implemented their transfer-pricing laws based on the arm's-length principle (OECD, 2011:2). The arm's-length principle endeavours to reconcile the fact that bias on value can occur especially between transactions involving associated enterprises. The intention of the principle is to emulate the various transactions between the associated enterprises as if both parties are independent and on an equal footing (Porto Capital, 2014).

Paragraph 1 of Article 9 (Associated enterprises) of the OECD model (2014a: 29-30) states that associated enterprises are those entities "where (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or (b) the same persons participate directly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State". The same paragraph further goes on to state that where "conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations that differ from those that would be made between independent enterprises, then any profits that 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".

Paragraph 3 of the commentary on Article 9 (Associated enterprises) of the UN model (2011:171) states that "with regard to transfer pricing of goods, technology, trademarks and services between associated enterprises and the methodologies which may be applied for determining correct prices where transfers have been made on other than arm's-length

terms, the former Group of Experts stated that the Contracting States will follow the OECD principles, which are set out in the OECD Transfer Pricing Guidelines. The former Group of Experts, in the United Nations Model Convention revised in 1999, came to the view that these conclusions represent internationally agreed principles and it recommended that the Guidelines should be followed for the application of the arm's-length principle which underlies the Article".

According to the OECD (2010b), when independent entities trade with each other the terms and conditions of their transactions are influenced by market forces. This may, however, not be the case with associated entities, even though such entities often seek to replicate the dynamics of the market forces in their trading activities. The OECD (2010b) further notes that where conditions imposed on transactions between associated entities do not reflect conditions that would have been imposed by entities that are trading independently (arm's-length conditions), the resulting profits that would have accrued to one of the entities will be taxed in the hands of that enterprise as if the conditions of that transaction were consistent with the arm's-length principle.

4.3 The different transfer pricing methods and the challenges thereof

The OECD has endeavoured to level the transfer pricing playfield by outlining five methods to be used in the determination of the arm's-length nature of transfer prices. The methods have been agreed to by OECD member countries, which include developed and developing countries (Europe Aid, 2011:10-11).

SARS in its Practice Note 7 (1999) embraces the arm's-length concept as well as the various methods that have been agreed to by the OECD. Even though the Practice Note is considered by many to be outdated due to the various legislation changes since it came into effect, the various methods of determining the arm's-length principle are still in line with the

latest OECD guidelines. However, the Practice Note does not deal with the issue of hard-to-value intangible assets, but only deals with the physical flow of goods and services. The process of drafting an interpretation note that will provide guidance in line with the new legislation is still underway but no changes with regard to the transfer pricing methods are expected as the methods are in line with the OECD guidance (Mberi, 2012:18). It is also not clear if hard-to-value intangible assets will be dealt with in the interpretation note.

The various transfer pricing methods, and some of the practical problems associated with the methods as detailed in the SARS Practice Note and by other authors on transfer pricing, will be discussed below.

4.3.1 The comparable uncontrolled price method

This method involves a comparison of prices charged in controlled transactions with the prices charged in comparable transactions with independent third parties. The transactions compared can be between two third parties or between a related party and a third party. (BarZvi & BenDov, not dated.)

Even though SARS (1999:15) states that the comparable uncontrolled price method “is the most direct and reliable way to apply the arm’s-length principle where it is possible to locate comparable uncontrolled transactions”, it has its own practical problems. These problems include the fact that it is extremely difficult to find transactions between independent enterprises that have characteristics similar enough to the controlled transaction without differences that have a material effect on the pricing of the transaction. SARS (1999:15) also notes that certain adjustments with regard to differences in the amounts and types of intangible property involved in the transaction may be extremely difficult to implement and that where there are differences between controlled and uncontrolled transactions or differences between the enterprises involved in a transaction, “it may be difficult or

impossible to determine reasonably accurate adjustments to eliminate the effect on price” (SARS, 1999:15).

For intangible assets it has also been noted that it is seldom that open markets are found where the intangible assets of an MNC are traded. Even in instances where such markets are found, the services offered are differentiated in terms of design, performance, functionality or other factors such as brand names or trademarks. Such intangible assets should not be subjected to a transfer-pricing analysis using the comparable uncontrolled price approach (Abdallah, 2004:167).

4.3.2 The resale price method

Under this method the arm’s-length nature of the amount charged in a controlled transaction is evaluated with reference to the gross profit margin realised when an entity resells goods to an associated enterprise. This gross profit margin is then compared to the gross profit margin realised by comparable entities in uncontrolled transactions (USTransferPricing.com, 2015).

According to SARS (1999:16), the major problem with this method is the determination of an “arm’s-length resale price gross margin”. This is because it is usually difficult to find a transaction between entities that are independent, which is similar to a transaction between associated enterprises where the differences noted do not have a material effect on the gross profit margin. The Practice Note also notes that accounting policies play an important role in the determination of resale prices, as the cost items taken into account (in terms of the accounting policies) to arrive at a gross margin differ from one company to another. The application of the resale price method often requires access to product data that is segregated and this information is not normally available in respect of uncontrolled entities that are used as benchmarks.

