

An analysis of the weaknesses in transfer pricing legislation pertaining to intellectual property

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Mini-dissertation submitted in partial fulfilment of the requirements for the degree *Magister Commercii* in South-African and International Taxation at the Potchefstroom Campus of the North-West University

Supervisor: Prof K Coetzee

May 2014



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DECLARATION

I declare that: “***An analysis of the weaknesses in transfer pricing legislation pertaining to intellectual property***” is my own work; that all sources used or quoted have been indicated and acknowledged by means of complete references, and that this mini-dissertation was not previously submitted by me or any other person for degree purposes at this or any other university.

SIGNATURE

DATE

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ABSTRACT

On 8 June 2012, National Treasury amended Regulation 10(1) (c) of the Exchange Control Regulations to specifically include intellectual property. In so doing, all companies wishing to displace intellectual property to an offshore destination had to obtain prior approval from National Treasury. However, National Treasury is reticent to grant permission to reassign these assets, as revenue from intellectual property is perceived to contribute vastly to the South African tax revenue.

This amendment came into being shortly after the dismissal in the Oilwell case. This case, in essence, held that intellectual property is not capital for the purposes intended by National Treasury, and therefore no prior approval to assign it offshore is required from National Treasury.

This dismissal led to a large outflow of intellectual property to tax favourable foreign locations. At the same time, it exposed transfer pricing risks that had previously gone unnoticed. Although these risks have once again been mitigated by the amendment to Regulation 10(1) (c), it does not mean that it is now a thing of the past, best left forgotten.

The South African government intends to relax or abolish all exchange control regulations in the future. At present the exact date when this is to take place is not known. Once the exchange control regulations are abolished, the transfer pricing risks associated with intellectual property will once again come to the forefront and will lead to significant loss to South African tax revenue.

The three main risks that became apparent during the period before the amendment to Regulation 10(1) (c) are the following:

- Transfer pricing risk consisting of mainly:
 - A lack of a comparables database to enable tax administrators to determine an appropriate arm's length price for intellectual property.
 - A lack of the relevant skills, experience and knowledge required to accurately assess transfer prices of intellectual property.
- Challenges in obtaining relevant, comprehensive and timely information to accurately determine arm's length prices for intellectual property transactions.
- A lack of understanding the principle of *economic substance* and legislation in South Africa to define *economic substance* parameters.

- In this mini-dissertation, these weaknesses are discussed in more detail to highlight to SARS the trials it faces when the exchange controls regulations are expelled. Various ways in which these flaws can be challenged head-on are also presented.

Key words

- Aggressive tax planning;
- Capital;
- Economic substance;
- Exchange Control Regulations;
- Exchange of information;
- Intellectual property;
- Multi-national companies;
- National Treasury;
- OECD Transfer Pricing Guidelines;
- Transfer pricing.

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List of abbreviations

- APA Advanced Pricing Agreement;
- ATAF African Tax Administration Forum;
- CFC Controlled Foreign Company;
- CGT Capital Gains Tax;
- CP Cost Plus;
- CUP Comparable Uncontrolled Price;
- DTA Double Tax Agreement;
- EES European Economic Space;
- EOI Exchange of Information;
- EU European Union;
- EUR Euro;
- GAAR General Anti Avoidance Rules;
- GBP Great British Pound;
- HMRC Her Majesty's Revenue and Customs;
- ITA Income Tax Act;
- MNC Multi National Company;
- MTC Model Tax Convention;
- OECD Organisation of Economic Co-operation and Development;
- RP Resale Price;
- SARB South African Reserve Bank;
- SARS South African Revenue Service;
- SEC Securities and Exchange;
- TAA Tax Administration Act;
- TNMM Transactional Net Margin Method;
- UN United Nations.

CHAPTER 1: INTRODUCTION

1.1 Introduction to the research topic

1.1.1 Introduction and background

The Exchange Control Regulations came into being on 1 December 1961. Authorities feared the large scale outflow of *capital* due to the negative attitude of the outside world to racial segregation prevalent in South Africa at the time. South Africa had also just become independent from British rule and the pressure was on local authorities to preserve the foreign exchange reserves.

From this backdrop, the need for exchange control was born and the Exchange Control Regulations were promulgated. After the elections in 1994, the South African Government declared that it will abolish all exchange control regulations, as these restrictions were no longer needed. The Government did not want to abolish all the restrictions at once and embarked on a phased process. (Deloitte, 2012b: 7)

Government Notice number R445 of 8.6.2012 was issued on 8 June 2012, announcing the amendment to Regulation 10 of the Exchange Control Regulations. The amendment centred on the fact that *capital* shall include any intellectual property rights, whether registered or unregistered. This change in Exchange Control Regulation essentially means that National Treasury approval needs to be obtained before any intellectual property can be moved offshore. (Exchange Control Regulation 10(1) (c) of The Exchange Control Regulations, 1961)

The amendment to Regulation 10(1) (c) to specifically include intellectual property as *capital* is very strange. It is a clear indication that the exportation of intellectual property was threatening the country's foreign exchange reserves to the extent that National Treasury deemed it essential to amend legislation to prevent this. This was a very important step taken by National Treasury in the aftermath of Oilwell (Pty) Ltd versus Protec International Ltd and Others (2011), where the court found intellectual property not to be *capital* in nature. (Deloitte, 2012b: 7)

The finding in the Oilwell case opened the door for multinational companies in South Africa to freely export intellectual property offshore, as it no longer needed to obtain approval from the National Treasury. According to Edward Nathan Sonnenbergs (2011a:3), in the past, it

used to be a complex, lengthy and expensive process to obtain approval to move intellectual property offshore. Exchange control authorities were also loath to approve the transfer. During the period that Treasury approval was no longer required, more and more companies were exploring the potential benefits that could be derived from making such a move. National Treasury caught on to this tendency and intellectual property suddenly gained prominence for exchange control purposes (please refer to Regulation 10(1)(c) of the Exchange Control Regulations, 1961).

The Oilwell case not only paved the way for the international transfer of intellectual property to an offshore destination. It also illuminated the fact that the South African tax administration faces certain weaknesses in accurately and efficiently assessing transfer pricing transactions of intellectual property. The tightening of the Exchange Control Regulations in terms of Regulation 10(1)(c), to specifically include intellectual property as *capital*, temporarily brought relief of these risks. However, Government is still dedicated to relaxing the exchange control regulations (South African Reserve Bank, 2013:1). The weaknesses that came to light during the Oilwell period remain until the South African Revenue Service take matters in hand.

1.1.2 Motivation of topic actuality

Intellectual property normally represents 40 to 80% of 'value-add' of multinational enterprises and it is a lucrative incentive to move intellectual property companies offshore to a low tax jurisdiction. International revenue earned through the use of the intellectual property is then taxed at a much lower rate, resulting in higher net profit at the end of the financial year. (Huibregtse *et al.*, 2011:1)

If the control of these transfers by National Treasury is relaxed, it could lead to a significant erosion of the South African tax base to the low-tax jurisdictions, if legislation is not geared to address aggressive tax planning schemes. These tax advantaged jurisdictions have caught onto the idea and many have adjusted their tax rates and substance thresholds in a bid to attract investment and tax revenue from companies incorporated in higher tax jurisdictions. (Huibregtse *et al.*, 2011:1)

The Organisation for Economic Cooperation and Development (OECD) also identified this behaviour. The OECD put pressure on these low tax jurisdictions to design substance requirements, adopt exchange of information rules and address substance in light of transfer pricing risk management. This was done in a bid to tackle aggressive tax planning by multinational enterprises (Huibregtse *et al.*, 2011:1). The amendment to Regulation 10(1) (c)

of the exchange control regulations is currently curbing this kind of behaviour in South Africa, but it is still prevalent in many overseas countries. This is why the OECD implemented mitigating measures.

The dismissal in the Oilwell case complicated tackling aggressive tax planning by multinational companies for SARS. The amendment to Regulation 10(1)(c) of the Exchange Control Regulations managed to nip these tax schemes in the bud. However, some day the South African Government will relax these regulations and then the risks experienced during the Oilwell case tenure will resurface.

This mini-dissertation aims to highlight the weaknesses in transfer pricing in terms of intellectual property and to provide potential suggestions for improvement. It also considers the measures put in place by foreign countries and the measures suggested by the OECD to address the never-ending need to gather relevant and comprehensive information and look at the economic substance requirements legislated by various countries (Huibregtse *et al.*, 2011:1).

After a preliminary examination, it was found that the areas expected to be affected by a relaxation of the exchange control procedures is transfer pricing, exchange of information and substance requirements. If Government were to relax the exchange control measures put in place to regulate the transfer of intellectual property, these will be the areas that local tax administration would have to zoom in on to prevent any unnecessary losses to the South African tax base.

The first focus area is transfer pricing. The wording of the transfer pricing legislation in The Income Tax Act No. 58 of 1962, as amended (hereafter The Act), and the guidelines provided by SARS lead to problems and uncertainty. This is due to the fact that the literal wording of the article in the Act focuses on individual transactions, instead of on the complete economic substance and commercial objectives of an arrangement. As of years of assessment commencing on or after 1 April 2012, section 31 of the Act, was changed to be more in line with the wording of the OECD Transfer Pricing Guidelines in an attempt to avoid unnecessary problems and uncertainty (National Treasury, 2010:75–76). However, this is an ongoing project and, after April 2012, section 31 has seen more changes.

South African tax legislation requires Chapter VI of the OECD Guidelines, which deals specifically with transfer pricing in relation to intangible property, to be followed when transactions of this nature are assessed. The Commissioner deems the provisions in the chapter relevant in dealing with the arms-length principle that comes into play when dealing

with transactions in intangible property (SARS, 1999:34). Despite the suggested application of Chapter VI of the OECD Guidelines by the Commissioner, during the 2012 and 2013 financial year, SARS outlined various areas for strengthening risk management in the tax environment. One of the compliance areas discussed refers to Transfer Pricing (SARS, 2012a:25).

