

A critical analysis of SARS' implementation of Advance Pricing Agreements

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ABSTRACT

Though the concept of transfer pricing has been in existence for over a century, it continues to evolve over time while remaining a topical issue globally. The increase in cross-border transactions by multinational enterprises due to globalisation and internationalisation has increased the complexity of these transactions. This has resulted in lengthy and costly dispute resolution processes that pose uncertainty for multinational enterprises when contemplating investment destinations.

This study aims to critically analyse and discuss the impending implementation of advance pricing agreements (APAs) by the South African Revenue Service (SARS). Specifically, the transfer pricing legislation of selected foreign countries that implemented APAs as well as the Organisation for Economic Corporation and Development (OECD) transfer pricing guidelines were analysed to determine whether SARS' implementation of APAs can be beneficial.

To test the hypothesis that the use of APAs is a proactive dispute resolution, a qualitative approach was applied to understand APAs, and the effect of its implementation thereof. A literature review was performed to address this study's research questions with more reliance placed on theoretical sources rather than numerical data.

The results showed that the use of APAs provide certainty, avoid time-consuming audits, and reduce transfer pricing dispute costs. These results suggest that the use of APAs encourages foreign direct investment and promote economic growth. On this basis, SARS should consider the implementation of APAs in the South African Income Tax legislation. The challenge that SARS may encounter is constraint of resources which may hamper the successful implementation thereof.

Keywords: Advance Pricing Agreements, multinational entities, transfer pricing, arm's length price, South African Revenue Service, Organization for Economic Co-operation and Development

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DEDICATION

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LIST OF ABBREVIATIONS

Abbreviation	Description
ADR	Alternative dispute resolution
APAs	Advance Pricing Agreements
BEPS	Base erosion and profit shifting
BRICS	Brazil, Russia, India, China, South Africa
CITA	Canada's Income Tax Act
CRA	Canada Revenue Agency
CASD	Competent Authority Services Division
CBDT	Central Board of Direct Taxes
HMRC	Her Majesty's Revenue and Customs
IT Act	South African Income Tax Act, No. 58 of 1962
Indian IT Act	Indian Income Tax Act of 1961
MTC	Model Tax Convention
MNEs	Multinational entities
MAP	Mutual Agreement Procedures
OECD	Organization for Economic Co-operation and Development
OEEC	Organisation for European Economic Cooperation
SARS	South African Revenue Service
SP	Statement of Practice
TIOPA	Taxation (International and Other Provisions) Act, 2010
UK	United Kingdom
UN	United Nations
USA	United States of America

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CHAPTER 1

INTRODUCTION AND BACKGROUND

1.1 INTRODUCTION

According to Beebeejaun (2018:1), improvements in logistics, infrastructure, transport and communication have accelerated the process of globalisation and contributed to the increase in international trade of goods and services. Some business entities have expanded their operations into the global market space by establishing their own networks of subsidiaries and branches in other countries that also engage in cross-border transactions (Beebeejaun, 2018:1).

Tax authorities across the globe continuously seek more effective ways to protect their tax bases as the global economy expands into every corner of the world (Holtzman & Nagel, 2014:1). The Organization for Economic Co-operation and Development (OECD) estimated that by the early 1990s, trade between related companies accounted for more than 60% of international trade (Kortebusch, 2014:5). Due to intensified globalisation and the internationalisation of the economy, the intra-group exchange of goods and services plays a growing role in international terms of trade (Kortebusch, 2014:4).

Business leaders consider regulatory uncertainties and risks that may arise in the country where they conduct business as key decisions in assessing the business environment (Whitford, 2010:1). These regulatory uncertainties and risks can make or break both the leaders and their companies (Whitford, 2010:2). Regulatory uncertainties and regulatory risks are key issues that governments and their fiscal authorities may seek to mitigate (Whitford, 2010:2).

Buckley and Casson (1985:1) define a multinational entity (MNE) as an entity that owns and/or controls income generating assets or another entity or entities in more than one country. Most MNEs, if not all, have the main aim of profit maximisation for their shareholders. These entities are generally driven by a profit motive which may result in them engaging in practices that erode the tax bases of developing countries (Beebeejaun, 2018:2; SARS, 2020:1). This is because the income transferred from one tax jurisdiction to another by related entities through transfer pricing affects the tax base of the transferring country involved in the cross-border transaction (Beebeejaun, 2018:2).

Transfer pricing is the setting of prices for transactions between associated entities involving the transfer of property or services (Radhakrishna, 2019:4; UN, 2013:2). From a tax perspective it is the

general term utilised for the pricing of cross-border, intra-group transactions between related entities (UN, 2013:2). These transactions are referred to as “controlled” transactions, as opposed to “uncontrolled” transactions between unrelated entities that can be assumed to operate independently, termed the arm’s length basis, in setting the terms for such transactions (UN, 2013:2).

However, Muhammadi *et al.*, (2015:1) state that transfer pricing is an instrument for international tax strategy development. In other words, to minimise their tax liabilities, the management of MNEs use transfer pricing strategies to move profits from the country of operation (the transferring source country) to sometimes lower tax jurisdictions (which may also be tax heavens) to maximise profits while eroding the tax base of the transferring country (Muhammadi *et al.*, 2015:1; UN, 2013:5).

Tax authorities may be under the assumption that MNEs set prices for cross-border transactions with the intention to shift profits to low tax countries by manipulating their transfer prices (Kortebusch, 2014:5). This is often construed as mispricing, that is, when MNEs impose prices amongst themselves that are not according to arm’s length principle (Beebeejaun, 2018:2).

Transfer prices that are set by MNEs for intra-group transfers between their internationally active affiliates must meet the criteria for arm's length transactions for tax purposes (Kortebusch, 2014:5). The arm's length price is defined as the price that corresponds to the price that independent third parties would set for the same service or product on the free market (Kortebusch, 2014:4).

Determining the transfer prices by MNEs is often a task that involves a lot of uncertainty, as it is not always a given that tax authorities of the affected countries will accept their chosen transfer pricing method (Kortebusch, 2014:5). Thus, when choosing transfer prices, entities do not know whether affected tax authorities will accept them and, if they are not accepted, to what extent their tax liability will be adjusted (Becker *et al.*, 2016:1). This uncertainty is because the determination of such intra-group prices has a direct effect on the tax base of the involved countries and therefore, on the amount of tax revenues attributed to them from the MNEs (Kortebusch, 2014:5). Therefore, it is critical for a developing country such as South Africa to balance the need for foreign investment by MNEs and cross-border trade with laws that effectively govern these activities to counter transfer-pricing manipulation and tax base erosion (Beebeejaun, 2018:2).

The setting of transfer prices for cross-border transactions is a contentious issue. The MNEs desire to minimise its tax liability, and the measures taken to achieve this such as transfer pricing, creates the potential for conflict between the governments of affected countries as an increase in one tax base can reduce the tax base of the other country involved, particularly the higher tax jurisdiction (Becker *et al.*, 2016:1). For internationally active companies, the non-acceptance of the chosen

transfer pricing method and an adjustment of the tax liability by one of the involved tax authorities can lead, for example in a bilateral setting, to double taxation in cases where the other involved tax authority does not adjust the tax payment (Kortebusch, 2014:6).

Transfer pricing exposure has recently increased for MNEs due to increased scrutiny from the sharing of information between tax authorities in different countries through Country-by-Country Reporting (CbCR) stemming from the OECD's Base Erosion and Profit Shifting (BEPS) report (Wrappe & Kramer, 2020:2).

In a survey conducted among MNEs, one of the most pressing problems encountered by these entities is tax uncertainty caused by transfer pricing (Becker *et al.*, 2016:1). The transfer pricing conflicts between MNEs and tax authorities are often solved by time-consuming, complex, and costly audits and litigations for both MNEs and tax authorities (Kortebusch, 2014:6). One means of reducing this tax uncertainty is the implementation of Advance Pricing Agreements (APAs) (Becker *et al.*, 2016:1). An APA is an agreement between one or more affiliated entities and one or more tax authorities that determines in advance of a series of business transactions between the affiliated entities, an appropriate transfer price for these transactions over a fixed period, such as three to five years (Kortebusch, 2014:6).

Kortebusch (2014:6) states that MNEs may make use of APAs to reduce, or even eliminate, the regulatory uncertainty associated with their determination of transfer prices. According to Becker *et al.* (2016:2), in the absence of an APA, a company is typically audited, and transfer prices are revised and set by involved tax authorities after investments and associated costs are sunk. Since the company anticipates this, it may opt against the investment if its future profitability is lower due to the revision of transfer pricing by tax authorities (Becker *et al.*, 2016:2).

Some countries have adopted the use of APAs to provide for agreements between MNEs and tax authorities so that a range of prices can be recognised as being at "arm's length" (Whitford, 2010:3). The APAs reduce the risk that entities can be audited and assessed with an additional tax liability after significant investments in transactions have already occurred (Whitford, 2010:3). An APA thus provides certainty and an instrument for preventing tax disputes on determined transfer pricing methods (Vero Stakk, 2016). The tax certainty for MNEs is maintained through the APA in both normal business conditions and during economic upheavals, such as the one caused by the COVID-19 pandemic (Wrappe & Kramer, 2020:1).

Wrappe and Kramer (2020:2) state that most taxpayers that have cross-border transactions with their subsidiaries, divisions or affiliations seek APAs because they are interested in some form of certainty such as freedom from: penalty exposure, double taxation and adjustments, customs

correction and an uncertain tax position for financial and tax reporting. Having such tax certainty from involved tax authorities generally enables the management of these MNEs to focus their resources and attention on their business activities instead of potential tax audits and litigations that may result in possible tax adjustments (Wrappe & Kramer, 2020:2).

Following the recommendation of the OECD's BEPS report, several countries have introduced different types of APA systems as a cooperative form of negotiating transfer pricing and reducing and/or eliminating regulatory uncertainty caused by transfer pricing. Some taxpayers have turned to these APAs to manage the uncertainty in the evolving international tax landscape (Kortebusch, 2014:7; Foley *et al.*, 2020:2).

Foley *et al.* (2020:2) indicate that for countries that implemented the use of APAs, tension has moved from transfer pricing tax disputes. The issue that now exists is regarding high volume of APAs in effect or under negotiation for achieving long-term transfer pricing certainty. A long APA period can help MNEs to manage transfer pricing risk but also poses the risk of the taxpayer being attached to an APA that has static pricing targets without a mechanism to adjust those targets in the event of a change to taxpayer-specific or macroeconomic conditions (Foley *et al.*, 2020:2). Therefore, there is a need to accommodate unexpected economic disruptions in these APAs such as the conditions many entities are now facing from the impact of COVID-19 (Foley *et al.*, 2020:2).

1.2 MOTIVATION OF TOPIC ACTUALITY

Though it has been considered, South Africa is still to include or implement the use of APAs in its transfer pricing legislation (SARS, 2020:2). However, the rapid increase in international trade has come with uncertainties due to regulatory risks caused by transfer pricing (Kortebusch, 2014:6). The South African Revenue Service (SARS) typically engages in costly audits and litigation on transfer pricing matters, after investment by investors is sunk, which are time-consuming and complex (Kortebusch, 2014:6). These regulatory uncertainties brought by the transfer pricing challenges may drive away potential foreign investors that may contribute towards South Africa's economic growth.

If the implementation of APAs can be beneficial and reduce or eliminate regulatory uncertainty, there could be need for the amendment of South African transfer pricing legislation to include APAs. This is evident by the discussion paper issued by SARS in 2020 in respect of APAs (SARS, 2020:2). Overall, not much research has been done, with conclusive evidence, in respect of APAs and their related benefits. A study on this matter could make a valuable contribution to the existing body of knowledge.

1.3 PROBLEM STATEMENT

The rapid increase in international trade has come with uncertainties due to regulatory risks caused by transfer pricing (Kortebusch, 2014:6). Like most countries, the economy of South Africa is open to the rest of the world. However, the non-existence of APAs in South African legislation could contribute to regulatory uncertainties which could possibly drive away potential foreign investors that can contribute to South Africa's economic growth.

MNEs face challenges of dealing with costly and time-consuming audits from tax authorities. Such audits could potentially lead to an increased adjustment of the tax payment to SARS, which can also lead to double taxation in cases where the other tax authority does not adjust for the tax assessment (Kortebusch, 2014:6).

SARS is considering the use of APAs to reduce or eliminate the regulatory uncertainty brought about by transfer pricing (SARS, 2020). The research questions that arise are whether SARS' implementation of APAs can yield benefits for all involved parties; what risks are associated with the implementation of APAs; and what resources will SARS require to implement APAs as South Africa is still a developing country.

1.4 RESEARCH OBJECTIVES

The following research objectives were formulated to address the research question:

1.4.1 Primary research objective

The main objective of the study is to critically analyse SARS' impending implementation of APAs through evaluating i) the transfer pricing legislation of foreign countries that implemented APAs as well as ii) OECD recommendations.

Following the abovementioned analysis, this study seeks to analyse the benefits and risks associated with APAs to establish whether SARS would have the ability and be able to implement APAs.

1.4.2 Secondary research objectives

To achieve the main research objective, the following secondary objectives are formulated:

- i. To consider the background and development of the problems that gave rise to the transfer pricing issue and the role of the OECD as a major force of influence on this topic. This objective is addressed in Chapter 2.
- ii. To describe the nature, typical structures and functionality of the different types of APAs and the ability of both the taxpayer and the tax authority to enter into such types of agreements. This objective is addressed in Chapter 3.
- iii. To analyse the tax legislation dealing with transfer pricing, specifically the APAs of the three foreign countries such as Canada, the United Kingdom (UK) and India. The aim of such analysis is to have a basis of comparison and to establish the benefits, risks and other issues that would come with the implementation of APAs by SARS for both SARS and the affected taxpayers. This objective is addressed in Chapter 4.
- iv. To summarise and conclude on the findings of the study and make recommendations for future studies. This objective is addressed in Chapter 5.

1.5 RESEARCH METHODOLOGY

According to Bisman (2010:5), the research methodology reflects an underlying philosophy consisting of an ontological view and associated epistemological assumptions. Differing views about the nature of reality (ontology) affect the relationship between the researcher and reality and whether reality, within the domain of knowledge, is deemed to be discoverable from an objectivist or subjectivist standpoint (epistemology) (Bisman, 2010:7).

Scotland (2012:9) describes methodology as concerned with why, what, from where, when and how data and documents are collected and analysed. The data collected will either be qualitative or quantitative (Scotland, 2012:10). Both ontology and epistemology influence methodological choice (Bisman, 2010:7).

1.5.1 Paradigmatic assumptions and perspectives

According to Rahi (2017:1) the term 'paradigm' is described as a collection of beliefs shared by scientists, a set of agreements about how problems are to be understood and analysed, how we view the world and therefore, go about conducting research.

There are traditionally two core research philosophical paradigms; commonly referred to as positivism and interpretivism (McKerchar, 2008:6). Paradigm choice reflects how the researcher views the world (ontology) and believes that knowledge is created (epistemology) (McKerchar, 2008:7).

In the context of the social sciences, researchers who seek objectivity in their explanation of social reality adopt positivism (McKerchar, 2008:7). The positivist approach has been described as based on a realist, foundationalist ontology that views the world as existing independently of our knowledge of it (McKerchar, 2008:7). In contrast, the assumption that the researcher cannot be detached from the subjects being studied is described as interpretivism (McKerchar, 2008:7).

The interpretivist paradigm believes on the researchers' deep understanding of a concept and explores the understanding of the world in which they live (Rahi, 2017:1). Interpretivists also believe that true knowledge can only be obtained through a deep interpretation of a study subject (Rahi, 2017:1). Scotland (2012:12) states that interpretive methods yield insight and understandings of behaviour, explain actions from the participant's perspective, and do not dominate the participants.

McKerchar (2008:7) continue to indicate that the positivist researcher is likely to adopt a quantitative methodology unlike the interpretivist researcher who is expected to employ a qualitative methodology when conducting a study.

This study follows the interpretivist approach and therefore the use of a qualitative approach is applied to analyse and evaluate the benefits' that can arise from SARS' implementation of APAs.

The logical reasoning is not required for qualitative research, instead, the researcher is expected to be more creative, inductive reasoning and use indirect means of collecting supporting evidence (McKerchar, 2008:7). Getting access to data and selecting populations is often problematic in tax research, however, such limitations should not prevent the researcher in conducting the study (McKerchar, 2008:11).

Qualitative research is typically about seeking answers to questions (and sub questions) and not about proving or disproving hypothesis (McKerchar, 2008:15). A qualitative methodology is used in this study as the aim is to get a better understanding of APAs and their related implications once implemented, which can be subject to interpretation. The research is inductive as it follows a logical process to establish the existence of shortcomings in the South African transfer pricing legislation and the potential benefits of implementation of APAs in a South African context.

1.5.2 Ontological assumptions

According to Bisman (2010:5) ontological assumptions affect the way a researcher views the world and what they consider to be 'real'. Put it differently, ontological assumptions are concerned with what constitutes reality, in other words '*what is*' (Scotland, 2012:1).

The researchers' ontological viewpoints shape their epistemological beliefs in terms of how knowing and understanding reality can be developed and of the relationships between the researcher and that which is researched (Bisman, 2010:5). The key question is whether there is a 'real' world 'out there' that is independent of the researcher's knowledge of it (Marsh, Ercan & Furlong, 2002:18).

According to the realist interpretation, measurement commits us not just to the logically independent existence of things in space around us and time, but also to the existence of quantitatively structured properties and to the existence of real numbers, understood as relations of ratios between specific levels of such attributes (Michell, 2005). On the other hand, the Stanford Encyclopaedia of Philosophy (2016) defines "relativism as the view that truth and falsity, right and wrong, standards of reasoning, and procedures of justification are products of differing conventions and frameworks of assessment and that their authority is confined to the context giving rise to them".

In this study, the relativist view is held as it holds that a single situation could be interpreted in different ways. Tax legislation is law that is subject to interpretation. Researchers may not necessarily perceive tax legislation the same way. In this study, information available on APAs is reviewed and a conclusion reached that may differ from another researcher's opinion if the same information is considered.

In evaluating the impending implementation of APAs in a South African context through the comparison of the legislation of similar foreign countries that implemented APAs, contrasting frameworks and reasoning are used, as the economic environment is different from that of South-Africa.

1.5.3 Epistemological assumptions

Deriving from ontology is epistemology, which is concerned with the theory of knowledge: its nature and limits and how people acquire and accept knowledge about the world (Bisman, 2010:5). If an ontological position reflects the researcher's view about the nature of the world, their epistemological position reflects their view of what we can know about the world and how we can know it; literally an epistemology is a theory of knowledge (Marsh *et al.*, 2002:19).

For this study, reality is viewed in terms of this study's objectives as relativist. The interpretivist paradigm is the research paradigm that correlates with the relativist view.

This study considers the origins of transfer pricing legislation in South Africa and evaluates how the legislation has progressed since it came into effect in 1995. The main aim of this study is based on the APAs framework as provided by OECD, the possible implementation of APAs in South African

legislation, and the evaluation of risks associated with the implementation and application of APAs in a developing country context.

The study further contains a comparison of South African transfer pricing legislation with other foreign jurisdiction's transfer pricing legislation such as Canada, India and the United Kingdom (UK) to determine whether South Africa's transfer pricing legislation should be amended to be in line with that of other comparable countries. Epistemological assumptions are concerned with how knowledge can be created, acquired and communicated, in other words '*what it means to know*' (Scotland, 2012:1).

Therefore, in this study we seek to answer a specific question regarding the benefits of SARS implementation of APA and the related limitations and risks.

This study is unlikely to result in a similar conclusion with other studies but rather, several findings that require consideration for further research. This is in accordance with qualitative research that is exploratory in nature and is applied when the researcher is not sure of the outcomes of the study. The aim of this study is mainly therefore to obtain a deeper understanding of the benefits, risks and other issues of implementing APAs.

1.5.4 Literature review

To confirm the appropriateness of the selected research methodology, similar studies were reviewed. According to Bredenkamp's (2015) study, "An analysis of Section 23M in light of the OECD guidelines relating to thin capitalisation", a non-doctrinal research approach was selected. Bredenkamp (2015:14) indicates that the methodology used to conduct the study was a literature review. Therefore, a non-doctrinal research approach, based on a review of existing literature is the most appropriate research method for this type of study as it can include the analysis, evaluation and interpretation of data. Hutchinson and Duncan (2012:112) state that a literature review is an enquiry into what has been written about a topic in the past. 'Testimony' can include secondary literature in the form of texts, journal articles, government reports, policy documents, law reform documents and media reports. A critical analysis of the existing research literature, both theoretical and empirical, related to the research topic is required for doctrinal research (Hutchinson & Duncan, 2012:113).

A literature review was performed to address this study's research questions. Relevant material was consulted as part of this study's literature review. More reliance is thus placed on theoretical sources rather than numerical data. Among the resources consulted were the South African Income Tax Act

58 of 1962 (IT Act), academic journal articles, OECD publications and guidelines, books and transfer pricing legislation of other countries that have implemented APAs. As South African courts of law have played a significant role in interpreting the law in tax disputes, the development of South Africa's transfer pricing legislation is also studied with reference to relevant case law.