With regard to intellectual property, different guidelines pertaining to the appropriateness of the mark-up used by the MNC may be used. The appropriate mark-up may, however, be determined from uncontrolled sales made by other entities under similar economic conditions and circumstances. In order to apply the resale price method effectively, it is essential that the functions performed, risks assumed and design of intellectual property be comparable. Comparability adjustments will also need to be made for differences in the mix and intensity of functions performed, the economic conditions of the transactions, and any other conditions related to the sale (Abdallah, 2004:167).

4.3.3 The cost plus method

The cost plus method requires an estimation of the arm's-length price by using the costs incurred by the supplier of property/services in a controlled transaction. Once the cost has been determined, a mark-up that takes into consideration the functions performed, risks assumed and assets employed is added to the costs to determine the arm's-length price in the controlled transaction (Europe Aid, 2011:11).

SARS (1999:17) has noted the following practical challenges in relation to this transfer pricing method, namely, that some companies are more cost effective than others and will incur lower costs. Another challenge noted with regard to this method is that there may be instances where there is no link between the costs incurred and the eventual market price charged. Also the type of costs included in the calculation of cost to arrive at a gross margin differs from company to company as a result of the differing accounting policies among companies. This transfer-pricing method requires access to segregated data that will not usually be available with regard to the uncontrolled entities used as benchmarks. The cost plus method has been further criticised for its limited applicability to services involving the creation, enhancing or use of intellectual property (OECD, 2006:1).

4.3.4 The transactional net margin method

This is a profit-based method that compares the profitability of a member of an MNC with profits of comparable entities undertaking similar types of transactions (EY, 2012a). This method has been criticised for the fact that the net margin of a taxpayer can be influenced by certain factors that do not have an influence on the price or gross margins, thus making the results of applying this method unreliable. Another challenge posed by this method is that taxpayer information may not be available at a point in time when the arm's-length price is to be determined, hence making it difficult to determine the net margin arising from a controlled transaction. With regard to the controlled transaction, information may not be available for comparison purposes. The method has also been criticised as a one-sided analysis that does not take into consideration the effect that the determined price has on the other party to the transaction (SARS, 1999:19).

4.3.5 The profit split method

According to Hughes and Nicholls (2010) "the profit split method (PSM) seeks to determine the way that a profit arising from a particular transaction would have been split between independent businesses that were party to the transaction". Hughes and Nicholls (2010) further state that the profit is divided based on the contribution of each associated entity to the transaction as determined by their functional profile as well as external market data. The method is therefore a two-sided analysis. The method has been criticised for the fact that the profits arising today may be the result of work that was done by an entity many years in the past. Also the inclusion of all costs in the profit to be shared could allow some participating entities to export the cost of their inefficiencies to other entities.

4.4 Other challenges arising from the arm's-length principle and hard-to-value intangibles

Tax authorities have noted with concern that some transactions involving intangibles are hard-to-value using the traditional principles and practices of determining an arm's-length price as a result of the fact that intangible assets are of a unique nature and would not have occurred between independent and unrelated parties (Deloitte, 2014b). It is not always easy to find market transactions that are comparable in order to set an agreeable transfer price. As a result of this transfer, pricing abuse is an ongoing problem in developing countries because MNC's continuously take advantage of the OECD guidelines to circumnavigate the relevant exchange controls and repatriate all their untaxed profits (World Finance, 2013).

Another difficulty noted by tax authorities with regard to hard-to-value intangibles is that at the time of the transaction, the income stream relating to such intangibles is normally of a highly speculative nature and the determination of an arm's-length price is problematic. It has been noted that the arm's-length principle may not provide tax authorities with practical solutions all the time and where it is not practical to use the arm's-length principle in such cases involving unique intangibles, another measure that is non-arm's-length should be considered. However, changing the guidance of the OECD to treat transactions on non-arm's-length terms could create problems, especially in those countries whose tax legislation specifically requires the use of the arm's-length principle. This would also not be consistent with Article 7 (Business Profits) of most tax treaties as this article incorporates the arm's-length principle (Deloitte, 2014b).

The public discussion draft on BEPS Action 8 Hard-To-Value Intangibles issued by the OECD in June 2015 (OECD, 2015a) contains proposals for tax authorities that enable the characterisation of certain transactions involving hard-to-value intangible assets based on speculation of various alternatives and pricing arrangements that are hypothetical (such as

price adjustment clauses and subsequent contract renegotiation) that could have possibly been entered into. PwC (2015) argues that even though this proposal is in sync with other proposals of the OECD that state that tax authorities should have far broader powers, this is the most controversial aspect of the OECD discussion draft as such a stance would in practice result in significant uncertainties as well as unpredictability with regard to the pricing of intangible assets.

It has been argued that the arm's-length principle cannot be easily implemented although it may sound easy from a theoretical perspective. There have been suggestions that the arm's-length principle by itself is a flawed principle. When associated entities trade/transact with each other the commercial or financial relations may not affect a transaction in the same manner as it would had the transactions been between independent parties. Also an MNC may endeavour to have increased profits on a global basis rather than on a company-to-company basis, regardless of where the other companies in the same group of companies as the MNC are incorporated. This would mean that the MNC will attempt to be as profitable as possible on a global level even if it means a single company/transaction within the multinational group results in a loss (Stelloh, 2014).