The principle of comparability is functional to the assessment of the arm's length price of a transaction. The potential for unique situations and cases involving unique intangibles and the availability of relevant comparables is extremely limited. This makes it difficult for local tax authorities to adequately assess transfer pricing transactions involving intellectual property (SARS, 1999: 9). In small domestic markets, where comparable third party transactions are rarely discovered, finding comparables is even trickier (UN, 2012b:19).

The second area of concern is the exchange of information. With an increased number of companies operating global businesses, the explosion of aggressive tax planning and schemes became more prevalent. To address aggressive tax planning, the OECD is placing more emphasis on the availability of timely, targeted and comprehensive information. The OECD indicated that the experience from various countries has proved that traditional audits alone do not provide sufficient information (OECD, 2011b: 12).

The third problem lies with the economic substance requirements. According to Brackx & De Haen (not dated), international guidelines on substance requirements are becoming more important to tax authorities worldwide. This is because many international companies operate subsidiaries offshore in low-tax jurisdictions to benefit from the lower taxes payable in those countries. The requirement for economic substance means companies are expected to prove the existence of an operational business that is more than a shell company existing on paper with a postal address. Uncertainty existed as to what constitutes *economic substance*, but the new OECD guidelines on transfer pricing provides useful guidance by indicating the following substance parameters:

- What roles and responsibilities are specifically assigned to what person in what jurisdiction?
- Does that person have sufficient equity and insurance coverage, given the business risks to which he is exposed?
- Is there enough skilled staff to carry out a local core business (Brackx & De Haen, n.d:1)?

Tax authorities also tend to look at the following:

- Are there any local directors and a bank account?
- Are local compliance formalities duly satisfied?
- Are meetings physically held locally?
- Are the company's operating expenses recorded in the local Statement of Financial Performance (Brackx & De Haen, n.d:1)?

1.2 Problem statement related to the research topic

From the above discussion the following problem statement can be drafted: The abolishment of exchange control regulations by the South African Government are in the pipeline. This inevitably means that the South African Revenue Service is faced with a number of weaknesses in terms of the assessment of transfer pricing transactions related to intellectual property.

1.3 Objectives of the study

1.3.1 Main Objective

To point out the areas of weakness that could lead to an erosion of South Africa's tax base once the exchange control regulations are relaxed, and to make suggestions for potential improvement.

1.3.2 Secondary Objectives

1.3.2.1 To summarise the definition of 'intellectual property' in terms of *capital* as defined by the findings in the tax courts (Chapter 2).

1.3.2.2 To investigate the treatment of transfer pricing in South Africa in relation to intangible property, and highlight some of the areas that prevent SARS from effectively assessing transfer pricing transactions. Also to define recommendations that could lead to the improvement in the assessment of transfer pricing transactions (Chapter 3).

1.3.2.3 To study the limitations in obtaining timely, targeted and comprehensive information from local companies and foreign jurisdictions, and make recommendations to address these limitations (Chapter 4).

1.3.2.4 To explore the term, *economic substance*, by referring to the following:

- Ordinary dictionary meaning of the words contained in the phrase
- Guidance provided by the courts regarding the term *economic substance*

- Guidance provided by South African tax legislation regarding the term *foreign business establishment* (Chapter 5).

1.3.2.5 To examine the parameters of *economic substance* implemented by other popular intellectual property company holding destinations (Chapter 5).

1.3.2.6 To define and conclude on the weaknesses in transfer pricing assessment in respect of intellectual property if Government decides to relax exchange control regulations in the future (Chapter 6).

1.4 Research method followed

The dissertation was completed by performing a non–empirical, evaluative literature review on the doctoral research paradigm. Various sources were consulted to perform the review. These sources included, among others:

- Guidelines provided by the OECD;
- Guidelines provided by the UN;
- Various Acts and Regulations including the Income Tax Act, the Tax Administration Act, Exchange Control Regulations, etc.;
- Articles on the subject matter written by various academics; and
- Relevant European case law.

A brief analysis of the *economic substance* parameters applied by various countries is presented. These countries have been selected for the following reasons:

- Some of these countries are popular intellectual property holding locations (refer to Table 1.1, page 6);
- Except for Madeira, all the countries are members of the OECD;
- The countries have various ways to determine *economic substance* and to provide guidance in establishing local substance parameters. This could provide recommendations to the challenges South Africa faces in the event that exchange control regulations are relaxed and the control by National Treasury over foreign exchange reserves is no longer in place. Multinational companies with subsidiaries established in low-tax jurisdictions are becoming the focus of tax authorities worldwide as part of their fight against tax fraud. These companies are forced to prove that their subsidiaries have genuine economic substance, or risk losing the tax benefits. Tax administrations with well formulated *substance* requirements stand to gain by preventing undue losses of foreign exchange reserves (Brackx & De Haen, n.d:1).

1.4 Overview of the research study

This mini-dissertation includes the following chapters. The chapters are listed below and include a brief overview of its contents.

Chapter 1: Introduction and background

Chapter 1 is the introduction to the research topic with a description of the problem statement, literature review and breakdown of sources. The chapter also provides an explanation of the viewpoint and approach taken in this research.

Chapter 2: The meaning of the term ‘intellectual property’ in the context of *capital*, as defined in The Act

Chapter 2 includes a discussion on the literal meaning of the words ‘intellectual property’ and how it fits into the meaning of the concept of *capital*. This will be based on guidance provided by the courts on the discussion of whether ‘intellectual property’ constitutes capital or not.

The chapter continues with an analysis of the interpretation and meaning of the term *capital* based on the guidance provided by South African tax law and the general treatment thereof.

Chapter 3: Transfer pricing and the limitations in successfully assessing transfer pricing transactions

Chapter 3 focuses on the term transfer pricing and which procedures are used to arrive at an appropriate assessment of the transaction that took place. The focus will be placed on areas such as the place of effective management (which normally indicates where the control of the asset is based), connected persons and the arm’s length principle. An important consideration in this chapter is the recommendations provided by the OECD in assessing transfer pricing transactions involving intellectual property.

The chapter also presents various weaknesses in the South African tax net in arriving at effective and relevant assessments where transactions involving intellectual property and transfer pricing are of concern.

Lastly a number of recommendations to address the weaknesses identified are provided. These suggestions could help enhance the manner in which transfer pricing transactions are assessed when it involves the transfer of intellectual property.

Chapter 4: The limitations in obtaining timely, accurate and comprehensive information

Chapter 4 focuses on the manner in which information is gathered in order to make a fair assessment of a transfer pricing transaction involving intellectual property. A look at the current methods imposed by local administrators is provided. Various additional methods as suggested by the OECD to obtain more comprehensive and relevant information is also discussed and considered in terms of the practicality thereof.

The chapter also investigates the usefulness of enforcing Article 26 of the OECD Model Tax Convention in all double tax agreements entered into by South-Africa and considers how this will enable the tax administrator to enhance information resources available to it. Lastly, certain options are considered in terms of the value it could add to the methods currently used by local tax administrators.

Chapter 5: Analyses of the meaning of *economic substance* and the application thereof

In this chapter the ordinary dictionary meaning of the phrase *economic substance* is explored in terms of the guidance provided by the courts. These tax opinions emphasize the importance of *economic substance* in the determination of whether the transfer of intellectual property took place in a legitimate fashion to a legitimate company in an offshore location. Further guidance is also provided by exploring South African tax legislation in terms of the meaning of *permanent establishment* which outlines the basic measures of *economic substance*.

The chapter also analyses the *economic substance* parameters applied by foreign jurisdictions in terms of the general substance requirements in popular intellectual property host countries and substance requirements in favourable intellectual property locations, such as; Hong Kong, Luxembourg, Madeira, Mauritius, Singapore and Switzerland. Substance requirements in various member states of the EU are also explored, such as; United Kingdom, Sweden, Germany, France and Spain.

The chapter concludes with the main considerations for South-African tax law in terms of defining *economic substance*.

Chapter 6: Conclusion and recommendations

Chapter 6 presents a conclusion on the impact that the eventual abolishment of Exchange Control Regulations will have on South African tax legislation, especially in terms of Regulation 10(1)(c) with reference to intellectual property and provides possible topics for further study.

CHAPTER 2: THE MEANING OF THE TERM 'INTELLECTUAL PROPERTY' IN THE CONTEXT OF *CAPITAL*, AS DEFINED IN THE ACT

2.1 Introduction

As discussed in the previous chapter (section 1.1.1, page 1), Regulation (10) (1) (c) of the Exchange Control Regulations, 1961, was amended on 8 June 2012. This was done after the court, in its dismissal of the Oilwell case, found intellectual property not to be *capital* for the purposes of National Treasury and the transmission of *capital* to an offshore destination. The Regulation was amended to specifically include intellectual property and render the effect of the dismissal irrelevant.

In this chapter, the secondary objective is considered (section 1.3.2.1, page 5) - the meaning of the concept 'intellectual property' and how it fits into the definition of *capital*, as defined in The Act.

The literal meaning of the term intellectual property as defined by the ordinary dictionary meaning is examined as well as the interpretation of intellectual property as provided by the British Intellectual Property Office and the World Intellectual Property Organisation. A discussion of whether intellectual property constitutes *capital* is provided by reference to various case law on this matter as it is not defined in the Income Tax Act as well as an interpretation of the meaning of *capital* as intended by the Exchange Control Regulations.

The Exchange Control Regulations do not contain a specific definition for the term *capital*. However, based on the fact that the Regulations specifically include intellectual property as *capital* it is important to determine the meaning of this term. The interpretation held by National Treasury and the interpretation held by South African tax courts is completely different. For National Treasury it determines the restrictions in terms of what items may be exported from our shores and for taxation purposes the transfer of *capital* (once it is permitted by National Treasury) triggers various sets of tax legislation as described in section 2.4, page 21.

Finally, the treatment of an asset that has been classified as *capital* is briefly summarised by reference to the various sections in the Act and the Eighth Schedule to the Act.

2.2 Literal meaning of the words ‘intellectual property’

Ordinary dictionary meaning

‘Intellectual Property’ is defined in the Oxford advanced learners dictionary of current English (1995:620) as “property such as an idea, a design, etc. that has been created or invented by somebody but does not exist in a physical form”. In other words, it has no substance and cannot be touched. It is difficult to understand why something without any physical form could attract so much attention.