1.5.5 Methodological assumptions

A critical analysis of the transfer pricing legislation is performed to obtain an in-depth understanding of the reasoning and the implementation of APAs as recommended by OECD. This includes an analysis and comparison of South African transfer pricing legislation with that of other countries that have implemented APAs. When deciding on the relevance of the comparable jurisdictions to be utilised for the study, it is noted that the first South African tax legislation enacted was based on English income tax legislation (Croome, 2013:6). The South African legislation has been substantially influenced by English law (Schreiner, 1967:11). This study endeavoured to compare the South African transfer pricing legislation with that of comparable jurisdictions such as UK, India and Canada.

The English law also significantly influences Canada's legal system (Pienaar, 2012:154). This study also considers and analyses the Canadian approach to transfer pricing legislation and the use of APAs to reduce or eliminate uncertainty brought about by transfer pricing. A comparative study about the development and application of South African and Canadian transfer pricing legislation can offer insights into the development of such legislation. The study goes further into analysing the development and application of APAs by Canada to establish the feasibility and benefits of implementing APAs by South Africa. Certain aspects of the South African Constitution, the foundation for all South African legislation, are also similar or based on, among others, the Canadian Constitution (Davis, 2003:187).

This study further endeavoured to analyse the implementation of APAs and the benefits thereof with that of India to draw a conclusion in respect of South African transfer pricing legislation in relation to its comparable international counterparts. In respect of the relevance of India as a comparable jurisdiction, it is noted that this country forms part of the Brazil, Russia, India, China, South Africa (BRICS) (SA Govt) and it is comparable to South Africa as it is classified as a developing country, similar to South Africa (Nayyar, 2016:3).

Researchers consult different sources to organise, analyse and re-present such information in a way that is persuasive to colleagues, legislators, judges and practitioners to follow their line of thoughts and reasoning. According to Langbroek *et al.* (2017:2), the foregoing is in accordance with traditional

legal research methodologies in which, authoritative texts like case law, legislation and doctrinal literature are considered as the main formal sources of information for understanding the law.

1.6 LIMITATION OF THE STUDY

The limitations of a study stem from the characteristics of the research design or methodology that influence the interpretation of the research findings. These limitations are the constraints on generalizability of results, utility of the findings from the methods used to establish internal and external validity or the result of unanticipated challenges that emerged during the study (Price, 2004:66).

The lack of available and reliable data on implementation of APAs in developing countries in Africa resulted in the selection of other comparable jurisdictions to South Africa. Comparing the transfer pricing legislation of other African countries may have resulted in more reliable data, however, no African country has implemented APAs.

Furthermore, when conducting this study, there was, to some extent, limited access to data or literature available in the public domain on the selected comparable countries. However, as the study made use of alternative information publicly available on the selected comparable jurisdictions.

1.7 ETHICAL CONSIDERATIONS

This study is based on non-doctrinal research methodology based on a literature review. No human interaction took place during this study. The study utilised data from secondary data sources that are trustworthy and reliable in adding value to the mini-dissertation. Moreover, ethical clearance was obtained from the North-West University Ethics Committee. Therefore, it can be concluded that known ethical risks are addressed.

1.8 CHAPTER OVERVIEW

Chapter 1: Introduction

This chapter provides the background of APAs and the purpose of its implementation, as recommended by the OECD. The relevance of the study is illustrated in this chapter. This chapter also outlines the problem statement, the relevant research objectives and the research methodology formulated with the purpose of addressing the research problem statement identified in the study.

Chapter 2: Challenges associated with transfer pricing and the need for OECD intervention

Chapter 2 presents the background to the development of problems that gave rise to the transfer pricing issue and subsequently led to the need for transfer pricing legislation to minimise tax disputes from transfer pricing. The chapter also discussed the OECD's role in addressing transfer pricing issues on an international scale. This chapter addresses the secondary research objective as outlined in section 1.4.2(i) of the study.

Chapter 3: The concept of an APA, the nature and functionality of the different types of APAs

In this chapter the definition of APAs, different types, classifications and functionality of different APAs are described in detail. Circumstances under which each APA type may be entered into and the effect of agreements to affected parties were considered. This chapter critically analysed the APA objectives and determined if such objectives are achievable by developing countries and at what cost. This chapter addresses the secondary research objective as identified in section 1.4.2(ii) of this study.

Chapter 4: Foreign transfer pricing legislation and the implications of APAs

In this chapter, foreign transfer pricing legislation, specifically in relation to APAs, was analysed to establish whether South Africa's transfer pricing legislation needs improvement through the implementation of APAs. Such analysis helps to determine the benefits and risks associated with APAs for South Africa. This chapter addresses the secondary research objective as identified in section 1.4.2(iii) of this study.

Chapter 5: Summary and conclusion

This chapter serves as the executive summary of the study and presents the conclusions drawn from the findings of the study. Possible recommendations from the results of the findings are made. This chapter addresses the secondary research objective as identified in section 1.4.2(iv) of this study.

CHAPTER 2

CHALLENGES ASSOCIATED WITH TRANSFER PRICING AND THE NEED FOR OECD INTERVENTION

2.1 INTRODUCTION

This chapter provides insights into the background into developments in transfer pricing that led to the implementation of transfer pricing legislation to minimise tax disputes arising from transfer pricing issues. Further, a detailed analysis of the OECD's role in remodeling transfer pricing legislation on a global scale is addressed, thereby addressing the secondary research objective as identified in section 1.4.2(i) of this study.

According to the United Nations (UN) (2017:23), of late, international trade consists of high volumes of international trade of goods, services, capital and intangibles within MNE groups. For accounting and reporting purposes, such transactions are called 'intra-group transactions' (UN, 2017:23). There is evidence that these intra-group transactions are growing steadily and have reached new heights with estimates of more than two thirds of all business transactions worldwide occurring within MNE groups (PWC, 2011:8). Beebeejaun (2018:1) states that intra-group transactions amongst related entities continue to dominate cross-border trade. This implies the involvement of transfer pricing practices among these related entities that pay tax in different jurisdictions at different tax rates.

The structure of intra-group transactions within an MNE group is determined by a combination of market and group driven goals which can differ from open market conditions applicable to independent, unrelated entities dealing at arm's length (UN, 2017:23-24). Therefore, a large and rapidly growing volume of international transactions are no longer driven only by market forces that determine the transaction terms between independent unrelated parties. Rather, the intra-group transactions are driven by the common goals of the related entities within the MNE group (UN, 2017:24). Thus, given such a situation, it becomes imperative for MNEs to establish the 'right price', the so called 'transfer price', for intra-group transactions such as the cross-border transfer of goods, intangibles and services (UN, 2017:24). Given the operation of market conditions and the common interest of entities within the MNE group when deciding on the 'right price', it follows that transfer pricing does not necessarily involve tax avoidance (UN, 2017:24).

It must be noted that the cross-border intra-group transactions are not purely motivated by tax implications or obtaining tax benefits, but rather for economic reasons. MNEs require entities within the group to implement transfer pricing for intra-group transactions to assist the group to measure the individual entity's performance (UN, 2017:24). This practice motivates MNEs to engage in cross-border transactions in order to attain the benefits derived from internalisation (Beebeejaun, 2018:5; Buckley & Casson, 1985).

According to Beebeejaun (2018:5), internationalisation "is the process through which an entity expands its business outside the national or domestic market". Through internationalisation, the entities within the MNE group derive benefits by means of a reduction in transaction costs related to research, negotiation and dispute settlement, that could be obstacles when trading with unrelated entities.

It is crucial to note that entities within a MNE group are separate legal entities, incorporated and operating in different jurisdictions with their own interests. Thus, these entities are considered as separate profit centres and the transfer prices they charge are used to determine the profitability of each entity within the group (UN, 2017:26). Thus, as distinct legal entities, it would be reasonable to acquire products or services from a related entity if the acquisition price was equal to or cheaper than prices charged by unrelated entities (UN, 2017:26). To avoid tax challenges from tax authorities, the prices between related entities should gravitate towards the arm's length price (UN, 2017:26).

However, given the pandemic caused by the COVID-19, the determination of arm's length prices by MNEs has become a challenge due to lack of reliable data for comparability analysis (OECD Commentaries, 2020:2). The unprecedented economic conditions caused by COVID-19 and the responses by governments' globally have led to practical challenges for performing comparability analysis and for the application of the arm's length principle by MNEs (OECD, 2020:5).

In the Davis Tax Committee (2014:1) report, it was argued that when MNEs operate in different countries where they are subject to different laws, they may engage in 'fictitious transfer pricing', 'mispricing', 'incorrect pricing', 'unjustified pricing' or similar, where they manipulate profits so that it appears lower in a country with higher tax rates and higher in a country with lower tax rates (UN, 2017:24).

The issue of transfer pricing does not necessarily relate to funds gained from illicit or illegal activities. Transfer pricing refers to the manipulation of prices between related entities on cross-border transactions to make profits appear in the country with the lower tax rate (Beebeejaun, 2018:5). Such

manipulation causes tax avoidance and evasion issues to arise (UN, 2017:24).

Transfer pricing may further be described as setting of prices for transfer of goods or services between related entities forming part of a MNE group (UN, 2017:24). The transactions between related entities are also referred to as 'controlled transactions', as opposed to 'uncontrolled transactions' between independent unrelated entities that can be assumed to operate independently in reaching terms for such transactions (Holtzman & Nagel, 2014:1). Uncontrolled pricing is defined as "an occasion when two parties can freely negotiate the price of goods or services" (Holtzman & Nagel 2014:1).

2.2 BACKGROUND OF TRANSFER PRICING

It is believed that the term transfer pricing has been in existence for over centuries, with the earliest concept having occurred during the 1920s in the United States of America (USA). It is further suggested that during the 1960s, the USA was at the forefront of transfer pricing through the implementation of transfer pricing rules (Mullachella, 2018:69). In 1988, the USA was also among the first few countries to implement transfer pricing documentation and compliance requirements for taxpayers. In the early 1990s, the arm's length standard for intra-group transfer pricing in binding APAs was issued by the USA, making it the first country to issue such a standard (Mullachella, 2018:69).

Large corporations in the USA manipulated profits to accrue in lower tax jurisdictions. For example, between the years 2007 and 2009, Pfizer Inc. reported a net loss of \$5.2 billion in the USA, where its corporate headquarters are located. However, for the same period, Pfizer Inc's foreign subsidiary (related entity) located in Ireland, reported a pre-tax profit of \$20.4 billion (Wu, 2010:1).

Another example is that of Oracle Corp. During the years 2006 and 2007, one of Oracle's subsidiaries managed to produce one fourth of Oracles' total pre-tax income but paid no income taxes. The subsidiary accomplished all of this without a single employee recorded, which raises the issue of 'source of income' (Wu, 2010:1). Data from different sources revealed that thousands of other MNEs take advantage of weaknesses in transfer pricing regulations and create enforcement and financial problems for governments as the manipulation of prices erode the tax base of the affected countries (Wu, 2010:1).

Large MNEs such as Amazon, AOL, Adobe, Hewlett-Packard and Microsoft have previously made headlines regarding the transfer pricing disputes over potential adjustments to income ranging from tens of millions to a billion dollars (McKinley *et al.*, 2013:1).

As much as governments around the globe work hard to improve and have stricter transfer pricing

legislation, MNEs abuse loopholes in international tax systems (Wu, 2010:1). Large MNEs with enough financial and legal resources such as Pfizer Inc., Oracle Corp and Google engage in legal transfer pricing activities by shifting assets to subsidiaries in foreign jurisdictions with lower tax rates to minimise the overall group tax liability (Wu, 2010:1).

According to Kortebusch (2014:1), due to steadily growing globalisation and the internationalisation of the economy, the intra-group exchange of goods and services plays an increasing role in international trade. According to estimates by the OECD, trade between related entities already accounted for more than 60% of international trade by the early 1990s (Kortebusch, 2014:1). The increase in cross-border trade resulted in crucial questions in the allocation of the tax base to the affected tax authorities in the different countries (Kortebusch, 2014:1).

The part played by MNEs in international trade and the difficulty imposed on international tax matters arising from the MNE group transactions have significantly increased since the 1980s (OECD, 2010:17).

Generally, transfer pricing is high on the tax agenda because of globalisation and remains one of the largest risks and toughest compliance challenges MNEs and tax authorities' face in cross-border transactions (PWC, 2011:1; Kanee, 2019:2). In the USA, 57% of the tax authorities and 48% of large corporate taxpayers highlighted that transfer pricing poses their primary tax compliance risk (Borkowski & Gaffney, 2014:34).

Another survey conducted by Ernst & Young indicated that 74% of parent companies and 81% of subsidiaries believe that transfer pricing is extremely important for their operations (Lin *et al.*, 2016:1). In agreement, Kortebusch (2014:2) mentioned that MNEs also rank the issue of transfer pricing as one of the most important tax challenges they face.

In an era of a modern globalised economy, with the advanced technologies and eased mode of transportation, transfer pricing continues to pose challenges to leaders of large entities (Perčević & Hladika, 2017:2). MNEs increasingly face the risk of double taxation from conducting businesses across international borders (Cazacu, 2017:2). Tax authorities in various jurisdictions have moved their focus to MNEs to ensure that MNEs adopt the arm's length principle in transfer pricing to pay appropriate and enough taxes due in the respective tax jurisdictions (Cazacu, 2017:2). Both tax authorities and MNEs acknowledge that the problems associated with transfer pricing requires an urgent and relevant solution in an ever-changing world economic environment (Melnychenko *et al.*, 2017:8).

One of the factors that causes transfer pricing challenges is that the MNEs seek ways to avoid or minimize taxes while tax authorities are also working hard to strengthen regulations on transfer pricing to curb tax revenue losses (Kanee, 2019:2). The importance of the transfer pricing topic from the tax authorities' perspective is also reflected in the OECD's attempt to address the issue of BEPS (Kortebusch 2014:1). BEPS is defined as a strategy that MNEs use to exploit gaps or inconsistencies in global tax systems by shifting profits to lower tax jurisdictions to reduce their overall tax liability (Mohs *et al.*, 2017:3; Liu & De Mooij, 2018:4). MNEs accomplish the shifting of profits in one of two ways, either shifting income to lower tax jurisdictions or shifting expenses to higher tax jurisdictions (Mohs *et al.*, 2017:4).

Cobham and Jansky (2018:208) indicated that tax avoidance by MNEs costs an estimated amount of \$500 billion in revenue losses to governments annually. As a result, tax avoidance strategies implemented by MNEs have prompted tax administrators around the globe to increase their transfer pricing staff and intensify audit scrutiny of MNEs (Kortebusch, 2014:1)

To curb the tax avoidance practises, many tax authorities assume that MNEs manipulate their transfer prices to shift profits to lower tax countries (Kortebusch 2014:1).

It can be concluded that the concept of transfer pricing has been in existence for over centuries. Over the years, many big corporates have managed to minimize the overall group profit by shifting profits to lower tax rates jurisdictions which erodes the tax base of other jurisdictions.

2.2.1 Issues underlying transfer pricing

Transfer pricing have a direct effect on the tax base of the involved countries in a cross-border transaction within a MNEs group, as the purpose of transfer pricing is to determine the income and capital for these countries. The tax base of involved countries is affected as the profit is shifted from one country to another (UN, 2017:27).

In any tax cross-border transaction, there are at least three parties involved; the MNE group (two related entities trading) and the two tax authorities of the countries involved in the transaction (UN, 2017:27). When one country's tax authority taxes the goods or services of the MNE group, it influences the tax base of the other country. Thus, tax cross-border transaction involves issues related to jurisdiction, allocation and valuation (UN, 2017:27), which is now to be further discussed in detail below.

2.2.1.1 Issues of the jurisdiction

Transfer prices allocate the tax bases across jurisdictions through the allocation of income among the countries involved in the cross-border transaction. As different countries have different tax laws and tax rates, MNEs have an incentive to manipulate transfer prices to shift the taxable income from a higher tax rate jurisdiction to lower tax rate jurisdictions (Becker *et al.*, 2016:3).

Some MNEs engage in practices that seek to reduce the group's overall tax liability through transfer pricing manipulation, which has added to the dimension of the jurisdictional issue (UN, 2017:27). Though the avoidance or minimisation of taxation by MNEs may be a key influencing factor in the setting of transfer prices for intra-group transactions, it is not the only factor contributing to the transfer pricing policies and practices of MNEs (UN, 2017:27).

The main goal of MNEs is to maximise the overall groups after tax profits. To achieve that, MNEs attempt to reduce their worldwide taxation by shifting profits from related entities in higher tax countries to related entities in relatively lower tax countries through either under-charging or over-charging the related entity for intra-group trade (UN, 2017:27). Another motivation for MNEs to engage in transfer pricing practices is to use a tax benefit, such as a tax loss either from the current year or carried forward from prior years, in the jurisdiction in which it operates (UN, 2017:27).

To curb profit shifting by MNEs, tax authorities require transfer pricing legislation that is in line with the arm's length principle as defined in Article 9 of the 'Model Tax Convention on Income and on Capital' and other countries corresponding rules. The arm's length principle as suggested by OECD, aims to ensure that a transfer price for a specific intra-group transaction is comparable to an 'uncontrolled transaction' that is assumed to be concluded between unrelated entities for the same transaction (Becker *et al.*, 2016:3).

Deloitte (2021:1) states that for a transaction to meet the arm's length principle, the conditions imposed between the controlled entities in their commercial or financial relations are required to be like those which would be made between uncontrolled entities.

The fact that MNEs operate in different countries with different tax laws and that have different tax rates creates an incentive to manipulate transfer prices to move profits to lower tax jurisdictions. The main purpose is to maximise the overall MNE group profit. This practise by MNEs creates jurisdictional issues as the profit shifting affects the tax base of the other jurisdiction.

2.2.1.2 Allocation issues

Many tax authorities around the globe seek more effective transfer pricing rules to protect their tax

bases from tax erosion as the global economy expands into every corner of the world (Holtzman, 2014:1). MNEs are global entities which are controlled by a parent company. MNEs share a common goal, resources and overheads, even though they operate as separate legal entities in separate jurisdictions. From the perspective of the MNE, these resources need to be allocated with maximum efficiency in the most optimal manner to maximise the overall group's profit (UN, 2017:28).

However, governments have different perspectives as the allocation of costs and income from the MNEs' resources need to be assessed to determine the 'correct' tax amount due to the involved countries. Sometimes to arrive at the 'correct' amount of tax leads to a 'war' between tax authorities as the allocation of costs and income is aimed towards maximising the tax base in their respective countries (UN, 2017:27). This results in increased challenges for MNEs, as tax authorities engage in detailed transfer pricing regulations with strict documentation requirements and sophisticated audit practices (Holtzman, 2014:1).

Transfer pricing regulations remain important for countries for reasons such as the protection of the tax base, elimination of double taxation and to enhance cross-border transactions for foreign direct investment. These regulations are more crucial for developing countries, to provide a climate of certainty and an environment for increased cross-border transactions, while at the same time not losing out on critical tax revenue from foreign direct investment (UN, 2017:27).

Transfer prices are necessary for MNEs to determine the allocation of profits between jurisdictions of a MNE group (Liu & De Mooij, 2018:4). The allocation of resources, income and expenses amongst the entities in the MNE group is important for-profit maximisation and sustainability in general. However, even when MNEs are not intentionally manipulating their transfer prices, it may be viewed as such by tax authorities due to different laws and interpretations that may create tax wars when allocating the income and expenses of the MNEs.

2.2.1.3 Valuation issues

Entities within the MNE group represent separate profit centres with their own interests. Transfer prices set up for intra-group transactions are required to determine the profitability of each entity within the group. Thus, when acquiring the goods or services from a related entity, the individual entity would consider the purchase price that is equal to or cheaper than prices being charged by unrelated entities (UN, 2017:24). It is not disputed that such prices should be at arm's length (UN, 2017:24).

Therefore, when entities engage in a transaction, the intention is to minimise costs and maximise income. For that reason, entities within the MNE group would prefer to purchase from a related entity

if the purchase price is cheaper. However, to avoid transfer pricing manipulation, the purchase price must be comparable or like a price that would be paid in an uncontrolled transaction.

2.3 DETERMINATION OF THE RIGHT TRANSFER PRICE

The approaches and techniques used to arrive at the 'right' transfer price keep evolving to satisfy all affected parties, that is, the MNE group and the two tax authorities. With an ever-changing global economy, it is important to consider that the economic aspects of transfer pricing involve economic principles being applied to a fluid marketplace (UN, 2017:30).

In 2011, it was reported that while the transfer pricing issue has reached new heights, with about two thirds of all global business transactions happening within MNE group, most developing countries have less sophisticated tax systems and administrations (PWC, 2011:1; UN, 2017:30). Blumenthal (2017:10) highlights that between 30% to 60% of international trade is within MNE groups. Furthermore, the lack of clear transfer pricing legislation has a negative impact, as both tax authorities and the MNEs have limited guidance to refer to when determining a transfer price in an intra-group transaction (PWC, 2011:1).

As a result, developing countries face the risk of absorbing the effects of stronger enforcement of transfer pricing in other countries, such as developed countries (UN, 2017:30). Such practices result in countries with less sophisticated tax systems and less strict transfer pricing rules to pay at least a portion of the MNEs tax costs in other countries. To prevent such practices and to compete on a global scale, governments are introducing new tightened transfer pricing legislation (UN, 2017:30).

However, for developing countries, it may be important for donors to offer technical support, to review and revise the transfer pricing legislation. Developing countries can be supported in drafting and implementing more-sophisticated transfer pricing legislation, such as APAs and more simplified compliance procedures (PWC, 2011:4).