The above is one of the reasons why it might be difficult to apply the arm's-length principle to certain transactions, including those involving hard-to-value intangibles. This is because it is very difficult/impossible to compare such a transaction by an MNC to a transaction between independent parties because an independent party would not be willing and will not enter into a contract wherein losses are guaranteed, let alone enter into a transaction where a proper return on investment will not be provided. On the other hand, an MNC as a whole can achieve significant savings overall despite making a loss attributable to one entity/transaction. From the perspective of the MNC, entering into a loss-making transaction would make commercial sense, given the overall profit-making bigger picture. Tax authorities would, however, seek to adjust any loss-making cross-border transactions between

associated companies, as tax authorities are normally interested in specific transactions and not the global position of the MNC. This may be a futile exercise as it would be difficult to find independent entities that would have entered into the same loss-making transaction as the MNC (Stelloh, 2014).

According to Durst (2010), the arm's-length principle does not work because it is so subjective and as a result is unenforceable. He argues that the assumption that the tax results of MNC's can be evaluated as if they were an aggregation of unrelated independent entities trading with each other at arm's-length is flawed and until this view is abandoned and another view more attuned to practical realities is adopted, the international tax system will remain difficult to administer. Durst (2010) further argues that another fundamental flaw with the arm's-length principle is that due to the fact that different entities with the same group are treated as if they were independent entities, the arm's-length system "respects the results of written contracts between these related entities" while at the same time these contracts do not have any real economic effects but are, however, given effect under the arm's-length standard. As a result of this, MNC's have been able to enter into internal contracts whereby interests in valuable intangibles are shifted to tax havens in which little if any real business activity is conducted by the MNC.

4.5 Case law relating to the arm's-length principle

The application of the arm's-length principle has been tested by various court cases. In South Africa there is no case law in relation to transfer pricing and the arm's-length principle. Case law from Canada and the USA will be considered so as to determine how the courts have handled disputes with regard to the arm's-length principle, as well as to draw lessons from the application by the courts of the principle.

4.5.1 Canada v GlaxoSmithKline Inc.

According to the judgements of the Supreme Court of Canada, the case of Canada v GlaxoSmithKline Inc. (2012) involved GlaxoSmithKline Inc. (Glaxo Canada), a pharmaceutical company that purchased ranitidine, an active pharmaceutical ingredient in a drug called Zantac from Adechsa SA, a related company that was a non-resident of Canada. The ranitidine was bought for between \$1 512 and \$1 651 per kilogram. During the same period that Glaxo Canada purchased ranitidine, two Canadian generic pharmaceutical companies purchased the same ingredient from other sources for use in their generic antiulcer drugs for between \$194 and \$304. The transfer prices for the ranitidine purchased by Glaxo were set by a licence agreement that also enabled Glaxo Canada to buy ranitidine, put it in a delivery mechanism, and market it under the trademark Zantac. The Minister of National Revenue in Canada assessed Glaxo Canada on the basis that the prices it paid for ranitidine were greater than the arm's-length price, which would have been reasonable had the two parties been dealing at arm's-length.

The taxpayer then appealed to the Tax Court of Canada where the assessment was upheld with one minor revision on the basis that an independent consideration of the licence and supply agreements was to be performed. Glaxo Canada further appealed the case and the Federal Court of Appeal allowed the appeal by Glaxo Canada and referred the matter back to the tax court for a determination of the reasonable amount payable by the taxpayer for the ranitidine transaction.

Following the allowance of the appeal by the Federal Court of Appeal, the Minister of National Revenue appealed the decision to the Supreme Court of Canada. The appeal was dismissed on the basis that the Minister should have considered the licence agreement in the determination of an arm's-length price. The court noted that the Tax Court of Canada

and the Minister of National Revenue should have taken the licence agreement into account in the determination of an appropriate arm's-length transfer price, as the price paid by Glaxo Canada included compensation to the Glaxo Group for use of Glaxo Group's intellectual property (namely the trademark) in the marketing activities of Glaxo Canada, as well as other rights and benefits that were conferred on Glaxo Canada by the Glaxo Group. There was, therefore, a need to find a similar transaction with a licence agreement that conveyed the same benefits and then compare the two transactions in order to determine the correct arm's-length price.

Commentary on the court case and its application to the research

The above case supports the view that has already been indicated above that the arm's-length principle is practically difficult to implement and that determining an arm's-length price in practice is not clear cut. The lesson that can be drawn from this case is that a detailed analysis of all the economically relevant factors needs to be performed before a range of arm's-length prices can be determined and that transfer pricing is not an exact science. Another important lesson that could be derived from the above case is the acknowledgement by the Supreme Court of Canada that transfer-pricing decisions do not exist in a vacuum and that they do not operate outside business realities, as was clearly evident in the abovementioned case (Bureau Van Dijk, 2015).

4.5.2 Veritas Software Corp v Commissioner

Veritas Software Corp v Commissioner (2009) is a United States of America court case where it was noted that the taxpayer entered into a cost-sharing agreement with Veritas Ireland, a foreign subsidiary, for the purposes of developing, manufacturing and storage of software products. In terms of the agreement, Veritas US granted Veritas Ireland the right to use certain pre-existing intangibles in Europe, the Middle East, Africa and Asia. Veritas

Ireland and its subsidiaries then entered into a cost-sharing agreement pertaining to research and development costs.