Meaning provided by Intellectual Property Organisations

The British Intellectual Property Office (not dated) views it to be something that is the result of the expression of an idea, in other words, a brand, an invention, a design, a song or other intellectual creation.

Intellectual property is also something that can be bought or sold. The World Trade Organisation (2012) extends the definition even further, into intellectual property rights. “Intellectual property rights are the rights given to persons over the creations of their minds. Normally it is the exclusive right given to the creator over the use of his or her creation for a certain period of time.”

According to the World Intellectual Property Organisation (not dated), intellectual property is described as “creations of the mind: inventions, literary and artistic works, and symbols, names, images and designs used in commerce”. Intellectual property is usually divided into two categories:

a. Copyright and rights related to copyright

This would be the rights of authors of literary and artistic works, which are protected by copyright for a minimum period of 50 years after the author’s death. The rights of performers and producers of phonograms in their recordings and broadcasting organisations are also protected by copyright. The protection of copyright and related rights in a social context is, to promote and incentivise creative work.

b. Industrial property

Industrial property can be divided into two main areas:

- The first area is the protection of distinctive signs, such as trademarks and geographical indications.
 - The protection of these distinctive signs aims to encourage and confirm fair competition, while protecting consumers and enables them to make informed choices between various goods and services. Protection is indefinite, as long as the sign in question remains distinctive.

- Other types of industrial property are primarily protected to promote innovation, design and creation of new technology. This includes inventions, industrial designs and trade secrets.
 - These rights provide protection for the results of the investment in new technology. This protection promotes the lure and financing of research and development activities. Protection is normally for a finite term, mostly 20 years in the case of patents (World Trade Organisation (2012)).

'Intellectual property' is summarised as being a creation of the mind or an expression of an idea that has commercial value and the originality of the creation or idea is protected by intellectual property rights. It is one of the most readily tradable properties in the digital marketplace.

2.3 Guidance provided by the courts on the discussion of whether 'intellectual property' constitutes *capital*

What is *capital*? How is *capital* defined from a tax point of view and how is it viewed from an economic point of view? An understanding of these principles will enable the reader to understand the discussion surrounding intellectual property and why it is important to decide whether it is *capital* or not. The determination of whether it is *capital* or not will influence the treatment by National Treasury (Is prior approval required before it can be exported?), as well as the tax treatment (*Capital* is non-taxable, but will have *capital* gains tax implications, while an item that is revenue in nature is taxable).

Meaning provided by the tax courts

The Act contains no definition of the term *capital*. The tax courts, over the years, have reached many conclusions on the subject, but there exists no single infallible test (Stiglingh *et al.* (2012:27)). The most common court decisions on the subject serve as a guideline to all

taxpayers and to SARS. However, each case that requires a distinction between 'income' and *capital* has to be decided based on the merits and facts of that individual case.

Maritz J stated in *CIR v Visser* (1937 T) (at 276): "Income is what *capital* produces, or is something in the nature of interest or fruit as opposed to principal or tree." This economic distinction is a useful guide in matters of income tax. However, its application is very often a matter of great difficulty, for what is principal, or tree in the hands of one man may be interest, or fruit in the hands of another. "Law books in the hands of a lawyer are a capital asset; in the hands of a bookseller they are a trade asset. A farm owned by a farmer is a *capital* asset; in the hands of a land-jobber it becomes stock-in-trade."

Intellectual property is commonly used in the hands of the taxpayer to generate income, for instance brands such as Nike, Coca-Cola or Levi attract customers and stimulate sales. It would therefore be classified as *capital*, as it is employed in the production of income.

Capital or revenue

The judge, in the dismissal of *Pyott Ltd v CIR* (1945 AD), Davis AJA, refused to accept that an amount could be both 'non-*capital*' and 'non-income'. He declared it to be a 'half-way house' which made no sense to him. In other words, he was of the sentiment that all amounts could be and should be classified as either revenue or *capital*. In the *Tuck v CIR* (1988 A) dismissal by the court, it was, however, conceded that a single receipt could be apportioned between a *capital* and income element. This dismissal made more practical sense for taxation purposes and is more clear-cut, especially when it comes to assessing a taxpayer on his or her taxable income. There should be no grey areas in the distinction between *capital* and income instruments.

In the judgment of *Elandsheuwel Farming (Edms) Bpk v SBI* (1978 A) (at 101), Judge Corbett summarised the question of what is *capital* and what is income. If an asset is sold in the course of carrying on a business, the proceeds will be regarded as revenue. If a capital asset is realised, the proceeds will be capital in nature. If, indeed, it is the case that the taxpayer has entered into a profit-making scheme, the proceeds will be revenue in nature. The onus of proof, however, always remains with the taxpayer.

The transfer of intellectual property to an offshore destination has gained an increased level of attention over the past few years. This is due to the concern that it could lead to an erosion of the South African tax base. As such, the question of whether this transaction forms part of a profit-making scheme, or a sale in the normal course of carrying on a business, will need to be addressed. Due to better tax incentives being offered in various

low-tax jurisdictions, the transaction could be held to be part of a profit-making scheme, resulting in the proceeds being taxed as being revenue in nature. If the multinational company fails to provide sufficient evidence to the contrary, capital gains tax and transfer pricing rules will come into effect. SARS then needs to be prepared to assess the transaction accurately, sufficiently and in a timely fashion.

Intention

The golden rule used by most courts, is to test the intention of the taxpayer. In *Lace Proprietary Mines Ltd v CIR* (1928 AD) it was established that the taxpayer's intention needs to be investigated at three different stages:

- At the time he acquired the asset;
- During the whole period over which he held the asset;
- At the time he disposed of the asset.

In *COT v Levy* (1952 A), the court decided if the taxpayer has mixed intentions in respect of an asset, his main or dominant intention would be decisive. If two alternative intentions with regard to an asset were displayed, the judgment in *Overseas Trust Corporation Ltd v CIR* (1926 AD) determined that the proceeds derived from the disposal of the asset would be income in nature. The same principles as discussed in the above two cases would be applied offshore to determine the intention of the multinational company when intellectual property is transferred offshore.

It often happens that a taxpayer changes his initial intention with regard to the use of an asset. In *SIR v The Trust Bank of Africa Ltd* (1975 A) the following consensus was reached in respect of a change in intention (at 101): "The question whether the profits realized on the sale of an asset constituted a revenue or *capital* accrual depended upon whether the purchase, holding and sale of the asset were steps in a scheme of profit-making, i.e. to make a profit by the resale of the asset at an enhanced price; or whether the sale constituted the realisation of a *capital* asset and it was acquired and held for purposes other than such a profit-making scheme."

Wessels AJ in *John Bell & Co (Pty) Ltd v SIR* (1976 A), concluded on the legal position as follows (at 103): "Moreover, my understanding of the cases that deal with the matter is that the mere change of intention to dispose of an asset hitherto held as *capital* does not *per se* subject the resultant profit to tax. Something more is required in order to metamorphose the character of the asset and so render its proceeds gross income. For example, the taxpayer

must already be trading in the same or similar kinds of assets, or he then and there starts some trade or business or embarks on some scheme for selling such assets for profit, and, in either case, the asset in question is taken into or used as his stock-in-trade.”

An example of a change of intention can be found in *SIR v Rile Investments (Pty) Ltd* (1978 A), where the court found the company had changed its intention. The company had started out holding certain land with mixed intentions (intending either to sell the land at a profit or to hold it as a long term investment - an asset of a *capital* nature).

It was concluded in *Elandsheuwel Farming (Edms) Bpk v SBI* (1978 A), that the mere decision to sell an asset of a *capital* nature does not qualify it as a change in intention. The transfer of intellectual property to an offshore location could also indicate a change of intention, as it could initially have been acquired as a long-term investment, but has now been disposed of in a profit-making scheme. Once again, the onus will lie with the multinational company (taxpayer) to prove that the *capital* asset was realised to best advantage and not to derive a profit, or avoid tax liability in South Africa.

The intention of a company in terms of the realisation of its assets was summarised in *CIR v Richmond Estates (Pty) Ltd* (1956 A) (at 361): “A company is an artificial person ‘with no body to kick and no soul to damn’ and the only way of ascertaining its intention is to find out what its directors acting as such intended. Their formal acts in the form of resolutions constitute evidence as to the intentions of the company of which they are directors...”

The court, in a case decided by the Court of Appeal of Botswana – *Tati Company Ltd v Collector of Income Tax* (1974 A), determined that the intention of the shareholders with regard to the assets of the company, could not be said to be the intention of the company, as it is a separate persona.

Nevertheless, the shareholders’ intention should never be completely ignored. The intention of the shareholders and the directors jointly, should be considered by SARS when assessing the tax consequences of a transfer of intellectual property to an offshore destination.

Fixed and floating capital

The distinction between ‘fixed’ and ‘floating’ capital has been used on numerous occasions as a measure for determining whether a receipt is income or *capital* in nature. In *CIR v George Forest Timber Co Ltd* (1924 A), the learned judge referred to the distinction between ‘fixed’ and ‘floating’ *capital* as follows (at 23): *Capital* is either fixed or floating. Floating *capital* is consumed or disappears during the production process. Fixed *capital* produces fresh wealth, but still remains intact.

Intellectual property should also be evaluated based on the concept of fixed and floating capital. In general, intellectual property will be classified as fixed capital, or the tree that produces fruit. It was discussed earlier in this chapter what the concept 'intellectual property' means, being a creation or invention of the mind. This creation or invention is then used or applied by a business to 'produce' revenue.

However, a company could also give other persons the right to use this creation or invention for their own benefit and charge the ultimate user royalty fees. In both instances, fresh wealth is created and therefore the intellectual property is fixed capital in the hands of the owner. To a lesser extent, examples could exist of companies who trade in intellectual property. In other words, the company buys intellectual property to sell it at a profit. This kind of transaction will be regarded as floating *capital*, as the *capital* disappears when it is sold to the buyer.