The UN published a report on the 'International Income Taxation and Developing Countries' in 1988. The report highlights the opportunities of transfer pricing manipulation by MNEs to the detriment of developing countries' tax bases (Dean, 2014:21). The UN recommends a range of mechanisms, specially tailored to deal with the intra-group transactions by developing countries (Dean, 2014:21).

In practice, there is an incorrect assumption made regarding the commercial and financial relations between related entities and the marketplace that it is different and always at odds with each other.

For some reason, MNEs may have an incentive to have an arm's length price for their intra-group transactions for evaluation of the true performance of their respected entities (UN, 2017:37).

The ever-changing global economy and increased internationalisation have changed the way of doing things. As such, the determination of arm's length price has also become complicated. Therefore, countries, more especially developing countries, must catch up and design sophisticated tax systems and administrations with clear transfer pricing legislation to avoid the risk of absorbing the effects of stronger enforcement of transfer pricing in other countries.

2.4 BACKGROUND AND FUNCTIONS OF THE OECD

The OECD is well-known international organisation with its origin traced back to 1961 when the former Organisation for European Economic Cooperation (OEEC), the USA and Canada entered into an agreement with the aim of promoting economic policies (OECD, 2021:1; Radhakrishna, 2019:9). The OECD's predecessor, the OEEC, was established in 1947 to implement and facilitate the USA led Marshall Plan 30, which was aimed at the reconstruction of post-WWII Europe. The success of the OEEC resulted in Canada and the USA joining the original members of the multi-country forum (Dean, 2014:12).

According to Dean (2014:11), to further international economic collaboration at that time, the OECD members signed a Convention in December 1960. By 1961, the Convention was accepted, and by 30 September 1961 the OECD was established. Even then, the OECD was instrumental in forcing countries to recognise the interdependent nature of their respective economies. As a result, by 1964, other countries had begun joining the founding OECD member countries to stimulate international economic co-operation (Dean, 2014:11).

The OECD published its first general guidelines in 1979, "The Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" (the OECD Guidelines) to assist countries in the implementation and application of transfer pricing policies (Dean, 2014:12). The OECD Guidelines provide a comprehensive framework for both member and non-member countries with cross-border transactions among MNE groups. In the changing global economy, the OECD has undertaken to regularly update the OECD Guidelines to ensure their continued economic relevance and application thereof (Dean, 2014:11).

The purpose of the OECD Guidelines is, among others, to simplify the application of transfer pricing principles and to ensure the uniform implementation of these principles to prevent the creation of preferential tax regimes and shifting of profits. Furthermore, the OECD gathers and utilises all the

information at its disposal to assist countries in combating poverty and promoting prosperity through economic growth and integration (Dean, 2014:12).

In addition, Radhakrishna (2019:8), states that the main intention of the OECD is to identify economic challenges and to promote economic policies for both OECD member and non-member countries to resolve transfer pricing issues. The OECD's aim is to promote policies that are observed and adopted internationally to improve the prosperity, social well-being and the equality of people all over the world (OECD, 2021:1).

The primary function of the OECD remains its publications which are crucial in circulating the organisation's intellectual output. The OECD is also involved in various administrative roles such as implementing standards and recommendations, conducting peer reviews and facilitating multilateral agreements (Dean, 2014:12).

The OECD has designed and issued transfer pricing guidelines that have been adopted by many countries including non-member countries to address the issues of transfer pricing (OECD, 2010:22). The report that laid this groundwork and was instrumental in transfer pricing legislation, was the OECD's 1979 report on 'Transfer Pricing and Multinational Enterprises'. This 1979 report was followed by another report in 1995, which provided clearly defined economic parameters within which to locate transfer pricing regulations (Dean, 2014:12).

These Guidelines have been updated on numerous occasions to ensure that they keep abreast with economic changes and realities (Dean, 2014:11). An update of certain chapters in the OECD Transfer Pricing Guidelines for MNEs and tax authorities was approved and adopted in 2010 (OECD, 2010:22). The OECD Guidelines provide detailed information regarding many aspects of international tax, such as the application of the arm's length principle, its status in international law, methodologies for its calculation and required documentation for transfer pricing transactions and dispute resolution procedures (OECD, 2010:22). The Guidelines as published by the OECD are followed by both MNEs and tax authorities on different levels in several jurisdictions globally and are also applied in South African domestic transfer pricing legislation (OECD, 2010:22; Olivier & Honiball, 2011:621).

Amongst the key concerns of the OECD, is profit-shifting practises by the MNEs that result in the erosion of a jurisdictions tax base (Radhakrishna, 2019:8). To eliminate or minimise the issue of profit shifting, the OECD conducted a study into BEPS (Radhakrishna, 2019:9). The OECD, together with the G20 countries, released a report in February 2013, entitled "Addressing Base Erosion and Profit Shifting", resulting in the formulation of 15 Action Plans (Bradbury *et al.*, 2018:2). The 15 Action

Plans is an addition of the OECD Guidelines, which established a proposed compliance framework for transfer pricing documentation. The OECD updated the Guidelines again, with the latest version issued in 2017 to reflect and provide clarification on the positions put forward by the BEPS project (Brandbury *et al.*, 2018:2). To date, the OECD Guidelines are still considered as one of the most comprehensive and reliable documentation on transfer pricing and have been accepted and adopted into transfer pricing legislation of many countries including South Africa (Dean, 2014:12).

In addition to the OECD Guidelines, the OECD has produced and facilitated the implementation of other transfer pricing documents, such as the Model Tax Convention (MTC) (Dean, 2014:12). The MTC is the culmination and codification of various treaties, both bilateral and multilateral, and is applied among both OECD member and non-member countries. The primary significance of the OECD MTC is its emphasis of the arm's length principle, which provides a uniform application framework for the taxation of MNEs (Dean, 2014:12).

The UN has, along with the OECD, played a crucial role by producing relevant material to clarify transfer pricing matters, especially those relating to the developed and developing country contexts (Dean, 2014:12). The UN began to publish its reports on transfer pricing from as early as the 1980s, starting with the 1988 report on 'International Income Taxation and Developing Countries' which considered the manipulation of transfer pricing by MNEs to the detriment of developing countries (Dean, 2014:12).

As early as 2003, the United Nations Model Double Tax Convention between Developed and Developing Countries (UN Model Convention) was published to assist developing countries with the principle of arm's length (Dean, 2014:13). The UN reports deals with specific developmental issues which arise in the developing country context, such as the lack of skills, resources and regulations and thus, these reports seek to provide solutions to such problems (Dean, 2014:13).

The UN also produced other relevant material which includes its 'Transfer Pricing Manual for Developing Countries'. The value of the UN manual has been questioned by some critics, as the OECD Guidelines are already viewed as being the authoritative source on transfer pricing by both OECD member and key non-member countries (Dean, 2014:13). However, the UN approach to transfer pricing further endorses the OECD arm's length principle, providing a logical and consistent body of material and expertise from which developing countries may draw upon (Van der Lith, 2011; Dean, 2014:13).

The OECD Guidelines continue to evolve into internationally recognised standards and are recognised as a reliable and authoritative source of guidance for transfer pricing, even by OECD

non-member countries (Van der Lith, 2011; Dean, 2014:13). In 2007, South Africa was included as one of the 5 key partners to the OECD following the OECD council resolution. The key partners to the OECD, such as South Africa, provides contribution to the work done by the OECD in a comprehensive manner, which includes participating in partnerships with OECD bodies (OECD, 2018).

South Africa, though a non-member country of the OECD, has also adopted various principles encapsulated in the OECD Guidelines into its transfer pricing legislation, especially in the context of section 31 of the IT Act (Dean, 2014:13). In 2010, SARS announced its plans to amend and realign its transfer pricing legislation with the OECD Guidelines (Honiball & Delahaye, 2013:16). Following such announcement, section 31 of the IT Act was revised and overhauled when the new provisions of section 31 of the IT Act came into effect in April 2012 (Honiball & Delahaye, 2013:16).

According to the information in Practice Note No.7 (PN7), SARS accepted and adopted the OECD Guidelines as an important and relevant document after comprehensive consultations and input from various tax practitioners and tax experts in many countries (Van der Lith, 2011). PN7 also recognises the international importance of the OECD Guidelines on transfer pricing and states that these should be followed, in the absence of specific guidelines to the contrary in the PN7, section 31 of the IT Act or in any double taxation agreement entered by South Africa and an affected country (SAICA, 2000). Section 31 of the IT Act is applicable to goods or services supplied after 19 July 1995. The PN7 states that it is to be operative as from that date (SAICA, 2000). The Commissioner of SARS released SARS PN7, pertaining specifically to sections 31(1) and 31(2) of the IT Act, which is in line with OECD Guidelines. PN7 provides the mechanism by which the Commissioner of SARS may adjust any consideration between related entities, by considering the conditions which would exist between unconnected entities trading at arm's length in comparable circumstances (SAICA, 2000).

Both the UN Model Convention and the OECD Guidelines have highlighted and facilitated the move toward a more uniform approach to transfer pricing, which have greatly influenced international treaty practices and have contributed to tax parity in transfer pricing (UN, 2017). The Associated Enterprise Article (Article 9), that is found in both the OECD Guidelines and the UN Conventions, have endorsed the arm's length principle in international tax law (UN, 2017:18).

Based on the above, it is noted that the establishment and existence of the OECD is to provide guidance on international tax issues amongst the OECD members. Due to the effectiveness of the OECD guidelines and recommendations, most countries including OECD non-member countries have implemented their guidelines. Also, the existence of the UN has contributed to resolving the transfer pricing issues, more especially from the perspective of developing countries.

The South African transfer pricing legislation refers to the OECD Guidelines and the tax authorities have indicated their intention to always have transfer pricing rules adjusted and aligned with these Guidelines (Honiball & Delahaye, 2013:16). Considering the relevance of the OECD guidelines, it would be important that South African transfer pricing legislation should be more aligned with the OECD Guidelines, including on the implementation of APAs in South Africa (Honiball & Delahaye, 2013:16). Given that South Africa is a developing country, the next section discusses the challenges faced by developing countries from transfer pricing and their impact on the tax base. The outcome of the discussion below may help to assess the need for South Africa to implement APAs.

2.5 CHALLENGES FACED BY DEVELOPING COUNTRIES REGARDING TRANSFER PRICING

The growth of MNEs has resulted in much-needed economic growth in developing countries as evidenced by an increase in jobs, reduced poverty and improved technologies that resulted in a decline in government expenditure. Further, globalisation and internationalisation has significantly contributed to the increase in foreign direct investment, more specifically in small economies in developing countries (Worasinchai & Bechina, 2010:1).

Worasinchai and Bechina (2010:2) continue to highlight that MNEs have over the years contributed to economic growth and welfare in developing countries through job creation and increased buying power by local citizens, resulting in increased tax revenue collections, increased exports, improved infrastructure and technological advancements. MNEs expand into every corner of the world through setting up subsidiaries, including in developing countries, to gain efficiency, economies of scale and exploit the differences between jurisdictions' tax rates (Beebeejaun, 2018:4).

Foreign direct investment dates to 1959 with the first of such investments believed to have been between Pakistan and Germany (Kiluma, 17:11). For the home government of the investor, the primary intention is to create an environment that protects the investor so that there may be a realisation of profit. From the host government side, the intention is to attract foreign direct investment for investors to transfer knowledge and technology to its citizens, promote economic growth and create employment (Kiluma, 17:11).

The growth of MNEs has also resulted in increased intra-group transactions across national borders. Despite the contribution that MNEs make in developing countries, some MNEs engage in profit shifting from source countries which need these revenues the most to further their economic growth and facilitate poverty eradication (Blumenthal, 2017:1). Thus, international trade practices of MNEs

became a tax issue when tax authorities became aware that MNEs manipulate their transfer prices for cross-border transactions within the MNE group to benefit from a lower tax liability in other countries (Beebeejaun, 2018:4).

International tax, especially transfer pricing related issues, has brought about a lot of issues, at a level of complexity and magnitude, which are often difficult to deal with, more especially for the smaller tax administrations of developing countries (UN, 2017:62).

Mold estimated that developing countries lose approximately \$35bn a year due to tax avoidance practices. The study further argues that such governments are more vulnerable to the practice of income shifting than developed countries (Beebeejaun, 2018:4). Global Financial Integrity (2010) estimated that on average, the tax revenue loss to all developing countries was between \$98bn and \$106bn annually, which is also equivalent to a loss of around 4.4% of the entire developing world's government revenues (Beebeejaun 2018:4).

The second presidential probe committee report on the saga with Accacia Gold Mining in Tanzania, a developing country, revealed an "industrial scale plunder of mineral wealth from Tanzania to the tune of 100 trillion shillings in unpaid tax revenue over 20 years through under-declaration of both the export volume and the value of gold and copper concentrates" (Kiluma, 2017:11).

The fact that developing countries have high value primary industries such as the oil, gold and gas industries as their primary economic pillars, is the main reason for loss of tax revenue. MNEs facilitate the shifting of profit through large volumes of cross-border transactions in and out of countries trading in these resources, which in turn encourages transfer mispricing practices (Beebeejaun, 2018:4). Developing countries struggle to curb the profit shifting issue due to shortage of adequate resources to control and monitor transfer pricing activities (Beebeejaun, 2018:4).

As indicated earlier, some MNEs manipulate transfer prices to ensure that their profits accrue and are reflected in lower tax rate countries, resulting in the erosion of the tax base of the countries from which the profit has been earned. The manipulation of transfer pricing reduces a country's tax revenue, resulting in a decline of economic growth for these developing countries (Blumenthal, 2017:8).

Over many years, tax avoidance has been in the spotlight by the media and the public at large. In effect, developing countries suffering from the adverse effects of tax avoidance have started a fight against tax avoidance practices through the implementation of strict transfer pricing legislation (Beebeejaun, 2018:3). This is because taxation is an important factor for economic development and

the relationship between governments and their citizens with tax revenues playing a crucial role for developing countries to build basic structures and increase the quality of life of the citizens (PWC, 2011:5).

Ideally, developing countries would like to strike a balance between protecting their tax base by curbing the profit shifting practice while still ensuring that foreign direct investments into their countries are not adversely affected (Blumenthal, 2017:8). The increased use of complex international tax structures to avoid paying taxes in certain countries has led to losses of tax revenues of those under-resourced countries and has resulted in more socio-economic challenges for these resource-constrained developing countries (Blumenthal, 2017:8).

To protect their tax bases, governments of developing countries are introducing stricter transfer pricing regulations to reduce profit shifting through intra-group transactions (Lohse, *et al.*, 2014:2). The growth of intra-group transactions has resulted in the development and expansion of transfer pricing rules in developing countries becoming a priority (Blumenthal, 2017:10). Furthermore, developing countries need to balance between maintaining its competitive advantage on attracting foreign direct investments and ensure that wealth remains within their jurisdictions to generate the tax revenue needed for further economic growth (Blumenthal, 2017:9; Beebeejaun, 2018:2).

Governments of developing countries must engage in various endeavours to provide an attractive investment climate and environment for foreign direct investments. At the same time, intensive transfer pricing audits are necessary but are costly and time-consuming. The transfer pricing audits may create fear and induce capital flight from MNEs (Beebeejaun, 2018:2).

An alternative way developing countries can receive additional tax revenues to compensate for the losses of corporate income taxes from foreign investments by MNEs, is through significant increases in other indirect taxes such as the VAT and other forms of taxes such as stamp duties and custom duties (Beebeejaun, 2018:9).

The scope and structure of transfer pricing legislation differs accordingly among the countries. Some countries emphasize on the requirements to follow the arm's length principles, as prescribed by the OECD and UN and other international organisations, while others complement these measures by requiring the mandatory submission of transfer pricing documentation to the tax authorities to justify the chosen set of prices (Beebeejaun, 2018:5).

Developing economies are also becoming increasingly aware of the importance of introducing a strict transfer pricing legislative and administrative framework to deal with transfer pricing issues

(Blumenthal, 2017:10). The unregulated transfer pricing countries could enable MNEs to transfer income and capital between countries and manipulate the price these transfers to obtain a tax benefit (Blumenthal, 2017:10).

For MNEs, the tax uncertainty of cross-border transactions could be a barrier to investment into a country. Particularly for developing countries, MNEs' investments are not only an instrument for the generation of revenue, but it is also a pillar for the investment climate (Blumenthal, 2017:11).

Blumenthal (2017:10) observes that transfer pricing was previously considered as an issue for developed countries, but things change, and it has also become a matter of concern for most developing countries. According to Beebeejaun (2018:4), Easson (1991) argues that transfer pricing has more detrimental effects on developing countries than on the developed countries, as the former are more vulnerable due to the limited knowledge on the subject matter, lack of expertise and staff to tackle the issue.

Developing countries often face administrative challenges when dealing and mitigating tax avoidance structures that MNEs may be using. Another administrative burden is the challenge faced by some governments in obtaining relevant supporting information from MNEs due to the inability to establish what information is relevant (Lohse, *et al.*, 2014:3). In some cases, developing countries are unable to gather taxpayer information due to the absence of documentation requirements, non-existence of databases to extract the information from or the inability to enforce existing requirements (PWC, 2011:1).

As mentioned earlier, the OECD provides guidelines on how countries (including non-member countries) should approach and deal with transfer pricing and the type of tax international laws to be implemented to regulate transfer pricing (Blumenthal, 2017:10). The OECD Guidelines were for OECD member countries, which are mostly developed countries. However, some developing countries, such as the BRICS countries, have adopted and apply of these guidelines (Blumenthal, 2017:10).

South Africa, a developing country, has developed legislation to address transfer pricing issues and to curb tax abusive behaviour. However, limited resources of the SARS's transfer pricing department may limit the effectiveness of the legislation (Blumenthal, 2017:10). To resolve the issue of transfer pricing requires both technical skills and sectoral expertise. To process and evaluate the taxpayer's information requires training and resources for developing countries (Blumenthal, 2017:10; PWC, 2011:1). There is need to support developing countries by providing more capacity and resources to mobilise domestic resources for development in line with the rules of good governance in taxation

(PWC, 2011:1). The benefits of the implementation of transfer pricing legislation strengthens how revenue administrations treat MNEs, which are mostly large taxpayers (Blumenthal, 2017:10).

The development of good governance in taxation globally would favourably affect the business environment for international trade and the practices of MNEs, which could contribute to investment and growth in developing countries (PWC, 2011:1).

The developing countries' primary objective should be to implement robust transfer pricing policies that allow them to prevent potential losses in tax revenues caused by MNEs transfer pricing manipulation while balancing that with the need to attract foreign direct investment (Blumenthal, 2017:10). The prevention of tax losses by developing countries is important as the OECD estimates that between 30% to 60% of international trade is within MNE groups (Blumenthal, 2017:10).

The cost of compliance with transfer pricing legislation represents high overall tax compliance costs for both MNE taxpayers and tax authorities. Finding ways to minimise compliance costs is of great importance for developing countries as it minimises government expenditure and attracts much needed foreign investment (Blumenthal, 2017:10).

One of the ways to minimise unnecessary compliance costs is for governments to appropriately tailor the documentation requirements to suit and meet the capacity and level of the assessed transfer pricing risk and should not be different from the common practices of the country (Blumenthal, 2017:10).

Transfer pricing legislation is designed and implemented to assist in dealing with transfer pricing issues, but many developing countries do not have specific transfer pricing provisions and those that do, are not strong enough to curb tax avoidance through profit shifting (OECD 2012:2).

Many developing countries that lack resources to track transfer pricing transactions also lack transfer pricing enforcement and those that do have, may not have adequate resources to do so which results in these countries not collecting all the tax revenue due to them from connected party transactions (Blumenthal, 2017:11). Increased transfer pricing enforcement by developing countries will potentially result in a gradual increase in tax revenues collected from MNEs as they engage in large volume transactions (Blumenthal, 2017:11). It is not disputed that globalisation and internationalisation has improved, in some areas, the livelihoods of citizens in developing countries. MNEs contributed significantly to the increase in foreign direct investment, more specifically into small economies, in developing countries. However, the benefit from investments by these MNEs may be outweighed by the cost paid by these developing countries. The resources of developing

countries have been exploited by MNEs through transfer pricing manipulation. The MNEs succeed in this practise because the developing countries' tax administrations lack sophisticated tax systems and administration capacity.

Transfer pricing may pose a threat to the economic growth of developing countries. The guidelines by the OECD and the UN may assist developing countries to curb profit shifting by MNEs. As such, the implementation of APAs in South Africa as recommended by the OECD may strengthen South African legislation, attract foreign direct investment, provide certainty and create harmony between the MNEs and SARS. However, developing countries may face challenges when designing and implementing stricter transfer pricing legislation due to lack of resources and capacity.

2.5.1 Lack of resources and capacity to effectively regulate transfer pricing legislation

Tax administrations in developing countries generally lack expertise, capacity, and resources to effectively monitor and administer transfer pricing transactions and lack bargaining power when engaging in negotiations with their counterparts (Blumenthal, 2017:11). Therefore, complex transfer pricing structures and large volumes of intra-group transactions among MNE groups present a challenge for these tax authorities (Blumenthal, 2017:11; McNair *et al.*, 2010:1). Developing countries often lack the necessary legal frameworks and resources to enforce transfer pricing legislation and sanction non-compliance and misconduct (PWC, 2011:9).