The two companies entered into a technology licence agreement in terms of which Veritas Ireland would pay royalties to Veritas US. The applicable royalty rates were included in the agreement as well as a buy-in payment, which was meant to cover the intangible assets.

The royalty rate could be adjusted so that it would remain an arm's-length rate. Veritas US received an amount of \$6.3 million from Veritas Ireland in fulfilment of the agreement and an amount of \$166 million, which was later adjusted to \$118 million by both Veritas Ireland and Veritas US, in relation to the buy-in payment. This adjustment was done in response to Veritas Ireland's updated sales and forecasts figures. The comparable uncontrolled transaction method was used to determine the arm's-length payment amounts.

In a notice of deficiency issued to Veritas US, the Internal Revenue Service used an income based method to evaluate the arm's-length nature of the buy-in payment and it determined that the correct buy in payment was \$2.5 billion (based on a valuation it had obtained) and made an income allocation of that amount to Veritas US. The Internal Revenue Service later reduced the allocation from \$2.5 billion to \$1.675 billion and argued that the buy-in payment should have taken into account Veritas Ireland's access to Veritas US's research and development team, marketing team, distribution channels, customer lists, trademarks, trade names, brand names and sales agreements.

Veritas US, however, contended that the Internal Revenue Service's determinations were "arbitrary, capricious and unreasonable" and that the comparable uncontrolled transaction method was the best method to calculate the buy-in payment. The tax court had to determine whether Veritas Ireland had made an arm's-length payment to Veritas US in relation to the buy-in payment, relating to the intangible property transferred to Veritas

Ireland in connection with the cost-sharing agreement. The court also had to determine if the Internal Revenue Service's calculation was "arbitrary, capricious and unreasonable".

In delivering its judgement, the court held that the valuer who performed the valuation for the Internal Revenue Service had erred as the valuation did not distinguish between the value of those intangible assets that were subsequently developed and those that were pre-existing. As such, the valuation included more intangibles than those that were required for purposes of the buy-in payment calculation. It was also noted that the Internal Revenue Service included intangibles that were not recognised by the US transfer pricing rules and that the tax authority incorrectly assigned a perpetual useful life for intangibles that had a four-year useful life. The court therefore ruled in favour of Veritas US and indicated that the method used by the company was the most appropriate method.

Commentary on the court case and its application to the research

The above court case also supports the notion that the arm's-length principle is difficult to apply in practice and it highlights some of the challenges that tax administrations face in proving the arm's-length nature of taxpayers' transactions. The Internal Revenue Service invested considerable time and resources that could have been used elsewhere in the preparation for its defence regarding its position in court only for the court to reject virtually 100% of the tax authority's approach.

4.6 Challenges that South Africa is likely to face with regards to the OECD's arm's-length principle

The arm's-length principle generally requires the evaluation of uncontrolled transactions by both the tax administrators and taxpayers. After evaluation, the uncontrolled transactions should be compared with those of associated entities (Mberi, 2012:19). One of the challenges that South Africa faces is that the application of the arm's-length principle is too

complex and costly to administer. The arm's-length principle has also been argued to be a resource-intensive concept as a large amount of resources is needed by tax administrations in establishing the arm's-length nature of complex transactions such as the ones involving hard-to-value intangible assets (OECD, 2011).

Apart from the resource-intensive nature of the approach, it is evident that time is of the essence when analysing such transactions. In other words, the closer to the time of transaction the evaluation is done, the better and the more reliable the information obtained. If such evaluations are done long after the transactions have occurred, the availability of the information poses a challenge (Mberi, 2012:19).

One other challenge that South Africa, in particular SARS, may face with regard to the proposals by the OECD that tax authorities should have far broader powers and that less emphasis should be placed on separate entities and legal contracts is whether the South African courts pay more attention to OECD guidelines, which do not rank the same as statutory law, or whether the courts will tend to place more reliance on legal contracts as per the law of contracts and implications of transactions arising from such legally binding contracts. Moreover, South Africa is a mere observer of the OECD and it remains to be seen whether the OECD guidelines may overrule the legal principles founded in the law of contract.

At present South Africa does not have advance pricing agreements (EY, 2012 b). According to PwC (2012) an advance pricing agreement is "an arrangement between the taxpayer and the tax authority covering future transactions, with a view to solve the potential transfer pricing disputes in a cooperative manner".

According to Europe Aid (2011:107-109), some of the other challenges faced by developing countries that South Africa is also likely to face are as follows: (1) lack of experienced transfer-pricing staff given the fact that transfer pricing is a specialist area; (2) lack of an

indepth understanding of transfer pricing as well as a lack of awareness of available information; (3) no promotion of good governance and independence within the tax administration and the transfer-pricing unit as a result of a lack of implementation of risk management frameworks; (4) no independence requirements and control mechanisms; (5) the non-availability of resources as well as tools necessary to collect and process all the necessary information; (6) the non-existence of sufficient local comparables to evaluate the arm's-length nature of transactions and the lack of access to commonly used databases with regards to transfer pricing; (7) the lack of review of the effectiveness of administrative implementation, in particular regarding transfer-pricing audits; (8) the lack of integration of further measures to ensure and facilitate taxpayer compliance; and (9) the non-existence of sufficient double-tax agreements that provide for automatic exchange of adequate information between different countries.