The frequency with which a certain transaction takes place could also be an indication of the nature of the transaction, i.e. income or capital. In *Stephan v CIR* (1919 WLD) normal tax was incurred, because it was determined that the motive was profit-making when a once-off salvage transaction was entered into. The court found in *ITC 43* (1925), that although a transaction was different from the taxpayer's normal transactions (isolated transaction), if it was still within the scope of his business, it was held to be subject to normal tax. In *CIR v Lydenburg Platinum Ltd* (1929 A), the conclusion reached regarding the issue of one transaction was summarised as follows (at 16): "...So that continuity (as it has been called) is a necessary element in the carrying on of a business in the case of an individual but not of a company. Indeed, many cases have come before this court where there has only been one profit-making transaction of a company and that fact has never been relied upon as in any way decisive of the question whether the profit was made in the carrying on of the company's business or otherwise."

Once again, the disposal of intellectual property will, in general, be a once-off transaction. This is due to the fact that intellectual property is employed in producing income, unless the multi-national company is in the business of acquiring and selling intellectual property as part of its stock-in-trade in the normal course of business. The general notion is that intellectual property does not normally constitute stock-in-trade or revenue and is commonly regarded as *capital* and, if sold, it would be a once-off transaction realising an asset to best advantage.

Realisation companies and trusts were explained as follows in *Berea West Estates (Pty) Ltd v SIR* (1976 A) (at 628): "Suppose for example, A and B and C own a tract of land, not having acquired it with a view to sale, and they wish to realize this *capital* asset; and they

promote a company and become the exclusive shareholders; and they transfer the land to the company for the purpose of realizing the asset; and, when it has been sold, the company is to be wound up and its assets distributed among the shareholders. The company would be regarded as a realization company, and not a company trading for profits, and the surplus would be regarded as a *capital* receipt; unless of course, the company conducted itself as a business trading for profits, using the land as its stock-in-trade.”

Disposal of intellectual property

The transfer of intellectual property to an offshore location will be regarded as a disposal in the South African context (most likely as a capital transaction), but the treatment of the intellectual property, once in the hands of the offshore company, will not influence the distinction between capital and revenue for the initial transaction that takes place on South African soil.

A taxpayer who receives interest (for the use of money), dividends (for the employment of shares), or royalties (for the use of patents or rights, such as prospecting rights or mineral rights) would be regarded as having received income of a revenue nature (*Modderfontein B Gold Mining Co Ltd v CIR* (1923 A), *COT v Rezende Gold and Silver Mines (Pty) Ltd* (1975 Z)). This is due to the fact that an asset of a *capital* nature was employed to generate income.

Interpretation in the Oilwell case

On 18 March 2011, the court dismissed the appeal in *Oilwell (Pty) Ltd versus Protec International Ltd and Others* (2011) and found that exchange control approval is not required when a South African resident transfers intellectual property to a non-resident. The South African Reserve Bank’s approach prior to the *Oilwell* case, was to treat all intellectual property as a right to *capital* and it required that permission be obtained from the Treasury, according to regulation 10(1)(c) of the Exchange Control Regulations, before any such *capital* could be exported offshore. In dismissing the *Oilwell* appeal, the court found in essence that:

- A trademark does not qualify as *capital* or as a ‘right to *capital*’ and therefore the application of Regulation 10(1)(c) is not required;
- A trademark is territorial in nature and can therefore not be exported. Intellectual property, in general, includes not only trademarks, but also patents, know-how, designs, models used for the production of a product, or provision of a service, as well as intangible rights that are in themselves business assets transferred to

customers, or used in the operation of business (e.g. computer software) (OECD, 2010d:2);

- In the event that a trade mark does qualify as *capital* or a 'right to *capital*', failure to obtain exchange control approval in terms of Regulation 10(1)(c) does not result in the transfer being null and void, *ab initio*.

Exchange Control Regulation 10(1) (c) of The Exchange Control Regulations, 1961, imposed by National Treasury before the amendment on 08 June 2012, dictated:

“Restriction on export of *capital*

10.(1) No person shall, except with permission granted by the Treasury and in accordance with such conditions as the Treasury may impose –...(c) enter into any transaction whereby *capital* or any right to *capital* is directly or indirectly exported from the Republic.”

The point of view taken by National Treasury in the amendment of the Regulation was supported in the preceding court case of Couve versus Reddot International (Pty) Ltd (2004). In this case, it was held that the transfer of intellectual property to a non-resident was deemed to be an export of *capital*, and that exchange control approval in terms of Regulation 10(1)(c) of the Exchange Control Regulations of 1961, was required. The Court, in this case, held firm that use of the words 'directly or indirectly' before the term 'export' in Regulation 10(1)(c) of the Exchange Control Regulations, 1961, meant that the widest possible meaning was to be read into the meaning of 'export'. The rationale behind this was to attempt to preserve South African *capital*.

In the Oilwell case the judge determined that intellectual property rights are not *capital* within the meaning of the term as intended in Regulation 10(1)(c) of the Exchange Control Regulations, 1961. The matter in the Oilwell case revolved around the trademark called 'Protec'. This trademark is currently registered in the name of Protec Autocare Ltd (incorporated in the UK) at the time of going to court. Oilwell (Pty) Ltd is a local company registered in the Republic of South Africa.

The purpose of Oilwell going to court was to have the trade mark register rectified to reflect Oilwell (Pty) Ltd as the owner, instead of Protec Auto Care Ltd. Oilwell relied on section 24(1) of the Trade Marks Act 194 of 1993, which provides that, in the event of an erroneous entry in the register, an interested party may apply to court to have the matter rectified.

The relationship between Protec International Limited (registered in Guernsey) and some of the other related parties had soured over the years. Protec International Limited were in financial straits and, as part of a settlement, the South African trademark was assigned to

Protec Autocare (Pty) Ltd. Oilwell came across the judgment in *Couve v Reddot International (Pty) Ltd* (2004), which stated that the transfer of intellectual property to a non-resident is viewed as an 'export of *capital* and exchange control approval needs to be granted by the South African Reserve Bank in terms of Regulation 10(1)(c) of the Exchange Control Regulations.' (*Oilwell (Pty) Ltd v Protec International Ltd and Others*, (2011))

Oilwell (Pty) Ltd wanted to have the transfer of intellectual property to Protec Autocare Ltd reversed on the grounds that no prior exchange control approval had been obtained, resulting in the transfer being void. Oilwell referred to the findings in the *Couve* dismissal to make his case (*Webber Wentzel*, 2011:1 and *Couve v Reddot International (Pty) Ltd* (2004)).

In the dismissal of the Oilwell case, the court held that exchange control approval was not required when a South African resident assigns intellectual property to a non-resident. (*Webber Wentzel*, 2011:1) This was the opinion before the amendment of Regulation 10(1)(c) to specifically include intellectual property as *capital*. It was stated by Oilwell's council that, considering the wide wording of the provision and the objective of the Regulation, *capital* is anything (or everything) with monetary value in the financial sense of the term. The council in the Oilwell case also referred to the definition in the *Encarta World English Dictionary*, which states the meaning of *capital* in a financial context is 'cash for investment or money that can be used to produce further wealth'.

Further support for this argument is found in Regulation 1 of the Exchange Control Regulations, 1961, which does not regard *capital* and 'assets' as similar concepts. *Capital*, in this concept, refers more to share capital. There are also other textual references in regulation 10(1) of the Exchange Control Regulations, 1961, where paragraphs (a) and (b) deal with the export of 'goods' (understood to be regarded as assets) while paragraph (c) deals with the export of capital.

Intellectual property is territorial and comparable to an immovable asset according to the Oilwell case. It cannot be exported. It was also further established in the Oilwell case that serious problems would rear its head if *capital* were to mean everything with a monetary value. In this context, immovable property would then be classified as *capital* and, even although it cannot be transferred to a different location, the sale of such property to a non-resident would be regarded as the export of the right to *capital* and would fall under regulation 10(1)(c) of the Exchange Control Regulations, 1961.

If the facts in the Oilwell case are considered from a tax point of view, the starting point will be to take a look at the taxpayer's intention. If an asset is used to generate income, it is

normally *capital* in nature. Where the asset is treated as stock-in-trade and sold with the intent of making a profit, the proceeds will be income in nature.

Oilwell's intention was to have the intellectual property transferred onto its name and to utilise the intellectual property as an income producing instrument. This was based on what it hoped would be a simple default in the application of the Exchange Control Regulations.. In other words, the asset would then be *capital* in nature (from a tax perspective) and exchange control approval would be required for a legal transfer.

From an accounting perspective, intellectual property is an asset and not *capital*, as stated in the discussion by the judge in the Oilwell dismissal. The dismissal in the Oilwell case was correct in stating that intellectual property is not *capital*. However, if the monetary value of intellectual property is reflected, one can understand why National Treasury felt the need to specifically include intellectual property as *capital* and, in so doing; attempt to prevent the erosion of the South African tax base.

According to a manual published by the United Nations (2012a: foreword), intra-firm trade comprises more or less 30% of global trade. This is reason to believe that the loss to the tax base, when intellectual property is expatriated, is quite significant. The UN (2012a:foreword) also states more research is required to determine the extent of the potential loss for individual developing countries due to the inaccurate assessment of transfer prices. It is assumed that this would also include the assessment of transfer prices in respect of intellectual property.

Clearly, the tax and financial understanding of the definition of *capital* are entirely different. The tax courts regard most assets (with exceptions) that are held to produce further wealth or income as *capital* (*CIR v Visser (1973 T)*). The financial market refers to *capital* from a monetary point of view and specifically excludes assets or goods from this understanding.

It was this distinctive difference in the interpretation of the term *capital*, as interpreted in the Oilwell–case, that allowed multinational companies to export intellectual property without the restrictions imposed by the Exchange Control Regulations, 1961. However, National Treasury realised the consequences of this interpretation and duly amended Regulation 10(1)(c) of the Exchange Control Regulations, 1961, to once again prohibit the transfer of *capital*, which specifically includes intellectual property.

Conclusion

According to Stiglingh *et al.* (2012:36) and the findings in the Oilwell Case, when the need arises to determine whether copyrights, inventions, patents, trademarks, formulae and secret

processes are income or *capital* in nature, the same tests as discussed above for other assets, should be applied. Each case should be judged on its own merits. If a person acquired and held such assets as an income-producing investment, any amount received for the disposal of it would be *capital* in nature. However, if it was acquired for the purpose of a profitable resale, the proceeds would be regarded as income in nature.