The inability to monitor and track intra-group transactions entered into by MNEs due to lack of resources and capacity in developing countries leads to tax authorities offering an opportunity for MNEs to shift profits from these developing countries to other low tax rates countries, the so-called 'tax havens' (Blumenthal, 2017:12).

An imbalance of power is created when two tax administrations differ with the transfer pricing expertise and capacity to administer and monitor cross-border transactions (McNair *et al.*, 2010:2). MNEs may be motivated to allocate a bigger portion of their profits and taxes from cross-border transactions to the tax authority that has the greater capacity and expertise to administer transfer pricing, usually in a developed country, to avoid tax disputes in developed countries (McNair *et al.*, 2010:6). The effect of power imbalances between jurisdictions is possible a factor in the challenges facing developing countries regarding transfer pricing as it may result in a loss of tax revenue for these countries (McNair *et al.*, 2010:6).

Further, developing countries lack forums to engage in regarding international tax matters, and specifically the forums that deal with transfer pricing (McNair *et al.*, 2010:6). McNair *et al.* (2010:6)

is of the opinion that the United Nations Committee of Experts on International Tax Matters (UN Committee) may be only multilateral forum in which developing countries can engage on international tax matters.

The difficulties faced by developing countries regarding transfer pricing issues are summarised by the UN Committee as stemming from a lack of resources and capacity to produce and implement transfer pricing legislation and monitor any abuse of legislation by MNEs that have the resources and capacity to enter many complex cross-border transactions (McNair *et al.*, 2010:9). Various authors have described the lack of resources and capacity as one of the challenges faced by developing countries in the fight against transfer pricing. MNEs have complex international tax structures that require expertise. The absence of skills and resources by tax administrations pose an opportunity for MNEs to engage in profit shifting. To assess the possibility of implementing APAs in a South African legislation, the South African transfer pricing legislation of discussed below.

2.6 THE SOUTH AFRICAN TRANSFER PRICING LEGISLATION

Prior to the introduction of transfer pricing legislation in South Africa in 1995, the practice of profit shifting by MNEs through transfer pricing could only be contested by using the general anti-avoidance provisions in section 103 of the IT Act (Dean, 2014:41). To effectively curb the profit shifting to other jurisdictions, South Africa implemented broader transfer pricing provisions, which came into effect on 19 July 1995 (Olivier & Honiball, 2011:621).

The transfer pricing provisions were subsequently amended with an overhaul of section 31 of the IT Act which came into effect on 1 October 2011 (Olivier & Honiball, 2011:621). The main reason provided for this change was to make the transfer pricing provisions aligned with the OECD Guidelines (Honiball & Delahaye, 2013:16). The provision of section 31 of the IT Act effectively broadened the scope and application of the legislation with the intention to include both direct and indirect cross-border transactions in the transfer pricing net (Olivier & Honiball, 2011). The provision also adjusted the focal point of the section from separate transactions to an entity-based approach (Honiball & Delahaye, 2013:17).

2.6.1 Developments of transfer pricing legislation in South Africa

South Africa is regarded amongst the first countries to accept and adopt specific transfer pricing provisions in Africa, as early as 1995 (Blumenthal, 2017:16). The first transfer pricing legislation of 1995 was updated to be in line with international standards as recommended by the OECD (Blumenthal, 2017:17). The earlier transfer pricing legislation provided SARS with discretionary power to adjust the price paid or received if a transaction was not considered to be at arm's length

(Blumenthal, 2017:17). Even though South Africa initially implemented transfer pricing legislation in 1995, SARS began to focus on transfer pricing issues in recent years (Blumenthal, 2017:17). South Africa began to incorporate into its transfer pricing legislation some transfer pricing provisions followed in Australia and New Zealand, which are both OECD member countries (Blumenthal, 2017:17).

Prior to the revision of section 31 of the IT Act, transfer pricing was regulated through compliance with Article 9 of the OECD MTC. Profits on cross-border transactions were either adjusted in terms of the general deduction formula in section 11(a) of the IT Act and if expenditure was grossly excessive, the adjustment was made in terms of the old section 103(1) general anti-avoidance provisions of the IT Act (Dean, 2014:41).

The then Minister of Finance, in his Budget Speech in 2012 made a pronouncement with regards to transfer pricing legislation which led to amendments in South Africa's transfer pricing regulations as contained in section 31 the IT Act (Sweidan, 2015).

SARS had issued a PN7 in 1999 that provides guidance to taxpayers regarding transfer pricing. The guidelines in PN7 reflect the OECD guidelines on documentation (Blumenthal, 2017:17). The guidelines in the PN7 are for interpretation and guidance purposes and are not legally binding, which is one of the weaknesses in South Africa's transfer pricing regime (Blumenthal, 2017:17).

South Africa's transfer pricing rules are based on the OECD's arm's length standard (Miller *et al.*, 2018:1). One of the recent main developments regarding the transfer pricing legislation is that South Africa adopted certain of the minimum standards proposed under the OECD's BEPS recommendations. Section 29 of the Tax Administration Act, No. 28 of 2011 (TAA) has been extended to include document retention requirements for transfer pricing (Miller *et al.*, 2018:1).

The transfer pricing documentation requirements apply to taxpayers that have aggregated connected party transactions with a value of R100 million or more (Miller *et al.*, 2018:1). The CbCR must be completed by parent companies of groups that have a consolidated turnover of R10 billion or more. SARS extended administration penalties under section 210 of the TAA for non-compliance relating to submission of the CbCR, master and local files (Miller *et al.*, 2018:1).

South Africa established a committee and appointed members to analyse and consider, from a South African perspective, the BEPS 15 Action Plans as recommended by the OECD, which led to the publication of a series of reports by SARS and the Davis Tax Committee (Blumenthal, 2017:17).

The UN and OECD has addressed the challenges faced by both developed and developing countries regarding transfer pricing (Blumenthal, 2017:18). Though South Africa is not a member of the OECD some South African officials were involved in the work of the organisation that developed the OECD Guidelines on transfer pricing and BEPS as well as the development of the UN work on transfer pricing (Blumenthal, 2017:17).

2.6.2 South African transfer pricing legislation weaknesses

In its first Interim Report, the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa (The Katz Commission) highlighted the fact that the country lacked adequate protection against the abuse and manipulation of transfer prices (Lord, 2014:9). The Katz Commission noted that the South African tax system needed legislative teeth to protect itself against excessive transfer pricing manipulation between related parties (Lord, 2014:9).

Though the South African transfer pricing legislation has been updated since then, there are still some weaknesses in the legislation that need to be addressed such as the lack of focus on the taxation of non-residents (Hattingh, 2015:24).

Hattingh (2015:24) highlights some of the weaknesses and potential areas for development regarding South Africa's transfer pricing legislation as follows:

- SARS has limited resources and capacity to conduct transfer pricing audits.
- SARS relies strongly on the use of alternative dispute resolutions (ADR) to resolve transfer pricing issues instead of litigation, which result in a greater degree of uncertainty.
- The APA programme has not been implemented in South Africa which could encourage compliance and ease global trade and attract foreign direct investment.
- Limited guidance on interactions with double tax agreements.
- It is still unclear as to whether transfer pricing documentation should be mandatorily or voluntarily disclosed by the taxpayers.

In the Finance Minister's 2016 Budget Speech, it was highlighted that the areas that would receive special attention would be on the practice of manipulated transfer pricing, treaty shopping and highly geared financing structures. The areas noted in the Budget Speech to receive specific attention echoed the increased international focus on transfer pricing (Blumenthal, 2017:17).

2.7. CONCLUSION

Based on the discussion in earlier sections of this chapter, it is accepted that the concept of transfer pricing has been in existence for over a century and that globalisation and internationalisation have

accelerated the transfer pricing problems.

The importance of MNEs for economic development is not disputed, more especially for developing countries. However, the practise of transfer pricing manipulation by MNEs has disadvantaged other countries and resulted in the need for organisations that provide guidance regarding international tax on a global scale.

The establishment of the OECD has been impactful by setting an international transfer pricing standard. The OECD has developed guidelines to assist its members to curb the issue of transfer mispricing. Some non-OECD member countries have also adopted the recommendations of the OECD to improve their international tax legislation.

South Africa has also followed suit by adopting and implementing OECD guidelines into its legislation. Some of the updates in South African legislation are in line with the OECD recommendations. This proves that South Africa recognises and acknowledges the work of the OECD. Thus, it can be concluded that South Africa could therefore also consider implementing the use of APAs as recommended by the OECD.

The research objective was therefore successfully addressed in this chapter by considering the background and development of the problems that gave rise to the transfer pricing issue and the role of the OECD as a major force of influence on this topic.

The implementation of APAs could possibly lead to some benefits for both South Africa and MNEs. However, of implementing the APA programme might be a challenge due to the issue of inadequate resources and skills required for the APA processes.

In the following chapter the concept of APAs is therefore discussed in detail, and the different types of APAs and the APA process at large is considered. The benefits and shortcomings of using APAs are also considered.

CHAPTER 3

THE CONCEPT OF AN APA, THE NATURE AND FUNCTIONALITY OF THE DIFFERENT TYPES OF APAS

3.1 INTRODUCTION

In this chapter, the concept of an APA is defined. Furthermore, the different typical structures and functionality of different types of APAs are considered to address the secondary research objective as identified in section 1.4.2(ii) of this study. The APA process, together with the advantages and disadvantages using APAs are discussed in detail to establish whether the South African transfer pricing legislation needs improvement through the implementation of APAs.

In the preceding chapters, it was mentioned that MNEs play a crucial role in economic growth in countries around the world, more so when they invest in developing countries such as South Africa. This is because developing countries need foreign direct investment to grow their economies and address the issue of poverty (SARS, 2020:4).

However, the increase in MNEs has led to increased transfer pricing risk, as most tax authorities fear that MNEs may move their profits from a higher tax jurisdiction to a lower tax jurisdiction. To curb this increased profit shifting and reduction of tax liabilities, tax authorities are focusing on transfer pricing by initiating tax audits to verify whether cross-border transactions within the MNE group are at arm's length, or at least complies with the relevant legislative provisions (Loana, 2017:1; Borkowski, 2008:2). This significantly increases uncertainty for MNEs (Avoseh, 2014:29).

In a case where the arm's length price simply does not exist or tax authorities do not agree with the MNEs pricing arrangements and policies (PWC, 2021), MNEs are often faced with the uncertainty as they may not know whether the legislative requirements have been fully complied with (Sadiq, 2007:2). This often occurs where the MNE is dealing with goods or services that are unique in nature and no active market is available in a country where the transaction takes place (Sadiq, 2007:2).

Tax audits conducted by tax authorities to verify the transfer pricing may result in transfer pricing adjustments and penalties, which may lead to double taxation and tax disputes (Loana, 2017:1).

De Waegenaere *et al.* (2007:2) defines double taxation as a situation that arises when different countries use different transfer pricing legislation and methods to determine the arm's length price and allocate income between countries.

A tax dispute can be defined as an event or situation that is caused by differences in interpretation, understanding and application of the tax legislation and the calculation of tax payable thereof between the taxpayers and tax authorities (Oktaviani & Tambunan, 2020:2).

According to Nielsen (2015:3), transfer pricing disputes between tax authorities and MNEs fall into three categories:

1. The tax authority questions the underlying assumptions used when a MNE applies a transfer pricing valuation method.
2. The tax authority questions the selection decision of certain transfer pricing valuation methods.
3. The tax authority disagrees with the MNEs representation of the value chain within the group.

To avoid tax disputes between MNEs and tax authorities, transactional transfer pricing documents are prepared by the taxpayer for the tax authority to review. In such documents, the MNE is required to convince the tax authority that the transfer pricing method they used meets the requirements of the tax legislation and the principle of arm's length (Oktaviani & Tambunan, 2020:2).

Even though the transfer pricing documents are prepared and submitted to the tax authority for review, they do not reduce the possibility of future tax audits and could result in tax disputes. Transfer pricing disputes generally do not have a single 'right' solution and the most acceptable results in such cases are usually achieved through negotiations between the involved parties (Ado, 2015:28).

Ado (2015:28) continues to argue that due to uncertainties in such disputes, and the need for a compromise between the parties during the negotiations, a framework is required to motivate a principled approach that promotes transparency and consistency. The framework that meets these features is the APAs (Loana, 2017:1). Sadiq (2007:2) also argues that to mitigate the legislative uncertainty brought by transfer pricing, countries should adopt the APA programme as a procedural mechanism. The adoption of the APA programme as an administrative response to the international tax disputes is generally perceived as a positive step towards solving the transfer pricing issue of determining an arm's length price (Sadiq, 2007:2; Tache & Luca, 2021:9).

Oktaviani and Tambunan (2020:3) note that there are several options that can be used by governments to minimize the incidence of transfer pricing disputes with the implementation of APAs being considered as a widely used and effective approach.

A 2013 survey revealed that the level of satisfaction with the use of APAs as a process of managing and mitigating transfer pricing disputes was found to be high, with 79% of the respondents recording their satisfaction (Ado, 2015:28). The results of the survey have been confirmed by the OECD which mentions that APAs have been increasingly used and are an effective way of solving transfer pricing disputes (Ado, 2015:28).

APAs provide a measure of certainty to MNEs as they act as a tool that proactively reduces transfer pricing exposure. The APA programme decreases the risk of a transfer pricing audit and reduces the significance of penalties associated with audit (Borkowski & Gaffney, 2014:8).

3.1.1 The concept of an APA

It is believed that the official use of APAs began in 1985 when the Japanese National Tax Agency negotiated its first APA which was instituted in 1987 (Avoseh, 2014:42; Borkowski & Gaffney, 2014:8; Alm & Ehrstedt, 2011:4). Japan was followed by the USA which began to institute its formal APA programme in 1991 (Avoseh, 2014:42), with Australia instituting an informal programme in 1991 as well as concluded a formal programme in 1995 and Canada starting its own APA programme in 1994 (Borkowski & Gaffney, 2014:8).

Following the APA programmes instituted in Japan, the USA, Australia and Canada, the OECD introduced the idea of APAs in its 1995 Transfer Pricing Guidelines, covering two sections (Avoseh, 2014:42): administrative approaches to APAs; and, the conduct of APAs under Mutual Agreement Procedures (MAP) as set out under article 25 of the OECD model.

The introduction and institution of an APA should “ensure the proper and smooth enforcement of transfer pricing legislation by giving administrative confirmation as to the most rational methods of calculating the arm’s length prices for entities” (Borkowski & Gaffney, 2014:8).

However, it must be noted that an APA does not assure the MNE that it will not be audited for other aspects of its transfer pricing activities as the APA only assures that the application of the agreed upon transfer pricing method does not trigger an audit (Avoseh, 2014:42; Borkowski, 2008:3).

According to Eden and Byrnes (2018:1), an APA is defined as “a formal arrangement between a tax authority and the MNE in which the parties jointly agree on the MNE’s transfer pricing methodology, estimated taxable income, and tax payments for a fixed period in order to reduce the possibility of the income tax dispute”. Stated differently, an “APA is an administrative approach to prevent transfer

pricing disputes by selecting criteria to use the arm's length principle before the transaction occurs" (Oktaviani & Tambunan, 2020:3).

According to Loana (2017:2), APAs allow an entity to set up transfer prices charged between related entities in a cross-border transaction in advance before the controlled transaction occurs. The main scope of an APA is the establishment of the transfer pricing methodology for the prices that can be charged within a related party cross-border transaction (Nielsen, 2015:3). An APA allows the tax authorities and the MNE to reach an agreement regarding the price setting with one or more relevant tax authorities for a specified time (Alm & Ehrstedt, 2011:42; Borkowski, 2008:2).

An APA is a dispute resolution technique that is aimed at preventing transfer pricing disputes before the transaction occurs. While traditional audit techniques deal with transactions after investment is sunk, APAs determine criteria for applying the arm's length principle to transactions in advance of the transactions taking place (Kerschner & Stiasny, 2013:1).

The APA is also different from the classic tax ruling procedure instituted by tax authorities because it requires a detailed review, negotiations and to a certain extent, the verification of the assumptions on which the determination of legal consequences are based. Further, the APA provides for continual monitoring of whether factual assumptions remain valid throughout the course of the APA period (OECD, 1999:2).

As opposed to other transfer pricing dispute resolution and management mechanisms, APAs represent a cooperative approach where the MNEs and the tax authorities negotiate and jointly agree, prospectively or retroactively on an acceptable transfer pricing methodology to govern the covered transaction over a fixed period (Ado, 2015:28; Alm & Ehrstedt, 2011:42).

When an APA has been entered, it becomes operative for specified periods and stay in force as set out in the arrangement. To negotiate an APA and reach an agreement can take a considerable long of time and this may result in a situation where some of the years intended to cover in the agreement to pass and the taxpayer may have already submitted their tax returns for those years (OECD Secretariat, 2012:11).

To resolve transfer pricing issues that arose in earlier years, some parties involved may agree that terms may be applied retroactively (roll-back) to address outstanding transfer-pricing issues (Borkowski, 2008:3). However, in bilateral or multilateral cases (discussed in section 3.2), the ability to do so depends on the willingness and the ability of the tax authority of the other country or countries involved (OECD Secretariat, 2012:11).

When an APA has been entered into regarding a cross-border transaction, the arm's length price for such a transaction for the specified period is determined using the APA (Prabhakar, 2020:1). In most countries that have introduced the use of APAs, APAs typically run for a minimum of three years with a maximum of five years or more, with the possibility of renewal and rollback (PWC, 2021) and with the intention to provide maximum certainty with respect to transfer pricing for the following fiscal years (Grant Thornton, 2021).

An APA could be used as a strategic tool to optimise tax compliance, reduce double taxation and maximise global profits for MNEs, which in turn results in fewer material transfer pricing audits (Borkowski & Gaffney, 2014:5).

It must be noted that one critical aspect of an APA agreement is that it commits to a methodology, that is, a set of circumstance-contingent prices or a range of prices, not necessarily to a specific price (Becker *et al.*, 2016:3).

It is noted that APAs have been in existence for many years. APAs are considered as proactive tax dispute resolution mechanisms. As such, APAs provide certainty as the parties agree about the arm's length price in advance of the transaction. It is also noted that the as early as mid-nineties, the OECD also contributed to the development of APAs with the objective of reducing the transfer pricing issue of determining the arm's length price for controlled transactions.

3.1.2. Objectives of an APA

To reduce the transfer pricing problems, MNEs have the burdensome process of compiling transfer pricing documents while tax authorities undertake the review process which does not eliminate the uncertainty of a tax adjustment after an audit (Avoseh, 2014:36). The introduction of APAs may be used as a substitute to the conventional review process and to resolve any potential transfer pricing differences in advance of the transaction in an ethical and accommodating manner (Avoseh, 2014:36).

The purpose of APAs is to provide some certainty about the MNE's future tax obligations on cross-border transaction (OECD Secretariat, 2012:3). Thus, preventing transfer pricing tax disputes between the MNE and the tax authority by determining in advance the range of the MNE's transfer prices and taxable income (Eden & Byrnes, 2018:2). An APA is a neutral tax procedure that improves the process of determining the MNE's taxable income within and between tax jurisdictions (Eden & Byrnes, 2018:2).

Prabhakar (2020:1) lists some of the cross-border transactions which APAs can be applied for:

- To sell or purchase raw materials and finished goods.
- To provide services within the MNE group.
- To provide financial assistance.
- To transfer and use tangible or intangible assets.

A key objective of an APA is to eliminate the potential of tax audit and double taxation on intra-group transactions. Thus, the use of APAs is intended to supplement the traditional administrative, judicial and treaty mechanisms for resolving transfer pricing issues (Avoseh, 2014:37). Some of the main objectives of the APA are (Avoseh, 2014:37):

- to facilitate principled, practical and co-operative negotiations;
- to expedite the resolution of transfer pricing issues prospectively;
- to provide for the use of resources of both MNE and the tax authority more efficiently; and,
- to provide a measure of predictability of the taxpayer's tax liability.

In addition to the above, APAs are used as a mechanism to avoid conflicts in the control of international transactions. APAs should be legally based on various provisions of the domestic legislation of the respective countries involved to avoid double taxation and fight tax evasion (Hernández, 2013:1).

The taxpayer initiates the APA process, and participation is purely voluntary (Nielsen, 2015:1). Thus, the taxpayer is directly involved in setting the most appropriate pricing structures and the APA provides the opportunity to resolve past issues through rollback (Kerschner & Stiastry, 2013:3).

In other literature, the APAs are described and interpreted as a kind of insurance undertaken by MNEs against future shocks in the tax treatment of controlled transactions. This opinion is motivated by the assumption that MNEs are risk averse and have a desire to be insured to reduce the uncertainty in their tax matters (Becker *et al.*, 2016:2). APAs serve as proactive administrative tools that assist MNEs and tax authorities in avoiding transfer pricing disputes in the future (SARS, 2020:6). Therefore, all the stakeholders in an APA win (Beebeejaun, 2018:11).

The purpose of the APA is therefore to facilitate the determination of the arm's length price for a cross-border transaction. The main objectives of an APA are to provide certainty and reduce the need for tax audits on transfer pricing mechanisms adopted by taxpayers. However, different objectives may be achieved with APAs depending on the type of an APA entered. The different types of APAs are discussed in section 3.2.