4.7 Conclusion

The objective of this chapter was to analyse the current guidance (international court cases as well as OECD and UN guidance) with a view to identifying any shortcomings in relation to the arm's-length principle. Several shortcomings/challenges were noted above with regard to the OECD's arm's-length principle as well as the OECD's draft guidance in relation to hard-to-value intangibles. Chapter 5 will provide recommendations pertaining to the shortcomings and challenges that have been noted in this and previous chapters.

CHAPTER 5: CONCLUSION AND RECOMMENDATIONS ON HOW THE TRANSFER PRICING OF HARD-TO-VALUE INTANGIBLES CAN BE APPROACHED WITHIN A SOUTH AFRICAN CONTEXT

5.1 Introduction

Base erosion and profit shifting is a problem that is faced by many governments throughout the world. Recently the transfer pricing of hard-to-value intangibles has generated a great deal of interest from tax administrations as a result of the use by MNC's of such intangibles to avoid tax.

MNC's have taken advantage of the fact that there is no clear guidance and, given the unique nature of hard-to-value intangible assets, it is difficult to determine an appropriate transfer price. The OECD has issued guidance with regard to hard-to-value intangibles that is meant to assist both tax administrators and MNC's. It is anticipated that this guidance will be able to assist and shed more light with regard to the appropriate approach to be taken. As previously mentioned in this study, developing countries are the hardest hit thus making it difficult for governments to provide basic amenities. There is therefore a need for lasting solutions to this problem so as to avoid further losses. This chapter will conclude the mini-dissertation by determining if the research objectives indicated in paragraphs 1.5.1 and 1.5.2 were met, providing recommendations to the various challenges noted in the various chapters and indicating further areas for possible future research.

The main objective of this mini-dissertation as indicated in paragraph 1.5.1 was to explore the challenges that the transfer pricing of hard-to-value intangibles pose within a South African context and to provide recommendations on how they can be overcome. The following secondary objectives per paragraph 1.5.2 were set in order to answer the research problem indicated above:

1. To outline the various strategies employed by MNC's to avoid tax using hard-to-value intangible assets (addressed in Chapter 2).
2. To identify challenges posed by the concepts of legal and economic ownership in relation to the allocation of returns from hard-to-value intangible assets (addressed in Chapter 3).
3. To analyse the current international guidance (court cases, OECD and United Nations guidance) relating to the arm's-length principle with a view to identifying any differences and shortcomings (addressed in Chapter 4).
4. To conclude and make recommendations on how the transfer pricing of hard-to-value intangibles can be approached within a South African context (to be addressed in Chapter 5).

5.2 Achievement of research objectives and summary of findings

The above objectives were considered and analysed by way of a qualitative study. A literature review was performed and the findings per each research objective are detailed below:

5.2.1 Main objective and secondary objective (1): To outline the various strategies employed by MNC's to avoid tax using intangible assets

The above objectives were dealt with in Chapter 2. In this chapter the term "hard-to-value intangible assets" was defined. The characteristics of hard-to-value intangibles were explored and the terms "tax avoidance", "tax resistance" and "tax evasion" were defined. The various strategies employed by MNC's in avoiding tax using intangible assets were then investigated.

It was noted that MNC's use various strategies such as planned licensing structures, tax havens and double tax agreements for purposes of treaty shopping, conduit companies, cost

sharing agreements, the Double Irish Dutch Sandwich and intellectual property structures using the IP Box regime in order to avoid tax. MNC's are also taking advantage of the effects of globalisation to structure their operations in a manner that results in the payment of as little tax as possible.

The following challenges were noted in this chapter: The loss of revenue by tax administrations as a result of the above strategies in the countries in which the MNC's are operating from. This is evident from the cases of the multi-nationals (Google and Apple), noted in the chapter, that have used some or all of the tax avoidance strategies mentioned above. The fact that large audit firms, specialist tax advisory firms as well as law firms are the ones who are assisting MNC's to come up with such tax avoidance structures in return for large sums of money in itself poses a challenge, as the methods employed by these firms in assisting the MNC's are perfectly legal. However, the end result is a loss to the fiscus as billions in tax revenue are lost. Domestic firms become less competitive compared to MNC's and due to the fact that the local and international tax environment has become complex, the challenge faced by tax administrations around the world, including SARS, is to come up with effective solutions to curb tax avoidance.

The offering of different tax advantages and tax rates by countries around the world is also a challenge as MNC's are taking advantage of this in setting up their structures in various jurisdictions with the end result that no or low tax is paid in these jurisdictions in comparison to countries in which the MNC's are operating. The last challenge noted in this chapter is that the anti-avoidance rules, CFC rules and thin capitalisation rules in most countries are too costly and complex to implement.

5.2.2 Main objective and secondary objective (2): To identify challenges posed by the concepts of legal and economic ownership

The above objectives were dealt with in Chapter 3 of the mini-dissertation. In this chapter the concepts of legal ownership and economic ownership with regard to hard-to-value intangibles and royalties were analysed in detail as well as the challenges that the concepts pose within a South African context. The chapter started off by defining the terms “legal” and “economic ownership”. It was also noted that the concept of beneficial ownership is the same as the concept of economic ownership. The importance of the concepts of economic and beneficial ownership was determined and it was noted that the concepts are used for the purposes of allocation of returns arising from hard-to-value intangible assets. The views of the OECD and court cases from Canada and the USA were considered in order to determine the basis on which the allocation of returns should be based and differences of opinion were noted. It was noted that the courts tended to follow more of a legal approach and the OECD an economic approach.