2.4 Guidance provided by South African tax legislation regarding the treatment of an 'asset' that has been defined as *capital* in nature

Intellectual property, including the right to use intellectual property, is included in the definition of an asset for Capital Gains Tax (CGT) purposes in the Eighth Schedule to The Act. The definition of an 'asset' in par1 includes: "property of any nature, whether, movable or immovable, corporeal or incorporeal". This excludes any currency, but includes any coin made mainly from gold or platinum. The definition also includes a right or an interest of any nature in such property.

Paragraph 11(1)(a) of the Eighth Schedule to the Act classifies a sale, donation, expropriation, conversion, granting, cession, exchange or any alienation or transfer of ownership of an asset as a disposal event for CGT purposes. An assignment of a trade mark offshore will be deemed a disposal of an asset resulting in a *capital* gain, or loss being realised for CGT purposes. Any gains realised will be subject to income tax at an effective rate of 18.67% (included in taxable revenue at a CGT rate of 66.67% and taxed at 28%).

Paragraph 38 of the Eighth Schedule to the Act stipulates that when a person disposes of an asset:

- To anyone by means of an donation;
- To anyone for a consideration not measurable in money;
- To a connected person for a consideration that does not reflect an arm's-length price, then the disposal is treated as a disposal of an amount to the market value on the date of the disposal.

In the event that the South African company assigns the intellectual property to a connected party offshore, it will be deemed to have taken place at market value for CGT purposes, if the transfer took place at nominal value. The market value of the intellectual property will therefore need to be established for the calculation of the capital gain or loss (Paragraph 38 of the Eighth Schedule to the Act.).

Allowances claimed on intellectual property in terms of section 11(gB) (Registration expenses of intellectual property) and or section 11(gC) (Acquisition of intellectual property) of the Act will result in recoupments for income tax when the intellectual property is transferred. This will result in these recoupments being taxed at a rate of 28% (section 8(4) (a) of the Act).

Section 58 of the Act determines that if the intellectual property is assigned offshore for an amount that is not considered to be an adequate arm's-length value, it will be treated as a deemed donation and donations tax at 20% may be payable (section 64 of the Act).

The South African transfer pricing rules will also be triggered when intellectual property is assigned to a connected party offshore (section 31 of the Act). Multinational companies are a group of connected persons with business activities in various countries and they are able to influence the transfer price set for intellectual property, which is not always in line with arm's length principles. (SARS, 1999: 5) Read more on transfer pricing rules in Chapter 3.

Exchange Control approval is once again required for assigning intellectual property offshore. South African multinational companies need to be aware of the tax consequences of such an assignment and ensure that all tax liabilities are correctly accounted for and tax planning opportunities are properly investigated. (Edward Nathan Sonnenbergs, 2011b).

2.5 Conclusion

The objective of this chapter is to summarise the definition of 'intellectual property' in terms of *capital* as it is defined in The Act. The definition was formulated by taking a look at the ordinary dictionary meaning of the concept and an understanding of the concept 'intellectual property' from the point of view of various international intellectual property organisations.

The concept of *capital* is not defined in The Act and a brief look at various court cases that dealt with the principle of whether a transaction is capital or revenue in nature was summarised. Based on the case law defining *capital* and the definition for 'intellectual property' a conclusion was reached as to when 'intellectual property' will be termed as *capital*.

The term 'intellectual property' has been defined as the result of the expression of an idea that leads to the creation or invention of a brand, an invention, a design, etc. Intellectual property also includes intellectual property rights, such as copyright and industrial property.

Industrial property protects the rights of distinctive signs, such as trademarks, while other industrial property is primarily protected to promote innovation.

The Act does not contain a definition for the term *capital* and reliance needs to be placed on the conclusions reached by the tax courts over the years. When it comes to determining whether intellectual property is capital in nature, the same tests as applied to other assets are used. In essence, if an asset acquired and held to be utilised as an income-producing instrument, is sold, it is treated as a capital disposal. If an asset was acquired with the intent of selling it at a profit, it will be a disposal of an income nature.

Intellectual property transactions trigger various tax treatments. These tax implications were discussed in detail in this chapter.

The transfer of intellectual property to an offshore location, as mentioned above, may trigger transfer pricing implications. This means that all transactions of this nature need to be effectively assessed to ensure that no aggressive tax schemes are taking place and tax revenue is paid where due and liable.

South Africa relies on the guidance provided by the OECD to assess transfer pricing transactions relating to intellectual property. However, due to the fact that South African Reserve Bank approval is required before intellectual property can be transferred, SARS is not regularly exposed to transactions of this nature and not necessarily adequately skilled. Furthermore, the OECD Guidelines are aimed at developed countries, while South Africa is still in a developing stage, which means the application of the Guidelines is not always practical. The second secondary objective (section 1.3.2.2, page 5) is considered in the next chapter by taking a look at the way intellectual transactions are assessed for transfer pricing purposes, and the challenges South Africa faces in achieving this.

CHAPTER 3: TRANSFER PRICING AND THE LIMITATIONS IN SUCCESSFULLY ASSESSING TRANSFER PRICING TRANSACTIONS

3.1 Introduction

The previous chapter examined the meaning or interpretation of the concept of *capital*. The dismissal in the Oilwell case would have led to an increase in the measure of intellectual property being transferred offshore to reap the benefits of lower tax rates in other jurisdictions. However, this was circumvented by the amendment to Regulation 10(1)(c) which now specifically includes intellectual property as capital. The outcome of this would have been an increase in the number of transfer pricing transactions and the assessment thereof by local tax administrators. This chapter focuses on the secondary objective contained in section 1.3.2.2 (page 5), namely the treatment of transfer pricing transactions in relation to intellectual property. This chapter also highlights some of the challenges encountered by local administrators in doing so.

The chapter starts out by describing the current methods employed by local tax administration to calculate transfer prices for transactions involving intellectual property. The exploration focusses on the terminology presented in the Act and Practice Note 7 issued by SARS and the methodology suggested in the Guidelines published by the OECD. This inspection provides a walkthrough of main principles such as traditional transactional methods, determining the place of effective management, understanding the concept *connected person* and *arm's length principle* and a summary of the principles suggested by the OECD in assessing transfer prices for intangible assets.

The latter part of this chapter inspects the weaknesses currently in South-Africa in successfully assessing transfer prices for the transfer of intellectual property and studies potential remedies to address the weaknesses that have been identified.

3.2 The assessment of transfer prices pertaining to intellectual property in South Africa

The term 'transfer pricing' in relation to intellectual property refers to the price at which an entity transfers its intangible asset to connected persons. Multinational companies are a

group of connected persons with business activities in various countries and they are able to influence the transfer price set for intellectual property, which is not always in line with the arm's length principles (SARS, 1999: 5).

Section 31(2) of the Act currently defines the term 'transfer pricing' as follows: "Where-

- a) any transaction, operation, scheme, agreement or understanding constitutes an affected transaction; and
- b) any term or condition of that transaction, operation, scheme, agreement or understanding-
 - i) is a term or condition contemplated in paragraph (b) of the definition of 'affected transaction'; and
 - ii) results or will result in any tax benefit being derived by a person that is a party to that transaction, operation, scheme, agreement or understanding, the taxable income or tax payable by any person contemplated in paragraph (b)(ii) that derives a tax benefit contemplated in that paragraph must be calculated as if that transaction, operation, scheme, agreement or understanding had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm's length."

Due to the strict exchange control measures in the past (before 2011), the transfer of intellectual property between multinational companies in South Africa was not a regular occurrence. The economic situation during the tenure of the Oilwell case raised many questions in terms of the effective and accurate assessment of transfer prices with reference to intellectual property. The expansion in international trade and commerce also led to significant changes in the volume and complexity of transactions (SARS, 1999:5).

According to Kruger (2012), the following are the main drivers for the existence of transfer pricing legislation:

- A reduction in customs duty rates;
- A relaxation of exchange controls (although National Treasury imposed stricter regulations governing the transfer of capital, in particular intellectual property);
- The OECD;
- Section 31 of the Act and Practice Note 7.

Section 31(2) of the Act defines the term 'transfer pricing'. Although the definition of transfer pricing seems quite simple, in reality the identification and calculation thereof can be rather tricky. Making the necessary arm's length adjustment can be a lengthy, difficult process, requiring intensive knowledge of the taxpayer's business and operations (Edward Nathan Sonnenbergs, 2011a:3).

The OECD Guidelines on Transfer Pricing recommend various transfer pricing methods. These methods are divided in two general categories; the traditional transactional methods

and the transactional profit methods. The most appropriate method to be selected depends on the circumstances.

- The traditional transactional methods include:
 - The comparable uncontrolled price method (CUP method)
This method compares the price of a product in a controlled transaction to a price charged for a fairly similar product in an uncontrolled transaction in comparable circumstances.
 - The resale price method (RP method)
This method is based on the price at which a product, which was purchased from a connected person, is resold to an independent third party. The resale price is adjusted to account for a profit margin, selling expenses, etc. The remaining balance is then regarded as the arm's length price.
 - The cost plus method (CP method)
This method entails that a certain mark-up is added to the costs incurred by the supplier of the goods or services in a controlled transaction.
- The transactional profit methods consist of:
 - The transactional net margin method (TNMM)
This method relies on a profit level indicator of comparable independent parties. The profit margin a taxpayer then realises in a controlled transaction is measured against this profit level indicator.
 - The profit split method
This method focuses on the combined profit to be split between connected parties in a controlled transaction. The profit is split between the parties using an economically valid basis to estimate the split of profits that would have been expected in an arm's length agreement (SARS, 1999:13).

The SARS do not have specific legislation addressing the treatment or method to be used to assess the arm's length principle when intellectual property is transferred to an offshore location. Instead, Practice Note 7 refers to Chapter VI of the OECD Transfer Pricing Guidelines in the unlikely event of such a transaction taking place due to South African exchange control restrictions (SARS, 1999:34).