3.2 TYPES AND FUNCTIONALITY OF APAS

Depending on the number of parties participating in the negotiations, an APA can be unilateral, bilateral or even multilateral (Avoseh, 2014:38; Oktaviani & Tambunan, 2020:3). When applying for an APA, the MNE must motivate the elected transfer pricing method and submit all necessary and relevant information on the specific intra-group transactions to all involved tax authorities (Becker *et al.*, 2016:3).

It has been noted that both bilateral and multilateral agreements are mostly negotiated with tax authorities that have existing tax treaties. Thus, these APAs are considered as an effective proactive measure, that is, a primary mechanism of ending the international tax dispute before it arises (Avoseh, 2014:38). Bilateral and multilateral APAs also decrease the risk of double taxation and are therefore, the most preferred agreements (Alm & Ehrstedt, 2011:42). Each APA type is discussed in detail in the following subsections.

3.2.1 Unilateral APA

The unilateral APA is an arrangement where the taxpayer and tax authority within that authority's jurisdiction institute an APA arrangement which does not involve the participation of tax authorities in other countries (Avoseh, 2014:39; OECD Secretariat, 2012:10).

In a case where the unilateral APA is entered, the tax liability of the involved MNE in another tax jurisdiction may be adversely affected. This is because there are possibilities of double taxation as the other country may not agree with the transfer pricing adopted in the APA (Avoseh, 2014:39; Brychta & Sulik-Górecka, 2019:3). Unilateral APAs do not involve a mutual agreement negotiation. The unilateral APA entered specifies a transfer pricing approach acceptable to the specific tax authority only and does not address the acceptability of the transfer pricing approach to other tax authorities (OECD 1999:3).

Nevertheless, while negotiating the APA, the competent authorities of the other affected tax jurisdictions are normally notified about the agreement under the exchange of information provisions of any treaty between the countries so that a bilateral APA may be considered (Avoseh, 2014:39; OECD Secretariat, 2012:10).

Due to the potential of double taxation because of the absence of the tax authority of the other affected country during the negotiations of the APA, the unilateral APA is the least preferred and recommended among the types of APAs (Oktaviani & Tambunan, 2020:3).

Compared to other APA types, the unilateral APA is relatively cheaper to negotiate in terms of resources and time. However, its main shortcoming is its inability to prevent double taxation between two competing tax authorities where there is no co-operation in accommodating the transfer pricing adjustment by the other taxing jurisdiction (Ado, 2015:30; Kerschner & Stiasny, 2013:3).

MNEs may be exposed to even more audits and stricter conditions by other tax jurisdictions not involved in the APA. To avoid such inconvenience, the OECD Guidelines prefers and recommends the use of bilateral or multilateral APAs (Ado, 2015:30).

Despite the shortcomings above, the unilateral APA may not be completely disregarded as it may still be useful especially in a situation where a cost-benefit analysis would still support the idea of a unilateral APA or the jurisdiction of the countries involved in the transfer pricing transaction do not have a tax treaty in place (Ado, 2015:30).

Furthermore, in cases where the uncertainty regarding the transaction is concentrated on one side or the other country involved in the transaction is not willing to enter an APA, a unilateral APA may be helpful (Kerschner & Stiasny, 2013:3).

3.2.2 Bilateral APA

A bilateral APA is defined as an agreement between the MNE group and only two tax authorities affected by the transaction. In this situation, the involved countries agree on the pricing methodology to be used in the cross-border transaction (Avoseh, 2014:38). A bilateral APA is intended to address the transfer pricing issues of a specific transaction from the perspective of both tax authorities involved (OECD Secretariat, 2012:10).

Therefore, a bilateral APA provides a guarantee to the MNE group that the method used in the transfer pricing transaction is accepted by both tax authorities. In turn, it gives assurance of a reduced double taxation risk and provides greater certainty to the MNE concerned (Avoseh, 2014:38). According to the OECD Secretariat (2012:3), bilateral or multilateral APAs give protection against economic double taxation, and they should be considered from an investment climate perspective.

The important feature of a bilateral APA is that both countries discuss and attempt to agree on terms of the transactions. Such discussions would take place under the MAP of the treaty between the two involved countries (OECD Secretariat, 2012:10). Such mutual agreement is negotiated between the competent authorities of the two tax jurisdictions under the relevant treaty (OECD 1999:3). The competent authority concludes the APA in a situation where the domestic provisions in such a

country do not permit the tax authority to enter into binding agreements directly with the taxpayer (Avoseh, 2014:38).

The bilateral APA is mostly used when the income of the MNE is subject to double taxation because of disagreements over the transfer price by tax authorities. Thus, the bilateral APAs are designed to prevent double taxation while reducing expected compliance costs (De Waegenaere *et al.*, 2007:4).

In the case of uncertainty caused by the implementation of BEPS measures, the use of a bilateral APA may be an effective tool to reduce such uncertainty. This is because the APA process provides the taxpayer with an opportunity to take a proactive step in presenting a complex transaction or issue to the relevant tax authorities with a view of minimising the adverse effects of BEPS (Osborn & Khripounova, 2016:5).

It must be noted that where the tax rates of two countries are similar, the bilateral APA is less beneficial. This is because when the tax rates are similar, the taxpayer is not motivated to shift taxable income to another country with a similar tax rate (De Waegenaere *et al.*, 2007:4).

The implementation of the bilateral APA is considered as a dispute resolution mechanism as it allows for a 'roll-back' as it is possible to solve the transfer pricing issues of the previous years before the conclusion of the APA (Oktaviani & Tambunan, 2020:5).

However, even though a bilateral APA is considered effective and efficient, its application is not cheap, and takes time, with an average processing time of between two and three years (Grant Thornton, 2021).

In SARS' (2020:7) discussion paper regarding the implementation of APAs, it is stated that the October 2018 Deloitte report, 'Indian Advance Pricing Agreement Programme Evaluation and Way Forward', revealed that the median time to conclude bilateral APAs around the world are as follows:

- Canada – 49 months
- USA – 42 months
- India – 42 months
- Japan – 29 months
- the UK – 26 months
- Australia – 20 months

The bilateral APA is a more effective and efficient agreement compared to the unilateral APA. The bilateral APA mitigates the risks created by the unilateral APA of possible double taxation risk. However, this type of APAs takes longer to conclude and is more expensive.

3.2.3 Multilateral APA

The multilateral APA is an agreement that involves more than two countries. In fact, it has the same effect as a bilateral APA. Thus, multilateral APA occurs where there is more than one bilateral mutual agreement (OECD, 1999:3).

Given that multilateral refers to more than one bilateral mutual agreement, concluding such APA takes significantly longer than the bilateral APA (Grant Thornton, 2021). In addition to unilateral APAs, tax authorities may enter bilateral or multilateral APAs only if treaties are in place between the involved countries (OECD Secretariat, 2012:10).

The APA process to conclude the APA is the same. The differences in the types of APAs is seen in the time it takes to conclude the agreement, the costs and the benefits from the use of such APA.

It appears that there are advantages to the implementation of an APA but there are associated costs attached to the conclusion of the APA. Therefore, for South Africa to implement the use of APAs, it is important to discuss the possible benefits of an APA. The benefits of an APA are therefore considered in section 3.3.

3.3 BENEFITS OF AN APA

When a tax authority conducts an audit, the intention is often to review all the material intra-group transactions with the hope of correcting the identified problems in transfer pricing. Thus, an audit imposes a significant burden on the MNE due to the large volumes of information required that lead to prolonged audits (Kerschner & Stiasny, 2013:2). Whereas the use of the APAs does not only simplify the MNEs situation, but also allows tax authorities to redeploy audit resources to other compliance matters (Kerschner & Stiasny, 2013:2).

Kerschner and Stiasny (2013:2) also argue that as public perceptions in the global market have significantly increased attention regarding how 'moral' an entity is, APAs have been a driving force for corporate governance. The APAs improves good governance for MNEs in the space of tax administration as the tax compliance signals the MNEs' willingness to comply with tax laws and to voluntarily meet its tax obligations.

The APA process deals with real time issues and resolves tax disputes. For those reasons, it is considered highly beneficial to both the MNE and the tax authority (Avoseh, 2014:39). Taxpayers and tax authorities who participated in APA programmes made many positive declarations about the benefits of APAs (Avoseh, 2014:39).

This is supported by the surveys that sought to find opinions about APAs where it was found that 80% of the participants highlighted the tax treatment certainty as a primary benefit of APAs. The tax certainty is coupled by other benefits such as the avoidance of double taxation, reduced risk of an audit after investment is sunk, reduction of compliance costs and increased ease of tax planning (Borkowski & Gaffney, 2014:8).

According to SARS (2020:5), the implementation of APAs programme could increase the foreign direct investment in Africa.

Overall, the use of the APAs is more beneficial than the normal procedure of conducting an audit after investment is sunk. The APAs are beneficial for both MNEs and tax authorities because taxpayers can focus on their main business operations while tax authorities can reallocate their resources to other compliance matters. These benefits for both the MNEs and the tax authority are considered in sections 3.3.1 and 3.3.1 respectively.

3.3.1 Benefits to the taxpayer

According to studies conducted on APAs, there are several benefits identified for taxpayers when they enter an APA (Avoseh, 2014:40). Usually, the use of APAs by MNEs provide tax certainty before engaging in the cross-border transactions. In addition, the use of APAs mitigates conflict between tax authorities (except in the case of unilateral APA) as the taxpayer is assured of a tax treatment that is uniformly accepted by all the taxing authorities (Ring, 2000:6).

APAs can also create an opportunity for MNEs to dedicate their resources on their bottom-line activities, lower the MNE group's overall effective tax rate and reduce uncertainty. The benefits also include the reduction of time required to negotiate MAPs and required to prepare and maintain transfer pricing documentation (Borkowski & Gaffney, 2014:8).

APAs also reduce the risk of a transfer pricing audit (including for prior periods in the case of roll-back mechanisms being applied), tax adjustments and penalties by the tax authorities. The APA process creates a good working relationship between the MNE and the tax authority during the negotiations for the appropriate transfer pricing method (Oktaviani & Tambunan, 2020:3).

Additional benefits that motivate MNEs to seek an APA are listed as follows (Avoseh (2014:40):

- Elimination of transfer pricing uncertainties’;
- Elimination of financial reporting uncertainties;
- Prevention of transfer pricing examinations;
- Simplicity and acceptance of transfer pricing method;
- APA negotiations are relative quicker than an audit;
- Saves time and costs;
- Strategy for reducing transfer pricing audit;
- Creates a conducive environment between the MNE and tax authority;
- Rehabilitation of the MNE’s relationship with the tax authority;
- Ability to extend the APA; and,
- MNE’s involvement in competent authority negotiations.

3.3.2 Benefits to the tax authority

Upon the conclusion of an APA agreement, the tax authority would have already acquired as much information as possible from the taxpayer (Avoseh, 2014:40). This is because the APA process enables the tax authority to gain information voluntarily from the taxpayer regarding the international transactions (Oktaviani & Tambunan, 2020:3). As such, limited resources are required by the tax authority for any subsequent review of the taxpayer’s return (Avoseh, 2014:40).

Avoseh (2014:41) notes that tax authorities may gain more benefits from the APAs as a result of accommodating manner under which APAs are negotiated. The APA process helps tax authorities to gain more insight about complex MNE international transactions and thus improve awareness of such transactions.

This presents an opportunity for governments to gain information about the international pricing practices and insights into specific international transaction issues while obtaining a deemed ‘compliance lock in’ for several years. Thus, there is no need for monitoring and review of the transfer pricing risk in the immediate future (Kerschner & Stiasny, 2013:2). In addition, the tax authority gets to interact with competent authorities of other countries in setting more comprehensive resolutions of transfer pricing issues (Ring, 2000:7).

An APA programme provides an opportunity for tax authorities to be efficient as the work that would have had to be conducted through the audit process is done during the APA negotiation process. Therefore, transfer pricing audit resources saved through the APA process can be used in other departments. For example, the tax authority can divert some of the transfer pricing professionals and

other important personnel members in the legal and compliance divisions to other complex tax matters. Therefore, the use of APAs positively impacts the amount of resources allocated to tax compliance (Avoseh, 2014:41).

An APA programme also provides less costly dispute resolution mechanisms and enhances the quality of information gathered for future improvements on international tax related transactions (Ring, 2000:7). Oktaviani and Tambunan (2020:3) further argue that an APA guarantees the tax authorities that their governments receive a fair profit from the transactions of MNEs operating within their jurisdictions.

It can be concluded that the use of APAs provides benefits for both MNEs and tax authorities. As MNEs want to be perceived as good corporate citizens in the country they operate in, the use of APAs may motivate these entities to be transparent about their international transactions. On the other hand, the tax authority is guaranteed to receive a fair portion of the profits from the transactions of the MNE and they can reallocate their scarce administrative resources to other tax matters.

3.4 IMPORTANT FEATURES OF THE APA PROGRAMME

The primary goal of APAs is to provide tax certainty to taxpayers on the determination of transfer pricing method and tax treatment of their cross-border transactions and to curb the profit-shifting practices by MNEs. An APA is often regarded as an alternative to tax audits and dispute resolution (OECD Secretariat, 2012:4). If a country has the capacity and resources to conduct an effective audit and has mechanisms for dispute resolution, the possibility of dedicating scarce resources to APAs is unlikely to yield any results (OECD Secretariat, 2012:4).

The APA negotiations need to be conducted by the transfer pricing experts and as such, there are many considerations with respect to the efficient use of tax authority resources (OECD Secretariat, 2012:4). Thus, when employing resources on an APA, there are reduced resources available for other compliance activities such as verification and audit. As such, governments always face the need to allocate resources and to find a balance between an APA programme and auditing activities (OECD Secretariat, 2012:4).

The scarcity of resources forces tax administrations to introduce a clear criterion to follow when planning to accept or reject APA applications (OECD Secretariat, 2012:5). This criteria allows the tax authority to have some control over the APA application programme and assist in allocation of its scarce specialist resources to engage only in complex international tax transactions that meet the requirements or where there is uncertainty over the application of the most appropriate transfer

pricing method. Such requirements may be included in the APA legislation or interpretation notes for guidance purposes (OECD Secretariat, 2012:5).

Khan (2019:17) discussed other important features of the APA programme that should be considered by both the tax administrators and taxpayers as follows:

- The application of an APA is costly and time consuming.
- The APA programme requires a technically skilled team that should act in an impartial and independent manner.
- The focus of the team during the APA application process should be to avoid double taxation issues instead of revenue maximisation.
- The application of an APA should be accessible to every taxpayer regardless of the size or industry by making the regulations and interpretation notes easily accessible, informative, clear and fair.
- Even though each jurisdiction has their specific requirements for APAs, those requirements must be in line with each of the applicants' domestic laws.
- There are steps in the APA process, from preliminary discussion until the conclusion of the agreement.

The APA is not a way to increase tax revenue for tax authorities. However, it is a tax dispute resolution approach between MNEs and tax authorities. It creates certainty and enhances the relationship between the MNEs and the tax authority.

Countries that have implemented APAs follow a certain process, depending on their legislation, to enter into the agreement. If and when SARS decides to implement the APAs, the APA process may be considered and adopted. Section 3.5 presents the commonly followed APA process by most countries that implemented the use of APAs.

3.5 THE APA PROCESS

The usual tax process follows a sequence such as the filing of the tax return, receipt of the assessment, dealing with the audit, and possibly disputing the additional assessment via an appeal or court process. Unlike the traditional way of declaring the transaction to the tax authorities, the APA process provides an alternative path of declaring cross-border transactions by a MNE group (Ring, 2000:6).

Each country has its own regulations and processes to follow when the taxpayer requires an APA. In most countries, the APA process is formally initiated by the taxpayer through approaching the tax

authority with a proposed APA (Avoseh, 2014:3). In most cases, prior to the application process, a taxpayer may request an informal pre-filing conference with the tax administrator to discuss the appropriateness of a proposed APA (Nielsen, 2015:3).

The APA proposal would provide details about the transaction and describe the transfer pricing method for such an intra-group transaction, along with supporting data (Nielsen, 2015:3). The APA process provides the tax authority with an opportunity to approve the transfer pricing methodology for intra-group transactions in advance for the duration of the agreed period and with the possibility of further extension (Tache & Luca, 2021:10).

In the proposal, the taxpayer should convince the tax authority that the proposed transfer pricing methodology is the best method for establishing the intra-group transaction at arm's-length price (Nielsen, 2015:3). Generally, the accepted method for determining an arm's length price for cross-border transactions is by using the available third-party comparable data (Nielsen, 2015:3).

When the tax authority receives the APA proposal, such proposal is allocated to a specialised APA team that analyses all the relevant material provided by the taxpayer in the initial request. In most cases, the tax authority requests additional supporting material from the MNE (Nielsen, 2015:4). However, it must be noted that the taxpayer's contribution is very important during an APA process. The taxpayer should not only provide requested comprehensive material but should also actively contribute to create a risk and functional analysis for the transaction (Kerschner & Stiasny, 2013:1).

Generally, an APA process includes the following steps (Khan, 2019:17):

- APA strategy and transfer pricing analysis;
- Pre-filing conference;
- Formal APA request;
- Evaluation and negotiation;
- Administration;
- Nullifying and revoking APAs and levy of penalties; and,
- Revising and renewing APAs.

Each step mentioned above is discussed in detail to give a better understanding of a comprehensive APA process.

3.5.1 APA strategy and transfer pricing analysis

This step involves a detailed analysis of the transfer pricing documentation provided by the taxpayer. The analysis performed for an APA is generally to understand the taxpayer's business, the international transaction and transfer pricing methodology proposed (Khan, 2019:17).

3.5.2 Pre-filing conference

Prior to filing a formal APA request, a taxpayer should request a pre-filing conference with the relevant tax authority to present all the relevant facts about the transaction and to also discuss, informally, the appropriateness of the APA proposal (Nielsen, 2015:3). The pre-filing also provides an opportunity for the taxpayer to explore the suitability and relevance of an APA and determine the amount of material that may be requested by the tax authority (Khan, 2019:18).

3.5.3 Formal APA request

The information obtained from a successful pre-filing conference usually provides the taxpayer with an understanding of the tax authority's views about the proposal. Further, the taxpayer gets to clarify any uncertain matters that need to be cleared before the formal APA request. The taxpayer begins to draft the formal APA request after considering all the information gathered during the pre-filing conference and submits this to the tax authority (Khan, 2019:19).

Upon receipt of the formal APA request, the tax authority reviews and considers the request and decides whether to proceed with the application. The tax authority may reject the taxpayer's request to enter an APA but may have to provide reasons for such a decision (OECD Secretariat, 2012:7).

3.5.4 Evaluation and negotiations

When the taxpayer completes the draft APA request, it is lodged with the tax authority for evaluation and analysis (Khan, 2019:19). Upon receipt of the request, the tax authority allocates an APA specialist team to analyse all the relevant material provided by the taxpayer (Nielsen, 2015:4). In most cases, the tax authority requests meetings and additional supporting material from the taxpayer before entering into the agreement (Nielsen, 2015:4; Khan, 2019:19).

During an APA application, the taxpayer and the involved tax authorities enter discussions and negotiations to reach common ground (OECD Secretariat, 2012:11). After negotiations, the taxpayer is required to provide additional information to the tax authority concerned. The completeness and accuracy of the material provided is crucial, as such information is used to determine whether the tax administrator would be interested to enter an APA and to determine the terms of the APA (OECD Secretariat, 2012:11).

During the APA negotiations, oversight and balance checks are important to mitigate the risks of corruption (OECD Secretariat, 2012:5). Also, during the negotiations some countries may be disadvantaged due to lack of knowledge, experience and skills to negotiate fair APAs, especially when faced with well-advised large MNEs. Similarly, in the case of bilateral and multilateral APAs,

countries with less experienced teams negotiating an APA may be disadvantaged when negotiating with more experienced countries (OECD Secretariat, 2012:5).

To mitigate the risks of entering an unfavourable APA, countries with less experience might consider APAs for a relatively short period, with an option to extend for a longer period if both parties agree. In the case of an unfavourable APA, the tax authorities may withdraw from the negotiations and decline an APA request (OECD Secretariat, 2012:5).

3.5.5 APA administration

Upon the finalisation of an APA and for the duration of the agreement, the taxpayer files an annual report with the relevant tax authorities under the APA (Khan, 2019:18). The purpose of the annual report is to (OECD Secretariat, 2012:7):

- (i) describe the taxpayer's business activities for the relevant period under review;
- (ii) demonstrate compliance with the terms and conditions of the agreement; and,
- (iii) confirm that the critical assumptions about the applicable transaction have been met during the period.

In addition to the annual report, the taxpayer must keep data and records to enable the tax authority to evaluate the taxpayer's compliance with the APA (Khan, 2019:18).

3.5.6 Nullifying and revoking APAs and levying of penalties

Avoseh (2014:43) states that during the term of the APA agreement, the tax authorities monitor the compliance with the terms and conditions of the agreement by the taxpayer. If it is found that the taxpayer does not comply with the terms and conditions of the agreement, the APA may be nullified and revoked.

The tax authority may also modify or revoke the arrangement from the date of failure or breach of certain conditions such as (OECD Secretariat, 2012:7):

- if the taxpayer has materially breached any of the critical assumptions;
- the assumptions cease to be valid; or,
- the country has amended or changed its tax laws or, treaty provisions that materially affect the arrangement.

In addition, where the taxpayer provided false or misleading information fraudulently or negligently during the APA application process, a penalty may be levied and the APA nullified (Avoseh, 2014:43).