Within a South African context there is no guidance with regard to how ownership of the intangible assets should be determined. This poses a major problem given the fact that the OECD guidelines and the various court cases discussed in the chapter have different opinions with regard to the allocation of returns. This makes it difficult for SARS to establish the owner of the intangible asset, as there is no absolute certainty as to how this should be done.

5.2.3 Main objective and secondary objective (3): To analyse the current international guidance (court cases, OECD and United Nations guidance) relating to the arm’s length principle with a view to identifying any differences and shortcomings

The objectives above were considered in Chapter 4 of the mini-dissertation. In this chapter the transfer pricing guidelines relating to the arm’s-length principle, the guidance on hard-to-

value intangibles issued by the OECD, and the United Nations transfer pricing guidelines were analysed with a view to identifying differences and shortcomings. The different transfer pricing methods of identifying arm's-length prices were discussed and the challenges relating to each of the methods were noted. It was also noted that the arm's-length principle has been described by some as a flawed principle that MNC's have taken advantage of to enter into contracts whereby interests in valuable intangibles are shifted to tax havens in which little if any real business activity is conducted by the MNC's. There have been calls from some scholars for another basis on which transfer pricing transactions can be evaluated other than the arm's-length principle. International court cases in Canada and in the USA were also considered so as to determine how the courts apply the arm's-length principle in relation to intangible assets.

The following challenges were noted with regard to the arm's-length principle in a South African context: The application of the arm's-length concept is a resource intensive and complex process, as large amounts of resources are needed by SARS in order to prove the arm's-length nature of transactions. The longer the timeframe between the occurrence of a transaction and the evaluation thereof by revenue authorities the more difficult it becomes to obtain information. A challenge that SARS faces is a lack of experienced transfer-pricing staff, given the fact that transfer pricing is a specialist area. As a result of lack of experienced staff, there is lack of an in-depth understanding of transfer pricing as well as a lack of awareness of available information.

Other challenges noted were the non-availability of resources and tools necessary to collect and process all the necessary information. The non-existence of sufficient local comparables to evaluate the arm's-length nature of transactions and the lack of access to commonly used databases with regard to transfer pricing were also identified as challenges.

South Africa also faces a challenge with regard to the non-existence of sufficient double-tax agreements that provide for the automatic exchange of adequate information between countries. Transactions involving intangibles are hard-to-value using the traditional principles and practices of determining an arm's-length price as a result of the fact that intangible assets are of a unique nature and would not have occurred between independent and unrelated parties. Comparability of such transactions is therefore a challenge. Also, transactions involving intangibles are difficult to value at the time of the transaction as the income flow is mainly speculative in nature at the time the transaction is entered into. The arm's-length principle may therefore not be applicable. However, changing the OECD guidance to adopt a practice other than the arm's-length practice may be problematic for countries such as South Africa whose legislation has already embraced the arm's-length principle. This is also inconsistent with other articles of the OECD model, such as Article 7: Business profits, which are based on the arm's-length principle.

5.3 Recommendations

From the above challenges highlighted the following recommendations are put forward per each secondary objective:

5.3.1 There is a need for a pro-active rather than reactive approach by SARS in order to counteract and eliminate base erosion and profit shifting (Secondary objective (1) achieved in Chapter 2)

There is a need for a proactive approach by SARS rather than a reactive approach when it comes to the activities of MNC's. The OECD has acknowledged in its report on Addressing Base Erosion and Profit Shifting (OECD, 2013c) that the current international tax systems in the various countries have not been able to keep pace with developments in the business environment and this has allowed MNC's plenty of opportunities to exploit legal loopholes as

well as to enjoy double non-taxation of income. There is a need for specific research by SARS to explore the extent and mechanics of profit-shifting strategies that MNC's are engaging in in South Africa, and also into the way MNC's are operating in modern times and how their operations are evolving. Such a study can provide valuable information for policy makers and assist them with the closure of any existing gaps in legislation and double-tax agreements that are being utilised by MNC's that in most instances has resulted in a loss of revenue to the fiscus and in domestic firms losing their competitiveness in the markets.

While SARS has closed the loophole regarding deductions claimed on tainted intellectual property by the introduction of section 23I in the Income Tax Act (58 of 1962), more still needs to be done as a result of the fact that section 23I has not stopped the problem of base erosion and profit shifting. Instead this is an ongoing problem in South Africa.

5.3.2 Adoption by South Africa of the changes in the OECD model tax convention to prevent treaty abuse (Secondary objective (1) achieved in Chapter 2)

The abuse of double-tax agreements was noted to be a major challenge. The majority of double-tax agreements between countries all over the world including South Africa are based on the OECD model tax convention. However, as a result of the fact that the provisions of the treaties were being abused by MNC's to engage in profit shifting, it became important that the OECD tax convention be refined in order to eliminate both the effects of double taxation and double non-taxation of income. It is recommended that South Africa, through protocols, adopt in its double-tax agreements the changes in the OECD model tax convention to prevent treaty abuse that was unveiled in October 2015.