In this chapter, the theoretical approach to assessing transfer pricing transactions where intellectual property is transferred to an offshore connected party is looked at. The challenges facing local tax authorities in properly assessing transactions of this nature will be discussed. A few recommendations that could be considered in future are briefly outlined.

3.2.1 Background

The protection of the South African tax base is vital to South Africa's wealth and development in the light of the acceleration of business activity in the global arena (SARS, 1999:5). Protection against the manipulation of transfer prices have always been provided by exchange control. This protection is specifically relevant where profits are transferred to lower tax jurisdictions. Multinational enterprises with valuable intellectual property would take advantage of a relaxation of these exchange controls to benefit from lower taxes in other countries (SARS, 1999:6).

The South African transfer pricing legislation has, since inception, been based on the arm's length principle. This principle is set out in Article 9 of both the United Nations Model Double Taxation Convention between Developed and Developing Countries, and the OECD Model Tax Convention on Income and Capital, as well as the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ('the OECD Guidelines') (UN, 2012g: 1).

To reduce the manipulation of transfer prices, local tax authorities introduced section 31(2) into The Act. Unfortunately the scope of section 31(2) did not specifically address various types of transactions and Practice Note 7 was formulated to broaden the scope. But even Practice Note 7 is limited and refers to Chapter VI of the OECD Guidelines on Transfer Pricing in terms of intangible assets (or intellectual property). These three sources are summarised in the paragraphs to follow to indicate the process followed to assess transfer prices of intellectual property.

An interesting question raised by the United Nations (2012b:15) is, in instances where transfer pricing and CFC-rules apply, which legislation should take precedence. In considering this, it was mentioned that, due to the fact that transfer pricing rules assume all transactions to take place under the arm's length principle, it should take precedence over CFC legislation. So, after a country applied the transfer pricing legislation, it can apply the CFC rules to the remaining reserves or retained profit of the foreign companies in the Group.

3.2.2 Place of effective management

Section 31(2) of The Act firstly focuses on the relationship of a resident to any non-resident operation or scheme. To assess transfer pricing transactions where intellectual property is involved, it is necessary to understand the concept of a resident in terms of a multinational enterprise. The definition of a 'resident' in section 1 of the Act, as described in subsection

(b), is any 'person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic.'

The OECD Model Tax Convention on Income and on Capital, in Article 4.3, has a similar description for a resident as opposed to an individual. A person is deemed to be a resident only of the State in which its *place of effective management* is situated (OECD, 2010a:4).

In the opinion of Huibregtse *et al.* (2011:1), the effective place of management also relates to the central management and control profile of the company. In the instance that a company is managed by its directors in board meetings, the place of effective management will be deemed to be in the country where the board meetings are held. If the company is managed outside board meetings, the key is to determine who is making the high level management decisions and where, and to determine the place of effective management from there. Business activities of connected persons also help establish the place of effective management (SARS, 1999:3).

Huibregtse *et al* (2012:5) suggested the following tips regarding the physical presence of an intellectual property company's management team to establish *economic substance*:

- The Director or CFO makes the decisions of the intellectual property company when he or she is physically present in the country of residence of the company;
- Record should be kept of the physical presence in terms of the above decisions by means of minutes of meetings, signed documents, travel documents, etc.;
- Intellectual property registrations must be signed in the name of the intellectual property company;
- All other contracts must be in the name of the intellectual property company and must be signed by management when they are physically present in the resident country of the intellectual property company;
- Key decision makers should only make legally binding decisions when they are physically present in the country of residence of the intellectual property company.

Interpretation Note No. 6 (SARS, 2002:4) provides as a guideline a list of facts and circumstances that need to be assessed on a case-by-case occurrence to determine the *place of effective management*. This list includes:

- Where the centre of top management is located;
- Location of and functions performed at the headquarters;
- Where the business operations are actually conducted;

- Where controlling shareholders make key management and commercial decisions in relation to the company;
- Legal factors such as the place of incorporation; formation or establishment; location of the registered office and public officer;
- Where the directors or senior managers or the designated manager, who are responsible for the day-to-day management, reside;
- The frequency of the meetings of the entity's directors or senior managers and where they take place;
- The experience and skills of the directors, managers, trustees or designated managers who purport to manage the entity;
- The actual activities and physical location of senior employees;
- The scale of onshore as opposed to offshore operations;
- The nature of powers conferred on representatives of the entity, the manner in which those powers are exercised by the representatives, and the purpose of conferring the powers to the representatives (SARS, 2002:4-5).

Luker (2011: 4-6) discussed the flaws in the term *place of effective management*, used as a tie-breaker for determining the place of residence of a non-individual. Luker referred to 3 weaknesses: improved technology, improved mobility, and conflicting interpretations of the term *place of effective management*.

In the past, the place of effective management was determined to be the place where:

- The company's business activities took place;
- Senior management meetings and activities took place;
- Where the company was incorporated and had its place of effective management.

The improvement in technology in the past decade or so made it possible for senior management to conduct meetings through the use of video conferencing. This means people in management no longer need to be in one place to attend meetings and to make operational decisions. Information is also stored in digital data banks, which enable management to obtain access to it, no matter what the location. All this makes pinpointing the *place of effective management* to a single location very difficult (Luker, 2011:4).

Companies operate global businesses, which necessitates the mobility of the managers of these worldwide businesses. Senior management currently travel a lot more than in the past. This makes applying the *place of effective management* principle difficult. A reality of today's economic environment is that the managing director of a global company is constantly on the

move. It is not far-fetched for this person to make decisions while on the move or flying over the ocean. A company's board may travel to conduct its meetings anywhere, sometimes on an internationally rotating basis. This improved mobility also makes it difficult to apply the *place of effective management* principle (Luker, 2011:5).

There is currently no international consensus on the term *place of effective management*. The concept is interpreted based on local tax laws, rather than as an autonomous concept. This also makes the application of the *place of effective management* principle quite tough as each country reads its own interpretation into it (Luker, 2011:6).

It goes without saying that any person who is not deemed to be a resident of South Africa is a non-resident of South Africa. Such a person is only taxed in South Africa based on revenue from a source deemed to be in South Africa (SARS, 1962:34).

Determining the *place of effective management* is not always an easy task. It requires in-depth knowledge of the operations of the business and its day-to-day management.

3.2.3 Connected persons

Section 31(2) of The Act also refers to connected persons in relation to the resident. The Act defines a 'connected person' in section 1 subsection (d) as follows: 'in relation to a company,

- (i) Any other company that would be part of the same group of companies as that company if the expression "at least 70 percent" in paragraphs (a) and (b) of the definition of "group of companies" in this section were replaced by the expression "more than 50 percent";
- (ii) – (iii) ...
- (iv) any person, other than a company as defined in section 1 of the Companies Act, 1973 (Act No. 61 of 1973), who individually or jointly with any connected person in relation to himself, holds, directly or indirectly, at least 20 percent of the company's equity share capital or voting rights;
- (v) any other company if at least 20 percent of the equity share capital of such company is held by such other company, and no shareholder holds the majority voting rights of such company;
- (vi) any other company if such other company is managed or controlled by-
 - (aa) any person who or which is a connected person in relation to such company;
 - or
 - (bb) any person who or which is a connected person in relation to a person contemplated in item (aa); and
 - (vii) where such company is a close corporation-
 - (aa) any member;

(bb) any relative of such member or any trust (other than a portfolio of a collective investment scheme in securities) which is a connected person in relation to such member; and

(cc) any other close corporation or company which is a connected person in relation to-

- (i) any member contemplated in item (aa); or
- (ii) the relative or trust contemplated in item (bb).'

Basically the definition states that any subsidiary of a company (with more than a 50% shareholding) any associate or any investment of a company will be regarded as a connected person. Furthermore, if any of these companies is managed by a person with an interest of at least 20% in the above mentioned companies or any relation to this manager that person will also be a connected person. A close corporation will be a connected person of any member or relation of such a member of the close corporation and will also be a connected person of a close corporation that is a connected person of any member or relative of the members of the first close corporation.

Practice Note 7 further refers to the definitions contained in section 1 of the Companies Act, 1973 (Act No. 61 of 1973) relating to a holding company and subsidiary in terms of a connected person relationship (SARS, 1999:4). This Act has been superseded by the Companies Act 2008, (Act No.71 of 2008), but it is safe to assume that the definitions contained therein still applies to Practice Note 7 as intended by the reference to the previous version of this Act. The Companies Act 2008 describes a holding company as follows:

‘a holding company in relation to a subsidiary, means a juristic person that controls that subsidiary as a result of any circumstances contemplated in section 2(2)(a) or 3(1)(a).’

Section 2(2)(a) of the Companies Act 2008 reads as follows:

‘For the purpose of subsection (1), a person controls a juristic person, or its business, if

- (a) in the case of juristic person that is a company
 - (i) that juristic person is a subsidiary of that first person, as determined in accordance with section 3(1)(a); or
 - (ii) that first person together with any related or inter-related person, is
 - (aa) directly or indirectly able to exercise or control the exercise of a majority of the voting rights associated with securities of that company, whether pursuant to a shareholder agreement or otherwise; or
 - (bb) has the right to appoint or elect, or control the appointment or election of, directors of that company who control a majority of the votes at a meeting of the board;’

And Section 3(1)(a) of the Companies Act of 2008 reads:

'A company is

- (a) a subsidiary of another juristic person if that juristic person, one or more other subsidiaries of that juristic person, or one or more nominees of that juristic person or any of its subsidiaries, alone or in any combination
 - (i) is or are directly able to exercise, or control the exercise of, a majority of the general voting rights associated with issued securities of that company, whether pursuant to a shareholder agreement or otherwise; or
 - (ii) has or have the right to appoint or elect, or control the appointment or election of, directors of that company who control a majority of the votes at a meeting of the board; ...'