In many cases, when the tax authority is considering nullifying or revoking a bilateral APA, they consult with the MNE and the competent authority of the treaty partner involved in the APA (Avoseh, 2014:43). Upon revoking the APA agreement, the taxpayer has the right to appeal against the additional assessment because of the revocation or cancellation of an APA (Avoseh, 2014:43).

This can be the case since the transfer pricing rule is deemed to apply on the transaction throughout the term of the arrangement as if no arrangement was entered. In a situation where the APA arrangement is not revoked, it may be cancelled or modified (including retrospectively) to consider the updated facts and circumstances of the transaction (OECD Secretariat, 2012:7).

3.5.7 Renewing and revising APAs

Normally, not later than six months before the end of the APA term (depending on the APA type), the taxpayer may request renewal of an APA (Avoseh, 2014:47). When submitting the renewal application, the taxpayer is expected to consider any changes or expected changes in facts and assumptions made since the beginning of the agreement and it should further demonstrate that the proposed transfer pricing methodology is still appropriate (Avoseh, 2014:47).

In some cases, such as change in market conditions, the APA agreement may be modified to align its terms in specific circumstances (Avoseh, 2014:47). This could be the case where there is a material change in the market such as the impact of Covid19 which makes the agreed transfer pricing methodology complicated to apply or third-party comparable data becomes irrelevant but does not invalidate the critical APA assumptions (Avoseh, 2014:47).

Prior to the modification of the agreement, the consent of the involved parties is required. Thus, consultations between the MNE and the competent authority of the other country in the case of bilateral agreements, should take place (Avoseh, 2014:47). In a nutshell, the APA renewal request follows the same procedures adhered to when initially applying for the APA (Khan, 2019:18).

The APA process discussed above is the same for all types of APAs. The difference could be the length of time it takes to conclude the agreement and the parties involved depending on the type of the APAs.

Like any other initiative, there are advantages and disadvantages of implementing an APA and going through its process. The advantages and disadvantages may not apply to all the parties participating in the APA programme. Sections 3.6 and 3.7 present the advantages and disadvantages to be considered by SARS before implementing the use of APAs.

3.6 ADVANTAGES OF IMPLEMENTING AN APA

Some authors have identified and described different advantages arising from the use of APAs. Tache and Luca (2021:10) and Loana (2017:3) note the following advantages from the use APAs:

- APAs are valid a long period of time, usually a minimum of three years which creates certainty for years.
- Accelerated procedures for transfer pricing analysis and determination of the arm's length price that is performed before the related party transaction takes place.
- Ensures transfer pricing certainty where tax rules are not clear so that MNEs can anticipate the tax consequences of the transactions that they enter.
- The use of APAs prevents future transfer pricing audits, tax adjustments and possible double taxation of results at group level.
- Reduced possibilities of incurring penalties for not complying with tax legislation.
- Preventing dealing with tax queries and time-consuming and costly audits which often result in transfer pricing disputes.
- Increased availability of tax authority's resources and capacity for reallocation to other compliance departments.
- The transparency when evaluating and analysing information from the taxpayer helps the tax authorities obtain a detailed understanding of complex and intricate MNE transactions.
- MNEs do not have to prepare a transfer pricing file for the transactions during the periods covered by the APA.
- It allows for high adaptability in determining reward for transactions performed within the group, such as production, distribution transactions, service provision and financing agreements.
- The period required to conclude an APA is generally short (for unilateral APAs - 12 months, respectively for bilateral or multilateral APAs - 18 months) compared to the period authorities undertake to analyse transfer pricing documentation and possible litigation.

It is assumed that MNEs are risk averse, thus one of the main advantages of APAs is the provision of certainty for all parties involved. APAs are considered as a form of insurance for MNEs (Kerschner & Stiașny, 2013:2). Kerschner and Stiașny (2013:2) further argue that even though the use of APAs can be time consuming and costly to conclude, the cost benefit analysis should be done to consider the time and costs involved in defending the audit and seeking relief from double taxation through the MAP process.

According to Ring (2000:7), the positive effects of a successful APA programme might be a generalised benefit flowing from the reduction of government administration and enforcement costs. Furthermore, the detailed knowledge gained on transfer pricing practice can be translated into learning, improved rules that all taxpayers with transfer pricing questions may benefit from.

3.7 DISADVANTAGES OF IMPLEMENTING AN APA

There are many benefits associated with an APA compared to the advantages presented by transfer pricing documentation files, but the APA disadvantages may have an impact on the business operations and thus, most taxpayers may opt to submit transfer pricing documentation files as opposed to the APA (Loana, 2017:4).

According to Oktaviani and Tambunan (2020:3), the disadvantages of APAs on the taxpayer's perspective includes sharing of confidential information about the previous years with the tax authority during the APA process before the APA is applicable.

Such practice may cause the taxpayer to be the object of tax assessment as the approval process of the APA often takes a very long time (Oktaviani & Tambunan, 2020:3). Sadiq (2007:2) mentions that in the USA, there was a court case involving the pharmaceutical giant GlaxoSmithKline and the Internal Revenue Service due to poor management of confidential information during the APA process.

Furthermore, the disclosure of sensitive confidential information issue is crucial, especially if the tax authority misuses such information obtained during the APA process to potentially open the door to further investigations (Kerschner & Stiasny, 2013:3).

In addition, requesting an APA takes a lot of time and there is no guarantee that the application will be approved by the tax authority (Oktaviani & Tambunan, 2020:3). Avoseh (2014:42) argues that the length of time it takes to conclude a bilateral or multilateral APA can create inefficiencies and significant costs. The APA programme may only be feasible for large MNEs with huge reserves since the APA process requires the expertise of an independent consultant and such expertise is normally expensive.

The period it takes to conclude an APA may also result in other MNEs losing interest in performing the transaction for which the analysis was requested, or the agreement may be obtained too late, affecting the business operations (Loana, 2017:3).

Also, the one-on-one negotiations of APAs between the taxpayer and a tax authority create a privilege for one MNE relative to domestic firms and over other MNEs (Oktaviani & Tambunan, 2020:3). Even when the APAs are favourable for all the involved parties, they may give a wrong impression to the public because negotiations take place behind closed doors and the process is restricted, with little to no information made available to the public (Oktaviani & Tambunan, 2020:3).

It must be noted that APAs were not introduced as a tax minimization strategy, but rather as tax planning tool for taxpayers (Oktaviani & Tambunan, 2020:3).

Avoseh (2014:41), Alm and Ehrstedt (2011:42) and Beebeejaun (2019:11) provide reasons why other parties may not want to participate in APAs as follows:

- Some MNEs do not get an APA because they may be too small to conclude an APA.
- For some countries, mostly developing countries, once the APA programme is established, it may not be as efficient as expected due to lack of expertise of competent authorities, making it difficult to monitor the terms of the APA.
- The drafting and conclusion of an APA is time-consuming, and it may put a strain on the transfer pricing resources of tax authorities.

3.1. CONCLUSION

Based on the discussion above, there are many benefits from the use of an APA as it achieves certainty for all parties participating in the agreement. The use of APAs can be beneficial for both the MNEs and the tax authorities by determining the arm's length price in advance and policies to avoid profit-shifting and tax disputes.

South Africa may benefit from the use of the APAs as it assists in providing certainty for MNEs that can bring investments into the country. Recommendations have been made to implement an APA programme in South Africa, even if it means the necessary skills for these highly specialised areas should be outsourced on a temporary basis.

Some countries that have similar tax legislation to South Africa such as Australia, Canada, New Zealand and the UK, have implemented APA legislation. That shows evidence of the benefits of the implementation APA and its relevance in South African legislation. Also, some BRICS countries,

Russia, India and China have APA legislation in place. There are other comparable countries in Africa that have the APA legislation in place such as Nigeria, Tanzania and Uganda.

Therefore, the following chapter discusses the APA tax legislation introduced in comparable countries to South Africa. The objective is to establish the possibility and the ability of SARS to implement APAs in South Africa.

CHAPTER 4

FOREIGN TRANSFER PRICING LEGISLATION AND THE IMPLICATIONS OF ADVANCED PRICING AGREEMENTS

4.1 INTRODUCTION

In this chapter, transfer pricing legislation of selected countries that have implemented the use of APAs is analysed. A comparison is made to establish the benefits, risks and other issues associated with the implementation of APAs and thereby addresses the secondary research objective as identified in section 1.4.2(iii) of this study. Such critical analysis is to be performed to obtain a deep understanding of the workings and the mechanisms of using the APAs as recommended by the OECD and to possibly establish South Africa's ability to implement APAs in its legislation. The transfer pricing legislation to be analysed are those of the UK, Canada and India.

It is imperative to note that all the selected comparative countries apply the arm's length method for all cross-border transactions within a MNE group. As mentioned in Chapter 3, tax authorities focus on transfer pricing by initiating tax audits to verify that the cross-border transactions within a MNE group are at arm's length, or at least complies with the relevant countries' legislation (Loana, 2017:1; Borkowski, 2008:2).

An analysis of how the selected foreign jurisdictions determine the arm's length price for cross-border transactions is discussed in the following sections. The analysis also establishes if there is consistency in the determination of the arm's length price as recommended by the OECD. It is imperative to note that in terms of section 31 of the IT Act, South Africa follows the arm's length method for cross-border transactions taking place within the MNE group.

4.2 DETERMINATION OF THE ARM'S LENGTH PRICE

4.2.1 The UK

Schedule 28AA of the Income and Corporation Taxes Act of 1988 contains the UK's transfer pricing legislation which requires the determination and the use of the arm's length price for MNE group transactions (Balkus *et al.*, 2005:29). The OECD Guidelines are incorporated in the UK tax legislation and UK prefers the traditional transaction methods instead of transactional profit methods when determining the arm's length price for cross-border transactions (EY, 2020:664). It is important to

note that the UK is a member of the OECD (OECD, 2020).

The UK tax authority, Her Majesty's Revenue and Customs (HMRC) emphasises the importance of comparability when MNEs are determining the arm's length price. The crucial comparables used in determining the arm's length price are the functions performed by the entities and the size of the entities thereof in relation to one another (Balkus *et al.*, 2005:29).

In a case where it is impossible to determine a comparable uncontrolled price (selling price between unrelated entities), the HMRC considers the 'resale price' or 'cost-plus' methods, which will depend on the facts of each case. Further, in a situation where OECD Guidelines in respect of pricing methodologies are not applicable due to insufficient reliable information being available, to establish the arm's length price, HMRC makes consider the use of 'gross profit' comparisons from applicable industry-wide data (EY, 2020:667). HMRC indicates that its objective is "...to ensure that the UK taxpayer is paying the proper UK tax on its profits under the law". To achieve this, HMRC ... will in practice use any method which seems likely to produce a satisfactory result in line with the OECD Guidelines" (EY, 2020:667).

4.2.2 Canada

In Canada, transfer pricing legislation is included under section 247 of *Canada's Income Tax Act* (CITA) which is administered by the Canadian tax authority, Canada Revenue Agency (CRA) (EY, 2020:115). It is indicated that rules and regulations are not applicable in the CITA, rather, the administrative practices are available in Information Circular 87-2R. In terms of the Information Circular 87-2R, taxpayers are required to make a reasonable effort in ensuring that controlled cross-border transactions are concluded at arm's length price (EY, 2020:115).

While no mention is made of the OECD Guidelines in Section 247 of CITA, the legislative provision is intended to reflect the arm's length principle as provided in the OECD Guidelines (EY, 2020:115). It is further stated that the CRA has also endeavoured to align its administrative guidance and approach to transfer pricing with the OECD Guidelines.

Just like in the UK, Canada is also a member-country of the OECD. Canada's legislation is not specific which method to be used in respect of cross-border transactions within the MNE group (OECD, 2017:1). Canada applies the transfer pricing methods contained in the OECD Guidelines. However, Canada's published domestic administrative guidance shows that it endorses the use of the OECD Guidelines and allows the OECD recommended methods. The CRA is of the view that the methods to determine the arm's length price have a 'natural hierarchy', with the traditional

transaction methods being the first preferred method followed by the transactional profit methods (EY, 2020:115).

Generally, in cross-border transaction, the CRA accepts the transfer pricing methods described in the OECD Guidelines, namely the comparable uncontrolled price, resale price, cost plus, transactional net margin, and profit split methods (Rolph & Kurjanowicz, 2020).

4.2.3 India

The transfer pricing legislation in India is dealt with in Chapter X of the Income Tax Act, 1961. Additional guidance, interpretation and implementation of the provisions of the Income Tax Act are contained in the Income Tax Rules, 1962 (EY, 2020:294). The Indian transfer pricing legislation is also based on the OECD Guidelines. Unlike the UK and Canada, India is not a member of the OECD. However, the OECD Guidelines have been recognised by India as providing useful guidance in applying the Indian transfer pricing rules in cases where the applied rules are not inconsistent with the income tax law (EY, 2020:294).

Furthermore, the Indian courts acknowledge the relevance and application of the OECD Guidelines for analysing and understanding Indian transfer pricing rules. However, the Indian rules take precedence over the OECD Guidelines in situations where the Indian rules specifically deviate from the OECD Guidelines (EY, 2020:294).

When India is determining the arm's length pricing, traditional transaction methods are preferred over the transactional profit methods (EY, 2020:294).

4.2.4 Conclusion

All the jurisdictions analysed have adopted the arm's length principle and apply the arm's length methods as prescribed in the OECD Guidelines. There is no prescribed hierarchy when selecting a suitable transfer pricing method, even though traditional transaction methods are preferred. It follows that the appropriate transfer pricing method to result in a more accurate and reasonable estimate of an arm's length price depends on the availability of reliable data and the extent of adjustments required to be made to ensure comparability.

When comparing the UK, Canada and India to South Africa, Schutte and Loots (2002:9) are of the view that because the South African economy is relatively small when compared with these countries, due to the lack of sufficient reliable comparable data, the application of traditional transaction methods may be difficult in practice. In such a case, South Africa may have the

transactional profit methods as the only option to apply.

Based on the analysis above, it follows that all four countries (South Africa, UK, Canada and India) are comparable as they follow the same approach as recommended by the OECD when determining the arm's length price for cross-border transactions.

To successfully address the secondary objective identified in section 1.4.2(iii) of this study, the following sections analyses the transfer pricing legislation of the UK, Canada and India in-depth, but more critically, the APA framework of the selected countries.

4.3 THE UK'S TRANSFER PRICING LEGISLATION

4.3.1 Brief background of UK's transfer pricing legislation

As an OECD member country, the UK follows the OECD's Guidelines (HMRM, 2021). The transfer pricing provisions are included in Part 4 (transfer pricing) and Part 5 (APAs) of the Taxation (International and Other Provisions) Act, 2010 (TIOPA) which was enacted in February 2010 and became effective on or after 1 April 2010 (PWC 2014b:792).

The TIOPA contains a redraft of the old transfer pricing provisions which were provided in Schedule 28AA of the *Income and Corporation Taxes Act*, 1988 and which came into effect on or after 1 July 1999 (PWC 2014b:792).

4.3.2 UK's transfer pricing provisions

The UK's transfer pricing rules are based on the arm's length method as provided for by the OECD (Casley *et al.*, 2016:3). The UK transfer pricing legislation ensures consistency with the arm's length principle in Article 9 of the OECD Model Tax Convention on Income and Capital (Cooper & Dalley, 2019). The OECD Guidelines and future amendments thereof are provided for in the UK's legislation by section 164 of the TIOPA. Section 164 states that the UK transfer pricing legislation must be interpreted and applied in such a way that is completely consistent and aligned with the OECD Guidelines (Muljee, 2017:46).

The UK's transfer pricing provisions requires that where a 'provision' is created by a transaction(s) between two related persons and that provision provide a tax benefit for either party involved in the transaction(s), 'the arm's length provision' must be substituted with 'the actual provision' (Casley *et al.*, 2016:3). This substitution results in increased taxable income or decreased tax loss of either person, meaning that the transfer pricing adjustment can only result in taxable income or be

unfavourable for the taxpayer (Casley *et al.*, 2016:3).

The UK transfer pricing legislation is broad and is intended to apply to both domestic transactions and cross-border transactions (PWC 2014b:793). In the UK law, there is no provision to make a secondary adjustment (such as deemed dividends), thus HMRC does not make any further adjustments (PWC 2014b:795).

The UK legislation has mechanisms to provide a compensating adjustment to taxpayers who are unfavourably affected by the transfer pricing adjustments (Casley *et al.*, 2016:5). In terms of section 166 of the TIOPA, there is an exemption from transfer pricing provisions which applies to a vast majority of transactions conducted by small or medium sized businesses (HMRC, 2021; Muljee, 2017:46).

When filing tax returns, UK entities are required to do self-assessment to ensure compliance with the arm's-length principle. In a circumstance where the taxpayer would have lower taxable income or higher assessed losses calculated based on the actual provision than would be if calculated based on the arm's-length provision, it is regarded as an 'advantaged person'. Such taxpayers are required to make transfer pricing adjustments when submitting their tax returns to avoid potential interest and penalties for 'carelessness' (PWC 2014b:793). The burden of proving that the determined transfer pricing is in compliance with the arm's length principle, rests with the taxpayer (Casley *et al.*, 2016:50).

4.4 THE APA PROGRAMME IN THE UK

4.4.1 Introduction

The UK introduced the APA programme into its legislation in 1999 (Leho & Price, 2019:1). The main purpose of implementing the APA programme was to assist entities in determining the most appropriate methodology to derive the arm's length price for complex transfer pricing transactions and to also prevent tax disputes arising that may otherwise result in a MAP being necessary (HMRC, 2019:1).

HMRC has found that in the UK, tax authorities and taxpayers face difficulties in selecting the appropriate method to apply when determining the arm's length principle. Thus, the implementation of APAs may result in transfer pricing issues being dealt with more efficiently in real time or as they arise rather than retrospectively, years later through audit (HMRC, 2019:2).

The transfer pricing legislation that deals with APAs is found in Part 5 of section 218 to section 230

of the TIOPA and the guidance on how to interpret the APA legislation in practice is provided for in a Statement of Practice 2/10 (SP) (HMRC, 2021; Khan, 2019:25). The SP is updated regularly to include best practices identified over time. In addition to the SP, there are HMRC manuals that provide guidance on APAs (Khan, 2019:25).

4.4.2 Background of the APA programme

Before 1999, APAs were agreed upon and granted under the MAP article of the relevant treaty (Khan, 2019:25). Within the statutory framework, HMRC introduced an APA programme in sections 85 to 87 of the *Finance Act* of 1999 with guidelines on the interpretation and application of these sections contained in a SP released in September 1999 (Avoseh, 2014:30; EY, 2020:669).

The transfer pricing legislation for the UK's APA process was previously contained in section 85 of the *Finance Act* of 1999 but has subsequently been redrafted as part of the UK's Tax Law Rewrite Project and is currently codified in sections 218 to 230 of the TIOPA. Previously, the practical guidance of APAs was available in SP 3/1999 but has now been superseded by SP 2/2010 (Avoseh, 2014:30).

The APA is considered as the only method that a UK taxpayer can agree on a transfer pricing method with HMRC (Hay & Norton, 2011:312). Before the revised SP came into effect in 2010, only unilateral APAs were available in the UK. The UK's APA legislation now provides for unilateral, bilateral and multilateral APAs (Hay & Norton, 2011:313).

4.4.3 The development of the APA programme

According to HMRC's view, the UK has historically preferred bilateral APAs, as only bilateral agreements could eliminate the risk of double taxation. This was also supported by the fact that when the APA programme started in the UK, there was a lack of domestic legislation and the UK could only make APAs under the MAP provisions with other treaty partners (Hay & Norton, 2011:313). The HMRC position has been relaxed over time and increasingly open to other types of APAs as well (Hay & Norton, 2011:314).

The APA programme is free to taxpayers in the UK. Therefore, to reduce the number of applications and workload burden, HMRC restricted entry to the programme to cases where the transfer pricing was complex. However, from the beginning of the APA programme, the HMRC lowered its 'complexity threshold' for applying for the APA (Hay & Norton, 2011:316). In terms of SP 2/2010, HMRC accepts the APA application into the programme where the transfer pricing is not complex but where the taxpayer's risk assessment would be 'high risk' without an APA or where the transfer

pricing method is highly tailored to the taxpayer's own circumstances (EY, 2020:669).

Both unilateral and bilateral APAs applications are considered, however, the HMRC encourage bilateral APAs over unilateral APAs. This is because bilateral APAs result in tax authorities of both countries affected agreeing on the selected method for dealing with the transfer pricing issues covered in the APA (EY, 2020:669).

4.4.4 The APA process

HMRC's Business International Division, which consists of dedicated teams of APA specialists that handles the APA process, is also responsible for all APA applications (Leho & Price, 2019:2). The APA specialists form part of a competent authority team which covers both APA and MAP cases (Hay & Norton, 2011:312).

MNE seeking an APA initiate the application process using the procedural guidelines set out in SP 2/2010. Entities considering an APA are required to contact the HMRC first with an 'expression of interest' to discuss their plans before submitting a formal application. In many cases, this entails the taxpayer meeting with HMRC to discuss the issues, and such preliminary discussions often take place anonymously (Leho & Price, 2019:1). Once HMRC has indicated its willingness to consider the APA, the entity may submit the formal APA application. HMRC then evaluates the application and seeks further supporting information from the entity if necessary (Leho & Price, 2019:1).