The OECD's report on preventing the granting of treaty benefits in inappropriate circumstances incorporates changes (which can be adopted by South Africa in its double-tax agreements) to the OECD Model Tax Convention, which is aimed at preventing treaty abuse. It incorporates provisions that address treaty shopping as well as specific treaty rules

such as the limitation of benefit clauses, which addresses the various forms of treaty abuse as well as ensuring that tax treaties do not prevent the application of local anti-abuse rules. Changes to the OECD's model tax convention provide clarity on the fact that the purpose of tax treaties is not to create opportunities for the non-taxation or reduction of taxation through tax evasion (OECD, 2015b:5).

5.3.3 Comparison of the current CFC legislation in South Africa to the latest guidance issued by the OECD on designing effective CFC rules and adjusting the current legislation (Secondary objective (1) achieved in Chapter 2)

One of the challenges that was noted in this research is the ineffectiveness of CFC rules in combatting the problem of base erosion and profit shifting. The OECD has issued guidance that is meant to strengthen the CFC rules of countries that form part of the organisation (OECD, 2015c). Even though South Africa is an observer to the OECD, it could benefit from this guidance in the further strengthening of its CFC rules to curb further revenue losses.

5.3.4 Possible adoption of new laws that prevent audit firms from assisting MNC's by engaging in impermissible avoidance agreements that result in the shifting of profits (Secondary objective (1) achieved in Chapter 2)

As indicated previously, audit firms as well as specialist advisory firms and law firms have been at the centre of assisting MNC's to shift valuable income from the countries where their economic activities take place to tax havens. Even though tax avoidance is perfectly legal in such instances, it can be argued that avoidance arrangements that result in billions of profits being shifted away to tax havens are impermissible avoidance arrangements as the main purpose of entering such arrangements is to obtain undue tax benefits. There is therefore need for the Auditing Profession Act (26 of 2005) to be amended in order to prevent audit

firms from being a part of impermissible avoidance arrangements. The legislation must give wide ranging powers to SARS to compel engagement partners to document and disclose what advice was given to MNC's and the impact of that advice on base erosion and profit shifting. Hefty penalties should be imposed on those firms that are found to have contravened this legislation or those whose advice would have led to the shifting of profits outside of South Africa.

5.3.5 Greater cooperation between countries with regard to exchange of information (Secondary objective (1) and (3) achieved in Chapters 2 and 4)

In order to combat the challenges arising from the transfer pricing of hard-to-value intangible assets, there is a need for greater cooperation between South Africa and other countries with regard to the exchange of information on activities conducted by MNC's in the respective countries. South Africa can benefit from such increased exchange of information in identifying transfer-pricing risk relating to MNC's as well as to understand the magnitude/extent of the operations and activities pertaining to MNC's operating in South Africa. It will also assist in the working together of tax administrations in order to ensure that MNC's are paying the right amount of tax in the right country. There is a need for automatic exchange of tax information agreements as currently the tax information exchange agreements are not automatic and the exchange of information is done on a request basis.

5.3.6 Modification of the IT14 Tax Return or IT14 Supplementary Declaration to require MNC's to list all the countries they are operating in as well as list the nature of their operations (Secondary objective (1) achieved in Chapter 2)

There is a need for either the IT14 tax return to be modified or a requirement in the IT14 supplementary declaration for MNC's to list all the countries they are operating in. There must be a requirement for the MNC's to detail the nature of their activities in the various countries. There must also be a specific section that requires that the details of any

transaction involving hard-to-value intangible assets are disclosed by the MNC's. Such a requirement would also assist SARS in identifying high-risk entities for audit purposes (Camay, 2015).

5.3.7 Incorporation of the principle of economic ownership and legal ownership into section 31 of the Income Tax Act (58 of 1962) (Secondary objective (2) achieved in Chapter 3)

From the court cases discussed in Chapter 3, it was noted that the concepts of legal ownership and economic ownership are fundamental in the determination of allocation of returns arising from the ownership of intangible assets. It was noted that the courts tended to favour the concept of legal ownership in the determination of allocation of returns while the OECD guidelines seem to place more emphasis on economic ownership. South Africa follows the OECD guidelines. It was noted in Chapter 3 that the guidelines do not rank the same as statutory law. In the event that there is a dispute between SARS and an MNC, it is likely that SARS will lose the court case as the foreign court cases that were discussed in Chapter 3 will have persuasive influence on the South African courts (as they are based on an interpretation of the law), something which the OECD guidelines do not have. It is therefore recommended that the concept of economic ownership be incorporated into the current legislation on transfer pricing.

5.3.8 Amendment to Section 31 of the Income Tax Act (58 of 1962) to cater for hard-to-value intangible assets

It is recommended that Section 31 of the South African Income Tax Act (58 of 1962) be amended to cater for hard-to-value intangible assets. The section in its current form requires that the tax payable on international transactions be based on the arm's-length principle. As was noted in Chapter 4, the arm's-length principle is not always applicable to transactions

involving hard-to-value intangible assets as there are normally no comparable transactions due to the uniqueness of the intangible assets. For example, it is difficult to determine whether the valuation of the Nandos brand has been performed on an arm's-length basis as there is no brand similar to Nandos with which to compare it. The OECD has noted in its guidance that in such instances the arm's-length principle will not be applicable and that in such cases alternative measures can be used (OECD, 2015a). Section 31 must therefore be amended to allow for the use of such alternative measures in the case of hard-to-value intangible assets.