3.2.4 Arm's length principle

The arm's length principle referred to in section 31(2) of the Act is the benchmark used for determining whether transfer prices are accurate and have not been manipulated in some way by the companies in the group. Chapter VI of the OECD Guidelines for Transfer Pricing was written as a guide for assessing transfer pricing transactions in a multinational enterprise when intellectual property is exported, as this kind of transactions are difficult to evaluate for tax purposes (OECD, 2010d:191). The main constraint is buried in the fact that South Africa is a developing country and the OECD Guidelines were written with developed countries in mind. The OECD Guidelines for Transfer Pricing refer to comparables when assessing transfer prices of intellectual property, but no such comparables exist in South-Africa's emerging market (SARS, 1999: 9).

According to the United Nations (2012b:7), an arm's length price is determined by comparing transactions in a group context, to transactions among unrelated parties under comparable circumstances. In other words, the price is influenced by the independent parties in the marketplace. The arm's length principle aims to place both controlled and uncontrolled transactions on equal footing when considering the tax implications they create (UN, 2012b:8). The arm's length principle is hard to apply in developing countries such as South Africa due to, among other reasons, the increase in intra-group trading in intellectual property and services (UN, 2012b:20).

The United Nations (2012b:9) is also exploring the option of a global formulary apportionment method. This method strives to allocate global profits of a multinational enterprise on a multi-factor weighted formula basis. This method is already in place in certain parts of the USA, Switzerland and Canada.

3.2.5 Specific application of the OECD Guidelines for Transfer Pricing to intangibles or intellectual property

Chapter VI of the OECD Guidelines for Transfer Pricing (2010d: 191-193) makes an interesting distinction between a marketing intangible and a trade intangible. This is part of simplifying the assessment of transfer prices of intellectual property. As such, a marketing intangible is described as a 'commercial intangible that aids in the commercial exploitation of a product or service'.

A trademark used to promote the sale of goods or services is a good example of a marketing intangible. A trade intangible involves risky and costly research and development to create the intangible. The purpose of this development is to earn a return on these efforts. Patents used or applied in the production of goods are normally an example of a trade intangible (OECD, 2010d: 195).

According to the United Nations (2012d:7) it is important to consider the characteristics of the property being transferred to enable a comparability examination to take place for establishing an arm's length value. As such, the United Nations also has a similar definition for a marketing intangible (aids in commercial exploitation) and a trade intangible (patents and know-how).

Intellectual property invariably has a special character, making the search for comparables, as well as determining a value at the time of the transaction, rather difficult. This makes it challenging to apply the arm's length principle to controlled transactions involving intellectual property. Associated enterprises within the multinational enterprise group could also structure a transfer in a way that would not have been contemplated by an independent enterprise for legitimate business reasons (OECD, 2010d: 196). Determining the transfer price for intellectual property is further complicated by the search for comparables. Due to licence agreements involving payment of royalties, the actual on-the-spot sales of intangibles, compensation including the price of the underlying processing costs, or a price consisting of a combination of the above may apply (UN, 2012b:12).

According to the United Nations (2012d:5), a transfer pricing analysis based on comparables should start off with a background investigation of the business operations and activities of the taxpayer. This investigation should include the identification of connected persons to the controlled transaction, identification of any cross-border controlled transactions, and the nature of the controlled transactions, i.e. the type of intangible used, etc.

To achieve comparable transactions when it comes to intellectual property, it is essential for the assessment of the arm's length principle from the perspective of the transferor, as well as the transferee of the property.

From the transferor's perspective, the arm's length principle would examine the price at which a comparable independent enterprise would be eager to transfer the property. From a transferee's perspective, the arm's length principle would be examined in terms of the value and use of the intellectual property to the transferee's business, and the price the transferee would be keen to pay (OECD, 2010d: 196). The arm's length price should, however, only be assessed for transactions that actually took place (UN, 2012d:5).

Another important factor in assessing the arm's length principle is whether the price is a 'package price'. In other words, the price includes the goods as well as the intangible property. In this case, no additional payment for royalties is required for the supply of the technical expertise. However, the 'package price' needs to be disaggregated to calculate a separate arm's length price in countries where a withholding tax is imposed on royalties (OECD, 2010d: 197). Where the price for the intellectual property is part of a package contract including rights to patents, trademarks, trade secrets and know-how, the package needs to be broken down in its separate components to successfully assess the arm's length price (OECD 2010d: 197).

The United Nations (2012d:6) contends that third party comparables information is not always obtainable at a transaction level. In these instances, entity level information could be used as external comparable. When determining the arm's length consideration, special factors should be considered to determine the comparability between controlled and uncontrolled transactions. A few of these factors include:

- The expected benefits from the intangible property;
- Any limitations on the geographic area in which rights may be exercised;
- Any restriction on the export of goods produced by virtue of transferred rights;
- The exclusive or non-exclusive nature of the rights transferred;
- Any capital investment, especially for the purchase of special machines or the construction of a new plant;
- Any start-up expenses incurred and development work required in the market;
- Any possibilities of sub-licensing;
- The reach of the licensee's distribution network;
- Participation rights of the licensee to further development of the property by the licensor (OECD, 2010d: 198).

The OECD in Chapter VI of the Transfer Pricing Guidelines (2010d:199) explains that if the intellectual property is a trade intangible (i.e. patent), the consideration of comparability should also focus on the nature of the patent, the degree and duration of protection afforded under the patent law of the relevant country, as well as the length of period the patent is expected to maintain its economic value. Other factors are also recommended for consideration in relation to trade intangibles:

- The production process for which the property is to be used;
- The contribution of the process to the value of the final product;
- The risk of product and environmental liability;
- The value added by on-going research and development activities (OECD, 2010d: 200).

Some degree of uncertainty often exists as to which transfer pricing method is the most appropriate when it comes to assessing transfer prices for intellectual property. Chapter VI of the OECD Transfer Pricing Guidelines offers some recommendations in certain situations. When the sale or licensing of an intangible property takes place, the CUP method is usually the most effective transfer pricing method. It is especially effective where the same owner transfers or licenses a comparable intangible property to an independent enterprise under comparable circumstances. If it happens that an associated enterprise sub-licenses the intellectual property to an independent third party, the resale price method could be effective in assessing the controlled transaction. In terms of the sale of goods that incorporate intellectual property, the CUP or resale method could also prove to be an effective method (OECD, 2010d: 199).

In terms of transactions involving marketing intangibles (such as trademarks) a comparability analysis should be conducted. This should be done before deciding on a transfer pricing method, with special emphasis on the value added by the trademark, taking into account consumer acceptability, geographic significance, market shares, sales volume and other factors regarded as relevant (OECD, 2010d: 200).

This is very significant, as intangibles may have very different characteristics, resulting in very different values in the open market. Specific characteristics of intangible property that need to be considered includes the form of the transaction, the type and form of property, and the period and depth of protection granted. The anticipated benefits of the use of the asset should also be borne in mind (UN, 2012d:7).

Transactions in which both parties own high value intellectual property, it is often difficult to find comparable uncontrolled transactions, while traditional transaction methods are deemed

inappropriate. Chapter VI of the OECD Guidelines on Transfer Pricing recommends the transactional net margin method in this instance. The profit split method is deemed to be the most appropriate, but difficulty in terms of practical application could occur (OECD, 2010d: 200).

The valuation of intangible property at the onset of a transaction could turn out to be very uncertain. The best approach is to refer to what independent enterprises under comparable circumstances would have done to account for the valuation uncertainty in pricing the transaction (OECD, 2010d: 201). Independent enterprises deal with valuation uncertainty in various ways:

- Independent enterprises would look at anticipated benefits in terms of the extent to which subsequent developments are foreseeable and predictable. The projection of anticipated benefits could be sufficiently reliable to fix the pricing of the intellectual property at the start of the transaction, without the need to reserve the right to make possible future adjustments (OECD, 2010d: 201);
- In some instances, enterprises find the anticipated benefits provide inadequate protection against doubtful valuations of intellectual property. These enterprises often adopt short term agreements or include price adjustment clauses in terms of the agreement to provide protection against following progresses that end up being unforeseeable (OECD, 2010d: 201);
- Independent enterprises could also decide to bear the risk of unforeseeable succeeding developments within certain limits. This goes with the joint understanding that renegotiation of the pricing arrangements will take place if significant unpredicted advances happen that change the fundamental assumptions on which the valuation of the intellectual property was based.(OECD, 2010d:201)

A functional analysis of the 'functions performed', 'assets employed' and 'risks assumed' by the enterprise, in terms of its international controlled transactions, should be employed to enable comparability factors to be identified. This exercise can assist in determining an arm's-length remuneration for an intellectual property transaction based on the understanding of the taxpayer's business operations, connected persons, and the roles of all the parties involved in the controlled transaction (UN, 2012d:7). Functional analysis determines how functions, risks and assets are divided among the parties involved in the transaction. This is vital, as the expected return of the various parties to the transaction is based on the level of functions performed, degree of risk undertaken, and the nature and value of the assets used (UN, 2012d:9).

Another scenario that could exist in establishing transfer prices for intellectual property is where the enterprise does not actually own the trademark or trade name. In other words, independent enterprises who undertake marketing activities, without actually owning the trademark or trade name, should be compensated, either as:

- A service provider who provides promotional services;
- A marketer that has a profit share on any returns attributable to the intellectual property (OECD, 2010d: 204).

A marketer is entitled to a return on any marketing intangibles above the normal terms of taking on marketing activities, based on an assessment of the rights and obligations imposed by the agreement between the two parties.

- A service provider
 - Acts as an agent;
 - The owner of the marketing intangible will reimburse the agent for publicity costs incurred;
 - The return received is equivalent to the agency activities performed.
- A marketer
 - The cost of advertising activities is borne by the distributor;
 - The distributor can generate a profit from its investment by developing the worth of the trademark from its turnover and market share, where sole delivery rights for the trademarked product was negotiated in a long term contract (OECD, 2010d: 204).

Depending on whether a service provider or marketer relationship and compensation base has been negotiated, the transfer price of the share of profits would be established based on what an independent distributor would earn in comparable circumstances. Important to note is that, where the distributor bears exceptional promotional costs beyond what an independent distributor in similar circumstances might incur for the gain of its own distribution activities, the distributor could earn an additional payment from the trademark owner. (OECD, 2010d: 204)

Legal ownership of an intangible needs to be determined, but if an enterprise does not have legal ownership, it could still be entitled to share in the remuneration from the utilisation of the asset. This could be due to an enterprise's contribution to a strategy to enhance the market share, as a result of associated marketing intangibles being created (UN, 2012d:16).