HMRC does not levy a fee for the APA application (Casley *et al.*, 2016:61). However, costs may be levied by other administrations and the HMRC may advise on this at the 'expression of interest' stage of the proceedings (Leho & Price, 2019:1).

Generally, every APA request is considered based on its merits (Khan, 2019:26). Due to the scarcity of resources available to perform work on APAs, HMRC generally only accepts and consider applications for (Casley *et al.*, 2016:60; EY, 2020:669):

- (i) more complex transfer pricing issues that impact compliance with the arm's length pricing rather than straightforward cases;
- (ii) cases where the non-existence of APA would likely to result in double taxation; and,
- (iii) cases where HMRC considers that it is good use of taxpayer and governmental resources.

HMRC defines 'complex' as when "there is real doubt as to how the arm's length standard should be applied". Conversely, where market comparables can be readily identified and available for the transactions in question, in accordance with the OECD Guidelines, HMRC is likely to regard such a

situation as 'straightforward' (Khan, 2019:26). According to Avoseh (2014:30), in the UK, the use of APA may be requested by:

- any interested UK entity, including a partnership, with transactions to which the provisions of Part 4 of TIOPA 2010 apply;
- any non-resident entity trading in the UK through a permanent establishment; and,
- any UK resident taxpayer trading through a permanent establishment outside the jurisdiction of UK.

The APA application may be withdrawn by either party at any given time prior to the conclusion and signing of the formal agreement. Thereafter, the application cannot be withdrawn by either party unless on specific circumstances such as (Casley *et al.*, 2016:61-62):

- (i) the application is nullified because the information provided by the relevant taxpayer is misleading or false;
- (ii) the application is revoked by the HMRC due to non-compliance by the taxpayer; or,
- (iii) the agreement is revised where there is a change in circumstances including the taxpayer's terms of the transaction.

HMRC aims to complete the APA process within 18 to 21 months of submission of the formal application and it is submitted that unilateral APAs may be completed much quicker than bilateral or multilateral APAs. The timeline in relation to bilateral and multilateral APAs depends on the procedures of the relevant tax administrations of the other jurisdiction(s) (Leho & Price, 2019:2).

The effect of entering an APA programme with HMRC is that it provides assurance and certainty to the MNEs that the treatment and application of those transfer pricing issues is accepted by the HMRC for the period covered by the agreement. On the other hand, MNEs commit themselves to demonstrating adherence and compliance to the agreed transfer pricing method during the term of the APA in the form of an annual report (OECD Secretariat, 2012:17).

An annual report is submitted by the taxpayer and generally accompanies the entities' annual tax return. The requirements of each annual report are set out in the APA. The broad intention is that annual reports should demonstrate in a specific format whether the entity has complied with the terms and conditions as set out in the APA (OECD Secretariat, 2012:17).

The APA programme in the UK normally lasts a minimum period of three years and up to a maximum period of five years. In certain cases, where the facts of the transaction in prior periods are considerably similar, special provisions can be made to roll back the APA duration (EY, 2020:669).

Some taxpayers may use this approach as a way of resolving tax audits (roll-back option) for prior years as the more co-operative nature of the APA negotiations has proved to be more successful in reaching common ground in comparison to an audit (Khan, 2019:23).

4.4.5 Conclusion on the UK's transfer pricing legislation

The UK's transfer pricing legislation places complete reliance on the OECD Guidelines. This is seen in how HMRC has incorporated the OECD Transfer Pricing Guidelines in full into tax legislation in terms of section 164 of the TIOPA. This means that both the taxpayer and HMRC cannot deviate from the OECD Guidelines when determining the transfer price. Furthermore, all HMRC guidance relating to the transfer pricing provisions are aligned and refers to specific paragraphs of the OECD Guidelines. This provides the taxpayer clear guidance on the treatment of 'controlled transactions' within the MNE group and how the arm's length principle should apply to.

To avoid double taxation, the UK gives preference to bilateral and multilateral APAs, and provides certainty with regards to the transfer pricing methods to be used by the entities involved in the cross-border transactions. Even though the APA application process is time-consuming and costly, the benefit of tax certainty outweighs the cost, which assists in the prevention of penalties from non-compliance and costly transfer pricing disputes.

South Africa should therefore consider allowing taxpayers involved in cross-border transactions to apply for APAs in respect of transfer pricing as an alternative to contemporaneous documentation that may not assist in a transfer pricing dispute and provide certainty.

4.5 CANADA'S TRANSFER PRICING LEGISLATION

4.5.1 Brief background of Canada's transfer pricing legislation

Canada, as a member country of the OECD endorses and follows the OECD Guidelines and its transfer pricing legislation and administrative guidelines are generally consistent with the OECD Guidelines (OECD, 2017:1; KPMG, 2021:2). The transfer pricing rules in Canada are contained in section 247 of the CITA (Rolph & Kurjanowicz, 2020; Robillard & Dupuis, 2014:1). The OECD Guidelines are not considered as law in Canada but rather only provide guidance (OECD, 2017:1).

Section 247 of the CITA makes no reference to the OECD Guidelines. Although not authoritative, courts, as well as other dispute resolution channels usually consider the OECD Guidelines when reaching a decision (Rolph & Kurjanowicz, 2020). The OECD Guidelines are not included in Canada's transfer pricing legislation but are rather used as guidelines. This distinction was clearly

stated in a decision by the Supreme Court of Canada (Canada v GlaxoSmithKline Inc., 2012 SCC 52; OECD, 2017:1).

Canada's tax authority, the CRA, also provides significant specific transfer pricing guidance through transfer pricing memoranda and information circulars (Rolph & Kurjanowicz, 2020).

4.5.2 Canada's transfer pricing provisions

Canadian transfer pricing rules are provided for in section 247 of the CITA with effect from periods beginning on or after 1997. These rules embody the arm's-length principle (PWC, 2014a:303). The CITA contains the legislation governing transfer pricing (PWC, 2014a:304).

In addition to the legislation, the CRA utilises two other platforms to communicate the transfer pricing legislation, administrative policies and guidance (BDO, 2013:1):

- CRA's Information Circular 87-2R which provides administrative policies and guidance with respect to the application of section 247 of the CITA and is cross-referenced to the OECD Guidelines; and, Transfer Pricing Memoranda (TPM-02 through TPM-12) which are periodically updated and intended to supplement the Information Circular 87-2R.

Canada's transfer pricing provisions are intended to apply to cross-border transactions within the MNE group (PWC, 2014b:304). The cross-border transactions between related entities are adjusted where the terms and conditions do not meet the arm's-length principles. Thus, when it is established that the primary purpose of the transaction is to obtain a tax benefit, the nature of the transaction can be adjusted (PWC, 2014a:304). A tax reduction, avoidance or deferral (or increase in a refund of tax) may be viewed to be a 'tax benefit' and may lead to the primary adjustment of transfer pricing (PWC, 2014a:304).

In Canadian law, there is provision to make a secondary adjustment, thus the CRA does make further adjustments (PWC, 2014b:683). In a case where there is a cross-border transaction between the Canadian resident taxpayer and related non-resident, which raises a tax benefit, the tax benefit amount is deemed to be a dividend and is subject to withholding tax of 25%. The withholding tax rate may be reduced depending on the provisions of a relevant tax treaty in place. This is accomplished through the combination of provisions in CITA sections 15(1), 56(2), 214(3)(a) and 212(2) (OECD, 2017:8).

The transfer pricing policy requires that transfer prices fall within the 'full range' of the comparables, which allows for a broad interpretation of a reasonable transfer price (Wilson, 2020:2).

Furthermore, Canadian law has a general anti-avoidance rule in terms of section 245 of the CITA which can be applicable to any transaction considered to be a tax avoidance transaction. The CRA may apply this section in transfer pricing situations if section 247(2) does not apply (PWC, 2014a:303).

Canada has a self-assessment regime; thus, the onus is on the taxpayer to prove that transfer pricing laws are adhered to (Rolph & Kurjanowicz, 2020).

4.6 THE APA PROGRAMME IN CANADA

4.6.1 Introduction

Canada introduced into its legislation the APA programme in 1990 and began operating since 1993 (CRA, 2020:11). The main purpose of implementing the APA programme was to provide increased certainty for taxpayers in their transfer pricing methodologies to derive the arm's length price for complex transfer pricing transactions to be applied to future related party cross-border transactions, in a manner consistent with the CITA (CRA, 2020:5).

The APA programme in Canada is purely administrative in nature. In CITA there is no provision that enables the creation, management or termination of the APA programme (Robillard & Dupuis, 2014:1).

Since the inception of the APA programme, it has become a key compliance tool for the CRA, while enhancing a collaborative and co-operative relationship between taxpayers and other tax authorities and improving tax certainty. The APA programme demonstrates that communication, transparency and compromise permit a mutually agreeable resolution of complex transfer pricing issues on a proactive basis (CRA, 2020:11). The APA programme has been implemented to aid taxpayers in preventing transfer pricing disputes that could arise in future tax years. The main objective of the programme is to provide increased certainty regarding future transfer pricing issues (CRA, 2020:4).

4.6.2 Background of the APA programme

The Canadian APA programme is available under Information Circular 94-4R. In Canada, there is no statutory provision for APAs, however, the Competent Authority Services Division (CASD) which is responsible for APAs, considers it as a 'preferred transfer pricing dispute resolution' (Lord, 2014:52).

Lord (2014:52) continues to say that the CRA implemented the APA programme for numerous reasons such as:

- (i) eliminating the possibility of double taxation;
- (ii) providing a platform for taxpayers to determine acceptable transfer pricing methods for non-arm's length cross-border transactions with related entities in line the CITA; and,
- (iii) assisting in the resolution of transfer pricing disputes.

The Canadian APA programme is administered through the CRA's CASD, which is part of the International and Large Business Directorate of the Compliance Programs Branch (CRA, 2020:4; KPMG, 2021:2).

4.6.3 The development of the APA programme

Since the inception of the APA programme in Canada, the CRA made all APA types available to taxpayers. It is noted that no significant changes have been made in Canada's transfer pricing legislation except the updates provided through the CRA's Information Circular, IC94-4R, International Transfer Pricing (Fortier *et al.*, 2018; Robillard & Dupuis, 2014:1).

The Information Circular, IC94-4R, provides the taxpayers with comprehensive guidance on APAs and the process of pursuing an APA in Canada that have been revised to include the procedural updated guidance on the pre-filing process, the criteria used to accept or reject APA requests, the roles and responsibilities of taxpayers and guidance on APAs that are subject to the arbitration process under Canada's network of tax treaties, most notably, the Canada-USA tax treaty (Fortier *et al.*, 2018).

Even though the CRA offers all types of APAs, the CRA has stated that it prefers the bilateral and multilateral APAs since they both eliminate double taxation for the years under the APA. In such cases, the Canadian Competent Authority rely on the mutual exchange of information procedure modelled after article 26 of the OECD Model Tax Convention on Income and on Capital during the APA process to exchange information with involved competent authorities (Robillard & Dupuis, 2014:1).

Currently, the CRA says it is engaged in bilateral and multilateral APA application processes involving taxpayers from 18 different jurisdictions such as Australia, Belgium, Chile, China, France, Germany, India, among others (KPMG, 2021:2).

Furthermore, according to the CRA's 2020 APA program report, the CRA has reduced the average

time it takes to complete a bilateral APA application by more than one year in 2020. On average, it took 36.9 months for the CRA to complete a bilateral APA application in 2020 – down from 51.1 months in 2019 (Connolly, 2021).

4.6.4 The APA process

The APA process in Canada is initiated by a taxpayer through contacting the CRA's CASD (CRA, 2020:3) Any Canadian taxpayer may apply for an APA irrespective of the size of its entity, the type or scope of its operations, or the nature of the transactions and proposed transfer pricing method (OECD Secretariat, 2012:16).

The CRA's CASD considers the scope and complexity of the transaction and not the size of the covered transactions or entities involved, along with other factors such as entities co-operation and necessity for the APA when accepting the APA application (CRA, 2020:8).

A taxpayer that is interested in obtaining an APA from the CRA must first send a pre-file package to the Director of the CASD to request an APA pre-file meeting which must take place within hundred and eighty days post the first tax year that will be covered by the APA (DLA Piper, 2019:2). An APA information package is required to be provided to the CRA at least two weeks prior to the APA pre-filing meeting (Robillard & Dupuis, 2014:2).

A pre-file meeting take place between the interested taxpayer and the CRA which provides an opportunity for the taxpayer to learn more about the APA programme and for the CRA to get more clarification on the taxpayer's business, industry, and most importantly, the requested covered transactions and to informally discuss the APA process with the taxpayer and the matters set out in the information circular (CRA, 2020:6; OECD Secretariat, 2012:16).

After the pre-file meeting, a decision is made by CRA to accept or reject the applicant taxpayer into the next stage of the APA process. A taxpayer accepted to continue in the process has to prepare a detailed APA submission providing the specifics of the covered transactions, including a detailed transfer pricing analysis and all information necessary for the CRA to review and complete its own transfer pricing analysis (CRA, 2020:6). Upon receipt and review of the APA application by the CRA, a decision is made to accept or reject the taxpayer's request for an APA (CRA, 2020:6).

The CRA does not levy a fee for the time spent on the APA process, however, when the APA application is accepted or upon renewal, a non-refundable fee is levied for 'out-of-pocket' costs, such as the cost of accommodation and travel of the team processing the application (Lords, 2014:53;

Robillard & Dupuis, 2014:3).

The APA application process also includes many unappealing aspects, such as the lengthy and expensive approval process. The taxpayer's cost of providing detailed information to the CASD can outweigh the benefits of the APA as the costs include 'sensitive commercial pricing and strategic information' of the taxpayer being disclosed by the CASD through industry databases and the use of such confidential information provided during the APA process in subsequent audits (Lords, 2014:54).

A taxpayer may withdraw from the APA process at any time during the application stage or after the application has been accepted. A taxpayer may formally withdraw the application when it engages the CRA in an APA pre-file meeting but either chooses not to pursue an APA or is informed by the CRA that the proposed covered transaction is not well suited for the APA programme (CRA, 2020:6).

Once the APA is approved, it is regarded as a binding agreement between the CRA and the taxpayer. The APA may be audited, revised, revoked or cancelled by the CRA, depending on significant changes to the facts and circumstances of the transaction which existed initially (Robillard & Dupuis, 2014:3). If the taxpayer complies with the terms and conditions of an APA, the tax authority may consider that the results of applying the agreed transfer pricing methodology (arm's length principle) have been satisfied in terms of section 247 of the CITA for periods specified in the APA (OECD Secretariat, 2012:17).

During the term of the APA, the taxpayer is required to file APA reports according to the terms of the APA. The report describes the actual operations for the period and demonstrates the compliance with the conditions of the APA (OECD Secretariat, 2012:17).

Upon expiry of the APA term, the taxpayer may request to renew the APA, in which case it follows the same form and procedures that apply to an initial APA request (OECD Secretariat, 2012:17). If the initial APA request is declined by the CRA or a decision not to continue in the APA process is made, the taxpayer is provided with detailed explanation for the CRA's decision (CRA, 2020:7).

The APA programme usually lasts for a minimum of three years up to five-years, depending on the relevant facts and circumstances (DLA Piper, 2019:2).

An APA relates to current and certain future transactions, but an APA may apply retroactively to past tax years provided that the appropriate waivers have been filed by the Canadian taxpayer under

subparagraph 152(4)(a)(ii) of the CITA (Robillard & Dupuis, 2014:2). The taxpayer may negotiate a roll-back option where the facts and circumstances are like those which are included in the APA (DLA Piper, 2019:2).

The CRA (2020:5) highlights that the APA process differs from the audit process as its focus is on future tax years rather than years that have elapsed. The APA sets out an agreed transfer pricing methodology to be used on a future cross-border transaction, for establishing a transfer price which is at arm's length for the transactions between related parties.

4.6.5 Conclusion on Canada's transfer pricing legislation

Canada's transfer pricing legislation endorses and follows the OECD Guidelines, but no reference to the OECD Guidelines is made in the CITA. The CRA provides additional material guidelines in respect of the transfer pricing provisions.

Canada also gives preference to bilateral and multilateral APAs instead of unilateral, which avoid the potential double taxation and provides certainty in respect of the agreed transfer pricing methods to be used by the countries involved in the cross-border transactions.

Furthermore, Canada's legislation provides for a secondary adjustment (deemed dividends) on transfer pricing adjustment in a case where the CRS is of the view that the arm's length principles are not correctly applied.

During the APA application process, the CRS charges a fee upon approval. Should South Africa implement APAs, it may consider levying the fee to only encourage necessary APA applications or complex cross-border transactions. The APA programme benefits always outweigh its cost and it provides certainty to taxpayers.

4.7 THE INDIAN TRANSFER PRICING LEGISLATION

4.7.1 Brief background of Indian transfer pricing legislation

Transfer pricing provisions in India follow the OECD Guidelines as a foundation of its regulations and were first enacted by the *Finance Act* of 2001 as a way of disclosing and assessing cross-border transactions between related entities in India (RSM India, 2016:19). The transfer pricing rules were included in Chapter X 'special provisions relating to avoidance of tax' under section 92 to section 92F and section 94A of the *Income-tax Act* of 1961 (Indian IT Act) and under rules 10A to 10THD of the Indian *Income-tax Rules* (Muljee, 2017:31).

With effect from 1 April 2013, the transfer pricing provision in India were amended by including section 92BA of Indian IT Act to cover domestic transactions between two related resident taxpayers (Muljee, 2017:31).

According to the OECD report, India has emerged as one of the countries considered as an economic giant (OECD, 2020b:20). As one of the rapidly growing economies in the world, it has become important for India's transfer pricing provision not only to be investor friendly but be strong in a enough manner to combat misappropriate application related to transfer pricing (RSM 2016:19).

4.7.2 India's transfer pricing provisions

India is a non-member country of the OECD. However, its transfer pricing legislation is in line with the OECD Guidelines where the arm's length principle is accepted and applied from the United Nations Practical Manual on Transfer Pricing for Developing Countries (Muljee, 2017:31).

In terms of section 92 of the Indian IT Act, when a taxpayer enters a cross-border or domestic transaction with a related entity, the income realised from such a transaction must be determined in terms of the arm's length principles. (DLA Piper, 2018:2). In the instance where the arm's length price favours the taxpayer by reducing the taxable income or increasing the assessed loss, section 92(3) of Indian IT Act applies and in such case no adjustment is made (Finance Bill, 2017:24).

Previously, there was no provision in the Indian transfer pricing legislation which allowed for secondary adjustments (such as deemed dividends or deemed interest). However, with effect from 1 April 2018, a new provision was enacted, section 92CE of the Indian IT Act, which provides for a secondary adjustment when a primary adjustment is made (Finance Bill, 2017:24).

A proviso to section 92C(2) of the Indian IT Act allows taxpayers a margin of inaccuracy, of not more 3% when calculating the arm's length price. The margin of inaccuracy for wholesalers is different, which is 1% (RSM, 2016:83).

The taxpayer has a burden of proof that the cross-border or specified domestic transactions are at arm's length price (RSM India, 2016:110).

The APA provisions are included in sections 92CC and 92CD of the Indian IT Act, which became effective on 30 August 2012 (RSM India, 2016:137).

4.8 THE APA PROGRAMME IN INDIA

4.8.1 Introduction

The APA programme was introduced in India with effect from 1 July 2012 in the *Finance Act* of 2012 (Hussain, 2020:1). Detailed rules and interpretations of implementing the APA programme were introduced by the Indian tax authority, Central Board of Direct Taxes (CBDT) in the official gazette of 31 August 2012 (Ado, 2015:32).

Since its inception, the Indian APA has been successful and highly embraced by taxpayers and tax administrations globally, with some practitioners remarking that it has provided a 'welcome opportunity' to prevent transfer pricing controversies and thus eliminating uncertainties associated with future litigation and double taxation (Ado, 2015:32; Vishwanathan, 2020).

Mullachella (2018:77) and Radhakrishna (2019:23) indicate that the Indian tax authority is a prime example of being an APA programme leader that has faced the challenge of dealing with an influx of APA applications. It usually takes the CBDT up to thirty-nine months to process and grant APAs. However, the CBDT has recently improved its APA application process and became more efficient and robust in dealing with applications from taxpayers.

The implementation of the APA program in India allows the CBDT to enter APAs with taxpayers in respect of cross-border transactions between related entities to determine the arm's length price or to specify the method in which the arm's length price is to be determined (CBDT, 2019:3). The relevant transfer pricing legislation that deals with APAs (unilateral, bilateral or multilateral) can be found in the *Finance Act* of 2012 through the insertion of sections 92CC and 92CD in the Indian IT Act (CBDT, 2019:3).

4.8.2 Background of the APA programme

The APA programme in India was introduced in July 2012 and enacted on 30 August 2012 (Grant Thornton, 2012:4; CBDT, 2019:). The main purpose of introducing the APA programme in India was to reduce the number of tax disputes on related entity transactions and to provide taxpayers with tax certainty when determining the arm's length price. When a taxpayer enters into an APA with the Indian tax authority, they mutually agree on the determination of the arm's length price for future specific transactions by prescribing the transfer pricing methodology and any important assumptions relating to that specific cross-border transaction, for a prescribed specific term (RSM India, 2016:137).