5.3.9 Training, upskilling and incentivising of SARS staff to be able to deal with complex transfer-pricing matters involving hard-to-value intangibles (Secondary objective (3) achieved in Chapter 4)

Even though the SARS transfer pricing unit has made significant progress in adequately staffing its transfer pricing unit, there is a need for SARS to continuously engage with more advanced countries in order to learn from them and also to benefit from the initiatives that these countries have embarked on to combat transfer mispricing related to hard-to-value intangibles. It is recommended that more secondments of SARS staff to these countries will assist to facilitate skills transfer and training, as well as the sharing of best practices with regards to transfer pricing audits relating to hard-to-value intangible assets.

Where possible, joint investigations with experienced tax administrations should be conducted, and the sharing of risk assessment approaches with such tax administrations should be considered. Such initiatives will result in SARS' staff having an in-depth understanding of transfer pricing of hard-to-value intangible assets. This will also allow employees to develop their experience and assist them to develop an awareness of information that is available in other countries.

There is also a need for SARS to become knowledgeable and skilled with regard to advanced valuation methodologies/techniques used by MNC's so that in instances where the arm's-length price cannot be determined by statistical methods (such as the profit-split method), valuation techniques can be used to determine the reasonability of prices used and the arm's-length nature of such prices.

5.3.10 Access to internationally used databases with regards to transfer pricing of hard-to-value intangible assets (Secondary objective (3) achieved in Chapter 4)

Access to internationally used databases is crucial in the determination of arm's-length prices. SARS can finance access to these databases by its staff so as to assist them during the execution of their audits. External experts who will provide guidance on the comparability of economic environments before a final arm's-length range to be applied to the transaction can also be contracted to assist SARS during transfer pricing audits.

5.3.11 Interpretation note to be issued by SARS to include hard-to-value intangibles (Secondary objective (3) achieved in Chapter 4)

There is a need for SARS to include hard-to-value intangible assets in the interpretation note that is currently being written. This would assist in providing much needed guidance to taxpayers with regard to how SARS views such transactions and the likely treatment thereof.

5.3.12 Amendment of legislation to impose specific transfer pricing penalties in addition to understatement penalties (Secondary objective (3) achieved in Chapter 4)

Given the extent of fiscal losses that occur as a result of profit shifting using hard-to-value intangibles, it is recommended that legislation, in particular the Tax Administration Act (28 of 2011), be amended to impose specific transfer pricing penalties in addition to understatement penalties. Such penalties will serve as a warning to MNC's engaging in profit shifting that if caught there will be severe tax implications. Given the fact that most MNC's

engaged in profit shifting generate billions of rands each year but end up showing a much smaller profit on their financial statements and tax returns, these specific transfer pricing penalties should be calculated with reference to or as a percentage of the transfer pricing adjustment made by the tax authorities in that year of assessment.

5.3.13 Introduction of Advance Pricing Agreements (Secondary objective (3) achieved in Chapter 4)

South Africa should consider the implementation of Advance Pricing Agreements in line with what other developed countries such as Australia have done. Such agreements would assist SARS to agree with MNC's on a transfer price upfront, hence saving SARS from the complexities of lengthy and expensive transfer pricing audits. The assistance of other developed countries such as Australia can be sought in the development of these advance pricing agreements.

5.4 Areas for further research

Possible areas for further research include the following:

- Is the current section 31 and section 9D of the Income Tax Act (58 of 1962) achieving the intended purpose of preventing base erosion and profit shifting, given the extent of the problem in South Africa?
- The implementation of advance pricing agreements in South Africa and the effect on transfer pricing in South Africa.

5.5 Conclusion

From the above research, it is evident that multinational companies are taking advantage of the fact that transfer pricing of hard-to-value intangibles is a complex concept in order to shift

profits to other jurisdictions which results in major losses in fiscal revenue. Developing countries such as South Africa end up struggling to curb poverty, yet billions of profits on which the relevant income taxes should have been collected are transferred offshore.

It was also noted that of late there has been an increased propensity by MNC's to shift profits via intellectual property, in particular hard-to-value intangible assets, as a result of the fact that the determination of an arm's-length price relating to such assets is problematic and in most instances impossible. The ability by tax authorities to collect the adequate revenue from the profits shifted to other jurisdictions, especially in developing countries such as South Africa, is hampered by the lack of experience, skills and resources to conduct effective transfer pricing audits, given that such audits are complex, take a long time to complete and are resource intensive.

In order for South Africa to effectively combat the challenges that hard-to-value intangibles indicated above pose, it is important to review the effectiveness of the current legislation that is in place. Given the complexities posed by the arm's-length principle to such assets there is a need for insertion in the current Section 31 of the Income Tax Act (58 of 1962) of alternative measures that can be used to determine appropriate transfer prices. There is also a need for a coordinated effort between South Africa and other developing countries so as to effectively combat the problem of base erosion and profit shifting especially with regard to hard-to-value intangible assets.

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