By way of public notification no. 36/2012, dated 30 August 2012, the APA Scheme (Rules 10F to

10T) was included into the income tax rules to formalise the validity of the APA programme. Therefore, the Indian APA programme only became functional and operational from 30 August 2012 (CBDT, 2019:5). The rules provide the detailed procedures for the feasibility study of the APA application; pre-filing consultation, payments of fees, filing of APA application, processing of APA applications, withdrawal of APA applications, terms and conditions of the APA, filing of Annual Compliance Report, Compliance Audit, revision, cancellation and renewal of APAs (CBDT, 2019:5).

The Indian APA programme has attracted considerable popularity with foreign investors indicating interest by filing over 1 000 applications (Deloitte, 2018:5). Since the inception of the APA programme, CBDT has allowed all three kinds of APAs, being unilateral, multilateral or bilateral (CBDT, 2019:6). However, no multilateral APA application has been received, with most applications being for unilateral APAs (approximately 85% of the applications) and the remaining applications being for bilateral APAs (Deloitte, 2018:6; Mullachella, 2018:76).

The dominance of unilateral APAs over the other types of APAs has been speculated by some to be because of India's stand on a corresponding adjustment clause under its income tax treaties, which has prevented it from entering into bilateral and multilateral APAs with some of its major trading partners such as France and Germany, with whom India does not have an equivalent of Article 9(2) of the OECD Model Tax Convention (Ado, 2015:32).

According to Goel (2018), the uncertainty caused by the OECD's ongoing work with BEPS has resulted to many taxpayers to actively seek APAs to provide for tax certainty. In turn, that resulted in the number of APA applications that the CBDT receives to increase over the years. However, Goel (2018) continues to warn against the impression that the influx of APA applications is due to the CBDT's efficiencies as this may not be the case.

4.8.3 The development of the APA programme

After years of the APA programme existence in India, the tax authority, CBDT has not made material changes, except the introduction of the roll-back option. As from 1 October 2014, India introduced a roll-back option to the programme (Finance Bill, 2014:12). Initially, the Indian APA programme did not have roll back provisions in its legislation, but it was later added to the programme after the CBDT realised its overall benefit (Deloitte, 2018:5).

The much-needed legislative changes were enacted in the *Finance (No. 2) Act* of 2014. The Income tax rules for implementing the roll-back provisions in India were promulgated in March 2015 and the APA programme was amended accordingly (CBDT, 2019:6). The roll-back provisions are applicable

for a maximum period of four years prior to the first year of the APA period (Finance Bill, 2014:12). Thus, a taxpayer would be able to have certainty in matters of transfer pricing for a maximum period of nine years in total by applying for an APA with roll-back provisions. The CBDT has issued Circular No. 10 of 2015 on 10 June 2015 to provide clarity on roll-back issues in the form of answers to Frequently Asked Questions (FAQs) (CBDT, 2019:6).

Furthermore, to provide clarity and awareness to taxpayers on several issues concerning the APA programme, the CBDT issued a booklet containing guidance on the APA programme and answers to frequently asked questions. The purpose of the booklet is to provide useful insight on the development and enhancement of the APA programme (CBDT, 2019:7).

The CBDT (2019:35) argues that while the taxpayers are able to get tax certainty over transfer pricing issues for a period of five or nine years (depending on whether roll-back provisions are applicable to an agreement), the Indian government has managed to divert the limited resources they have away from the audit and litigation processes and allocated to more productive work. The CBDT now considers the work performed by its personnel within the transfer pricing department as more productive as opposed to working on audit and litigation processes (Goel, 2018).

4.8.4 The APA process

In India, any taxpayer who has entered a cross-border or related party transaction or is contemplating to enter such a transaction is eligible to apply for an APA (DLA Piper, 2018:2). The APA application process to be followed is provided for in rules 10H, rule 10-I and rules 10-O to 10S of the transfer pricing provision.

Generally, the Indian APA rules require a dedicated APA team which consists of a team leader who is an expert in international tax and transfer pricing, income tax authorities assisted by experts in economics, statistics, law and other industry expertise (depending on the industry of the taxpayer submitting the application) as and when needed (PWC, 2014b:3).

For unilateral APAs, the Director General of Income Tax (International Tax and Transfer Pricing) would be responsible for the programme and is supported by the Commissioner of Income Tax. For bilateral or multilateral APAs, the Competent Authority of Office of India would be responsible, supported by the Director APA (PWC, 2014:3).

As with other countries, the APA application is initiated by the taxpayer through the request for a pre-filing consultation. The process commences with the pre-filing application (Form No3CEC) and

a consultation meeting between the taxpayer and the CBDT (Hussain, 2020:2). The objective of the consultation is to determine the scope of the agreement, the applicable transfer pricing issues, and establishing the extent to which the cross-border transactions qualify for an APA. The taxpayer may choose for an anonymous pre-filing consultation. It must be noted that this process is not binding on either the taxpayers or the CBDT (PWC, 2014:4).

If the taxpayer is keen to enter the APA, a formal APA application follows on the prescribed form (Form No3CED) containing specified required information, along with the APA application filing fee (Hussain, 2020:2; PWC, 2014:4). The APA filing fee payable depends on the amount of the proposed covered transactions over the proposed APA term (PWC, 2014:4; DLA Piper, 2018:2).

Once the application is accepted, the taxpayer and the tax authority engage in negotiations where additional material may be required. Post negotiations, the APA application is finalised, where the comments on the draft APA are exchanged until the final agreement is signed, giving effect to the initial years covered under the APA term that have already elapsed (PWC, 2014:4; Hussain, 2020:2).

Before the finalisation of the terms of the agreement, the taxpayer may request in writing for changes to an application at any stage. In such circumstances, the taxpayer may need to provide reasons for the requested amendments and submit supporting documentation with a proposed course of action. The Director General of Income Tax (International Tax and Transfer Pricing) (for unilateral APAs) or the Competent Authority in India (for bilateral or multilateral APAs) may allow the changes to the application, if such an amendment does not have the effect of altering the nature of the application as originally filed. Such an amendment may require an additional fee to be paid (PWC, 2014b:4).

Further, the taxpayer may withdraw the application at any stage before the final APA is signed. If the taxpayer chooses to withdraw the APA application, the APA filing fees would not be refunded (PWC, 2014b:4).

Once an agreement is signed by all the parties, the taxpayer would be required to file a revised return (for the covered years that has elapsed in a case of a roll-back APA) within three months from the end of the month in which the agreement is entered (PWC, 2014b:5).

During the term of the APA, the taxpayer is required to prepare an annual compliance report for each year containing enough information detailing the actual results for the year and demonstrating compliance with the terms of the APA. Such annual compliance reports need to be provided within thirty days of the due date of filing the income tax return for that year, or within ninety days of entering

into an agreement, whichever is later (PWC, 2014b:5).

The APA is valid for a minimum period of three years up to maximum period of five consecutive years with the option to roll-back to four prior years of assessment as introduced in section 92CC(9A) Indian IT Act in 2014 (DLA Piper, 2018:2). In addition, the APA becomes void and invalid if there is a change in the critical assumptions or a failure to meet the certain conditions on which the APA was based (RSM India, 2016:43).

All types of APAs may be renewed with the consent of all the parties involved. In the case of bilateral or multilateral APA, the consent of tax treaty partner is also required (PWC, 2014b:4). A request for renewal of the APA would follow the same procedures and steps that apply to an initial APA application. It is important for taxpayers to seek APA renewal early enough to allow the renewal to be negotiated and put in place prior to the expiration of the earlier APA. If the facts and circumstances are largely similar, a renewal can be completed in a relatively shorter timeframe (PWC, 2014b:4).

4.8.5 Conclusion on the Indian transfer pricing legislation

India is not a member country of the OECD but adopted and apply the OECD Guidelines when determining the transfer price for related party transactions, whether locally or internationally.

India has accepted the use of bilateral APAs in its policy, which assists to avoid a potential double taxation and provides certainty with regards to transfer pricing methods to be used by countries involved in cross-border transactions. During the APA application process, India charges an APA application fee. Since the inception of India's APA programme, the programme has received a positive response and provided much needed certainty to taxpayers who are party to the APA for a period of five to nine years (where the roll-back option has been included in the APA).

Secondary adjustments are also available in Indian legislation for cases where the arm's length principles are viewed as being incorrectly applied.

APAs are a good example of how tax authorities and taxpayers may collaborate to find solutions to vexing transfer pricing problems. It creates a win-win situation for all stakeholders and fosters certainty, a commodity with a very high premium in these uncertain times. As a developing country, the implementation of APAs in India has been favourable for its economy as it is considered as an 'investor friendly' environment.

Developing countries such as South Africa that need direct foreign investment to boost the economy

may benefit significantly through the implementation of APA as it provides certainty to investors.

Section 4.9 analyses the transfer pricing legislation of the UK, Canada and India against that of South Africa.

4.9 COMPARASION OF UK, CANADIAN, INDIAN AND SOUTH AFRICAN TRANSFERPRICING LEGISLATION

Various transfer pricing issues of South Africa, the UK, Canada and India have been discussed in previous sections of this study; South Africa in section 2.6, UK in sections 4.3 and 4.4, Canada in sections 4.5 and 4.6; and India in sections 4.7 and 4.8.

A comparison is made, and an analysis is presented of all four countries' transfer pricing legislation and practices. The comparison of all four countries' transfer pricing legislations and other matters is summarised in Table 1.

Table 1: Comparison of the UK, Canada, India and South African transfer pricing legislations and other matters

Description	UK	Canada	India	South Africa
Country follows the arm's length principle as recommended by the OECD	Yes.	Yes.	Yes.	Yes.
The OECD Guidelines included in the legislation	Specifically included OECD Guidelines in section 164 of the TIOPA.	Does not place complete reliance on the OECD Guidelines but endorses and follows the guidelines.	Does not place complete reliance on the OECD Guidelines but endorses and follows the guidelines.	The OECD Guidelines are included in SARS PN7 and Interpretation Notes, but these publications are not legally binding.
Domestic transfer pricing rules	UK have domestic transfer pricing rules to curb tax arbitrage which does not usually happen.	Does not have domestic transfer pricing rules.	India has domestic transfer pricing rules to curb tax arbitrage which does not usually happen.	Does not have domestic transfer pricing rules.
The burden of proof that the transfer pricing complies with the arm's length principle	Burden of proof lies with the taxpayer.	Burden of proof lies with the taxpayer.	Burden of proof lies with the taxpayer.	Burden of proof lies with the taxpayer.
Application of secondary adjustment on transfer pricing adjustment	No secondary adjustment.	Yes, secondary adjustment applies.	Yes, secondary adjustment applies.	Yes, secondary adjustment applies.

Levy of penalties for transfer pricing adjustment	Imposes the penalties on adjustments based on the general penalty provisions, which range between 5% to 200%, and the interest provisions apply.	Imposes the penalties on adjustments based on the general penalty provisions, which range between 5% to 200%, and the interest provisions apply.	Imposes the penalties on adjustments based on the general penalty provisions, which range between 5% to 200%, and the interest provisions apply.	Imposes the penalties on adjustments based on the general penalty provisions, which range between 5% to 200%, and the interest provisions apply.
Documentation requirements	Documentation requirements are compulsory. Penalty is levied where documentation requirements are not complied with.	Documentation requirements are compulsory. Penalty is levied where documentation requirements are not complied with.	Documentation requirements are compulsory. Penalty is levied where documentation requirements are not complied with.	Documentation requirements are compulsory. Penalty is levied where documentation requirements are not complied with.
CbCR	Adopted and is based on the OECD guidelines.	Adopted and is based on the OECD guidelines.	Adopted and is based on the OECD guidelines.	Adopted and is based on the OECD guidelines.
Double taxation agreements	Available and are used to exchange information with other jurisdictions.	Available and are used to exchange information with other jurisdictions.	Available and are used to exchange information with other jurisdictions.	Available and are used to exchange information with other jurisdictions.
The use of APAs	Yes.	Yes.	Yes.	No.

Source: Muljee, 2017.

4.9.1. Conclusion

Based on the comparison above, it seems that all four countries' transfer pricing legislation are very similar despite the size or the location of each country. Very few differences were noted, but the major difference is the absence of an APA programme in South Africa.

South Africa should consider the implementation of APAs. Given that countries like South Africa has implemented APAs, South Africa may learn from those countries' mistakes and avoid repeating such. By taking into consideration the discussions above, below the possible implementation of APAs in South Africa is discussed.

4.10 POSSIBLE IMPLEMENTATION OF AN APA PROGRAMME IN SOUTH AFRICA

Based on the analysis in Chapters 2, 3 and 4 of this study, the success of the implementation of an APA programme is dependent on the government of each country and the relevant tax authorities to provide clear guidance to ensure the effectiveness, efficiency and sustainability of the programme.

From a South African perspective, the National Treasury and SARS are the key role players in establishing and implementing an effective and efficient APA programme. When South Africa

introduces the APA programme, due consideration should be given to the timing needed to organise and prepare the implementation of the programme as well as aligning the programme so that it meets the governments' policy objectives. According to SARS (2020:13), it is estimated that it will take three to four years to implement an APA programme in South Africa.

4.10.1 Benefits of APAs in South Africa

Nicolaou (2016) argues that tax evasion by MNEs has negative effects on both developing and developed countries economies. The tax evasion is even more critical for developing countries as commercial tax evasion does not only loots revenues meant for socio-economic growth, but in certain circumstances it also encourages corruption and undermines the authenticity and legitimacy of governments.

Even though South Africa is not a member country of the OECD, it follows and applies the OECD's recommendations. The arm's length principle with respect of cross-border transactions between related entities is provided for in section 31 of the IT Act.

In the case where SARS revises the assessments of MNEs after it finds that the transfer pricing is not in accordance with the arm's length principle in terms of section 31 of the IT Act, the remedy available to the taxpayer is to object against the assessment in line with the rules provided for in Chapter 9 of the TAA. Should the taxpayer not be satisfied or disagree with SARS' objection outcome, the taxpayer can lodge a formal internal appeal against the objection decision. Should such taxpayer not be happy with the appeal outcome, the next stage is to lodge an application for ADR with the relevant appeal committee that made the decision (SARS, 2021).

During this entire dispute process, which can take many years to complete, SARS applies the rule of "pay now, argue later". The rule requires the taxpayer to pay the tax amount even prior to the dispute resolved. The validity and legality of this rule was confirmed by the Constitutional Court in the case *Metcash v SARS* (2001).

Alternatively, the taxpayer can utilise the MAP under the relevant treaty as a dispute resolution remedy in terms of Action Plan 14 of the BEPS. Generally, Article 25 of the tax treaties speaks to the dispute resolution process (SARS, 2018:6). In a situation where the potential economic double taxation may take place, the taxpayer has the option of invoking the MAP and present its case to the competent authority of residence or both competent authorities of the treaty to resolve the matter (SARS, 2018:6). The MAP is also applicable to transfer pricing disputes. Although SARS permits taxpayers to use MAP for transfer pricing issues, it has excluded the requests for APAs from the

MAP (SARS, 2018).

Both dispute resolution processes discussed above, ADRs and the MAP, occur after the assessment has been raised, thus, the taxpayer is required to pay the tax debt and must subsequently object the outcome. In other words, the process is not proactive, rather reactive and that creates uncertainty for MNEs willing to invest in South Africa. In the recent discussion paper by SARS (2020:5), it is argued that South Africa is a leader on the African continent and a gateway for foreign investment into the rest of Africa.

Upon consultations with relevant stakeholders, the Davis Tax Committee released its first “BEPS Interim Report” in 2014. One of the Davis Tax Committees’ recommendations was for SARS to ensure enough transfer pricing training to its transfer pricing unit personnel and build capacity thereon (Davis Tax Committee, 2014:16).

The shortage of specialised transfer pricing professionals and the cost of retaining them may pose a challenge to SARS. However, with transfer pricing being the dominant tax issue facing MNEs, according to Ernst & Young’s 2005-2006 Global Transfer Pricing Surveys, the cost of employing transfer pricing professionals in APAs may be less than those incurred in resolving transfer pricing disputes in the absence of an APA programme in South Africa. SARS (2020:13) also suggests that to mitigate the issue of limited capacity, South Africa should implement an APA programme gradually by using a phased approach.

The South African transfer pricing legislation is silent about proactive dispute resolution solutions such as the APA even though it is focused on the arm’s length principle. Generally, the Davis Tax Committees’ reports recommends the implementation of an APA programme in South Africa but highlights capacity scarcity in SARS’ transfer pricing unit (SARS, 2020:6).

4.11 CONCLUSION

Based on the comparison and analysis conducted in this chapter, it seems that the UK, Canada, India and South Africa have transfer pricing legislation that is very similar despite the size and location of each country. Very few differences were noted, but the major difference is the non-existence of an APA programme in South Africa.

This chapter shows that all the countries discussed above have endorsed and adopted the use of arm’s length principle as recommended by the OECD. Even though there is a lack of comparable uncontrolled transactions in South Africa, South African still applies the arm’s length principle for

transfer pricing transactions. This shows that even though South Africa is a developing country it can adopt and implement the APAs programme into its tax legislation.

Further, in this chapter it has been established that the APA process applied by the UK, Canada and India are similar as discussed in the preceding chapter. Therefore, South Africa may enjoy the same benefits (which outweigh the challenges) flowing from the implementation of an APA programme, including the attraction of foreign direct investment. South Africa should consider the implementation of APAs. Given that countries like South Africa have implemented APAs, South Africa may learn from those countries' mistakes and avoid repeating such. When South Africa decides on the implementation of the APAs, it can adopt and adhere to the current working processes applied by other comparable countries.

Therefore, it can be concluded that the research objective was successfully addressed in this chapter by analysing the transfer pricing legislation of the selected countries to obtain a deep understanding of the workings and the mechanisms of using the APAs as recommended by OECD.

The next chapter summarises the findings of each chapter, the proposed recommendations for future research and provide a conclusion to the study.

CHAPTER 5

SUMMARY AND CONCLUSION

5.1 SUMMARY OF FINDINGS

The objective of the study was to critically analyse SARS' impending implementation of APAs through i) the evaluation of the transfer pricing legislation of foreign countries that implemented APAs and ii) OECD recommendations.

As illustrated in Chapter 2, the concept of transfer pricing has been in existence for over a century due to globalisation and internationalisation. However, there have been some challenges due to differences in or inappropriate determination of transfer prices. The practise of transfer pricing manipulation by MNEs causes BEPS and has disadvantaged other countries. This has resulted in the need for organisations that provides guidance on international tax matters on a global scale.

The OECD has been impactful in setting an international transfer pricing standard. South Africa has adopted and implemented the OECD Guidelines into its recent legislation updates. Thus, South Africa can also consider the implementation of APAs, as recommended by the OECD to proactively resolve transfer pricing issues, provide certainty to taxpayers and enhance foreign direct investment in the country.

MNEs are important for economic development, more especially in developing countries. The APA programme aims to achieve certainty amongst taxpayers on the arm's length price set amongst related entities. As determined in chapter 3, the use of APAs has benefits that exceed its disadvantages. The most significant benefit from the use of APAs is the certainty it provides for both taxpayers and tax authorities. Over and above that, specifically for South Africa, it can open gates for direct foreign investments for the country and in Africa as a whole. As stated by SARS (2020:5), the "gateway-to-Africa incentives can be enhanced by an APA programme."

It has been established in Chapter 4 that an APA programme can be viewed as a long-term investment. The goal of an APA is to determine in advance, the transfer pricing in a cross-border transactions between related entities to ensure certainty for MNEs and guarantees of the receipt of tax revenues due to the respective tax jurisdictions from MNE group transactions.

Instead of lengthy and costly ADR and MAP processes, SARS and the taxpayer can proactively

engage with one another to deal with and agree on an arm's length price in advance. The APA programme will be beneficial to SARS as it provides the opportunity to gain insight into various industries without having to summon information through audit or other verification processes. On the other side, the taxpayer may be able to reduce the costs of expensive transfer pricing audits, achieve certainty on its cross-border transactions and avoid lengthy dispute resolution processes and ultimately focus and dedicate its resources to its core business.

5.2 CONCLUSION

Based on the study's analysis, it seems that South Africa stands to benefit from the implementation of an APA programme in the long run. South Africa will be in a better position when introducing an APA programme in future as it can learn from the experiences of those countries that have already implemented APAs without having to incur the same costs and time on the APA learning process.

The APA programme in South Africa will also encourage foreign direct investment in the country and promote economic growth as foreign MNEs will be encouraged to invest in a country where there is certainty when it comes to transfer pricing.

For a developing country such as South Africa, the success of the APA programme lies in the capacity and skills of the staff as well as leveraging off past experiences of APA programmes in developing countries such as India and developed countries such as the UK and Canada.

Based on the findings of this study, it can be concluded that the incorporation of an APA programme in transfer pricing legislation and the implementation thereof into the South African legal and tax systems is possible. According to SARS discussion paper on APAs issued in 2020, South Africa is considering the implementation of APAs.

5.3 RECOMMENDATIONS FOR FUTURE RESEARCH

At the time of concluding this study, SARS has not implemented the APA programme in South Africa. As outlined in Chapter 2, the main challenge that is preventing SARS from the implementation of APAs is the lack of resources and skills to implement an effective and efficient APA programme. Future research should consider possible methods to address the issue of lack of resources and skills at SARS to expedite the implementation of APAs in South Africa.

Further studies should be conducted to determine whether there is a direct correlation between the implementation of APAs and foreign direct investment that could potentially contribute to the economic growth of the country.

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