3.2.6 Summary

The above discussion summarised the processes that would be followed to assess the transfer price of an intellectual property transaction based on Chapter VI of the OECD's Guidelines on Transfer Pricing. It is evident that it is a lengthy and laborious task that involves great skill and experience. Therefore, to protect South Africa's tax base once Exchange Control Regulations are abolished, it is essential that effective transfer pricing procedures are put in place by local tax authorities.

The transfer pricing methodologies the OECD recommends includes:

- The comparable uncontrolled price method (CUP method);
- The resale price method (RP method);
- The cost plus method (CP method);
- The transactional net margin method (TNMM); and
- The profit split method.

The South African Reserve Bank (SARB, 2013:2-3) asserts that Government is of intention to gradually abolish exchange controls and implement other policy changes to still protect the South African foreign exchange reserves. This weakness in the assessment of intellectual property transfer price is an area that requires focus to avoid the undue erosion of the South African tax base.

The determination of the *place of effective management* is an important factor in the assessment of transfer prices of intellectual property. The definition of a 'resident' in section 1 of the Act as described in subsection (b) is any 'person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic.'

The OECD Model Tax Convention on Income and on Capital in Article 4.3 has a similar description for a resident entity other than an individual. In the opinion of Huibregtse *et al.* (2011:1) the effective place of management also relates to the central management and control profile of the company. Interpretation Note No. 6 provides as a guideline a list of facts and circumstances that need to be assessed on a case-by-case occurrence to determine the *place of effective management*.

The definition of a 'connected person' is stated as any company that holds at least 50 % of the equity shares in another company in the same group of companies, any associate or any investment of a company, will be regarded as a connected person. A person who individually

or jointly with any other connected person to himself holds at least 20% of the equity shares or voting rights of the company is also regarded by the definition to be a 'connected person'. Furthermore, if any of these companies is managed by a person with an interest of at least 20% in the above companies or any relation to this manager, that person will also be a connected person. A close corporation will be a connected person of any member, or relative of such a member of the close corporation, and will also be a connected person of a close corporation that is a connected person of any member or relative of the members of the first close corporation.

The arm's length principle referred to in section 31(2) of The Act is the benchmark used for determining whether transfer prices are accurate and have not been manipulated in some way by the companies in the group. According to the United Nations (2012b:7), an arm's length price is determined by comparing transactions within a group context to transactions between unrelated parties under comparable circumstances. The United Nations (2012b:9) is also exploring the options of a global formulary apportionment method, which strives to allocate global profits of a multinational enterprise on a multi-factor weighted formula basis.

Chapter VI of the OECD Guidelines for Transfer Pricing describes in detail the methodology to be used to determine an arm's-length value for an intellectual property transaction. This discussion is based in principle on multinational enterprises and tax administrators in developed countries that have access to a wealth of information and are in a position to identify suitable comparables. Although South Africa does not have access to similar sources, it uses Chapter VI of the OECD Guidelines for Transfer Pricing as a guideline to determine transfer prices for intellectual property (SARS, 1999: 9).

3.3 What are the challenges facing local tax administrators (SARS) in effectively assessing transfer pricing transactions of intellectual property?

Intellectual property constitutes an increasingly important asset in the process of adding value to a multinational enterprises' core business (Huibregtse *et al.*, 2011:1). However, pricing difficulties tend to arise when unique intellectual properties are utilised by multinational enterprises (OECD, 2012:14). Transfer pricing risk is normally high when a multinational enterprise transfers intellectual property to a connected party. A transaction of this nature leads to difficult valuation questions. These questions are centered on the fact that intellectual property is mostly unique and to find acceptable comparables is problematic (especially in the environment of a developing country) (OECD, 2012:25). This section takes

a look at the more significant challenges local tax administrators face when they are expected to effectively assess the transfer pricing transactions involving intellectual property.

SARS Strategic Plan

The SARS outlined in its Strategic Plan 2012/2013 – 2016/2017 (2012:19) the various risks it faces from its exposure to global uncertain economic climate, the compliance behaviour of taxpayers and traders in response to this climate, and the risks associated with its own internal operations. On the other hand, SARS is burdened with the responsibility to generate tax revenue for Government to pursue growth and development that is fiscally sustainable (SARS, 2012b:4). An evolution from utilising domestic loopholes, to taking advantage of cross-border structuring and transfer pricing manipulations, seems to be at the order of the day for many businesses. SARS identified the following main reasons for this:

- Global economic uncertainty forced multinational companies owning valuable intellectual property to seek alternative ways to protect their profitability and still ensure growth of shareholder wealth;
- Due to South Africa's position as an investment destination into Africa, many multinational companies are flocking here. The top 500 multinational companies have the ability to shift profits from high tax jurisdictions to low-tax jurisdictions. By shifting intellectual property offshore to low-tax jurisdictions, these companies are able to effectively minimise tax obligations;
- The OECD Transfer Pricing Guidelines and UN transfer pricing frameworks are aimed at developed countries. South Africa is a developing country with a shortage of transfer pricing skills and expertise. It therefore leaves room for the manipulation of transfer pricing transactions, or aggressive tax planning, especially where it involves intellectual property, due to the complexity thereof (SARS, 2012b:19).

SARS faces many challenges, specifically if the infrastructure development programs envisioned by Government in terms of economic growth, job creation and the alleviation of poverty, is taken into consideration (SARS, 2012b:4). As referred to in Chapter 1 (section 1.1.2, page 3), South Africa's approach to transfer pricing is not as aggressive as in the top 500 multinational enterprises' jurisdictions, although it was the third country in the world to introduce transfer pricing legislation. A number of transfer pricing assessments have been unsuccessful mainly due to:

- The lack of a comparable database relevant in the South African context.

TABLE 3.3.1 Transfer pricing methods and comparables

Country	Acceptable methods	Priority of methods	Availability of benchmarking/ comparative data	Are foreign comparables acceptable to local tax authorities?
Hong Kong <i>(Deloitte 2012: 48)</i>	CUP, Resale Price, Cost Plus, Profit Split, TNMM; other methods if sufficiently supported.	The most appropriate method is required. Transaction-based methods are preferred over profit-based methods.	Financial data from published accounts of Hong Kong listed companies is available via numerous databases. Taxpayers generally will rely on common databases provided by vendors (such as BVD's Osiris).	In the absence of local comparables, yes, as long as they can be proved to be comparable to the tested party.
Luxembourg <i>(Deloitte, 2012: 74)</i>	Luxembourg legislation does not prescribe the use of any specific transfer pricing method. Circular 164/2 refers to the OECD Transfer Pricing Guidelines to ensure the application of the arm's length principle.	Luxembourg imposes no priority of methods.	Limited Luxembourg comparables data is available. Pan-European benchmark studies are usually accepted.	There are no specific regulations. Pan-European benchmark studies are usually accepted.
Singapore <i>(Deloitte, 2012: 107)</i>	CUP, Resale Price, Cost Plus, TNMM and Profit Split.	Taxpayers must use the methods that produce the most reliable results.	Several databases are available to identify comparable companies. Financial data from published accounts is available from the Accounting and Corporate Regulatory Authority.	There are no specific guidelines published by the Singapore tax authority. In practice, the IRAs show a clear preference for local comparables and foreign comparables would likely be more acceptable if it is not feasible to obtain domestic comparables.
South Africa <i>(Deloitte 2012: 111)</i>	<i>CUP, Resale Price, Cost Plus, Profit Split (e.g., Contribution Analysis or Residual Analysis), TNMM.</i>	<i>There is no priority of methods; however, the most reliable method is preferred.</i>	<i>Comparable data regarding South African companies is not publicly available.</i>	<i>Yes. Pan-European comparables are preferred, although comparables from other regions may be acceptable, if the reasons for the use of those comparables are explained in the policy document.</i>
Switzerland	All OECD transfer	Historically,	There exists limited Swiss	There is no specific

(Deloitte, 2012: 119)	pricing methods are accepted, with no preference.	preference was given to the traditional transaction methods, such as the CUP, Cost Plus, and Resale Price methods, in line with the 1995 OECD Guidelines, although the TNMM was widely used in practice. Profit split methods were mostly used in the context of advance pricing agreements with another country or countries. However, given the increased transfer pricing sophistication on the part of the tax authorities, and the 2010 update of the OECD Transfer Pricing Guidelines, all transfer pricing methods are considered equal.	comparable data. Pan-European benchmark studies covering Switzerland in the search scope are usually accepted.	prohibition; in practice, foreign comparables are acceptable. Tax authorities may review comparables, as a study submitted should be of adequate qualitative standard.
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(Deloitte, 2012a: 48–120)

- South Africa conforms to Chapter VI of the OECD Guidelines for transfer pricing. However, the OECD framework favours developed countries and it might not be conducive in the arena of developing countries, such as South Africa. A strong comparable would be an independent company with activities in similar markets. However, in South Africa the availability of independent comparables, or public information on independent comparables, is limited (UN, 2012d:36);
- Some of the more favourable intellectual property locations (all developed countries) and their transfer pricing methods and comparables are indicated in Table 3.3.1 above (Deloitte, 2012: 48–120). Comparables data for South Africa is not publicly available. Instead, Pan-European comparables are used and, in exceptional circumstances, comparables from other regions. Due to the uniqueness of intellectual property, these comparables are not always a reliable benchmark. South Africa has limited access to the relevant databases. It therefore does not always have sufficient resources to analyse and adjust the

foreign comparables to make it relevant to the intellectual property transaction (UN, 2012d: 37);

- SARS's Practice Note 7 (1999:9) indicates that in cases involving unique intellectual property, it can be problematic to obtain a high degree of comparability, due to the lack of a practical similarity. The Practice Note also lists a non-exhaustive list of features that may be relevant in comparing two intellectual properties. Some of the features relevant to intellectual property include:
 - Form of the transaction;
 - Type of property;
 - Duration of protection;
 - Degree of protection; and
 - Anticipated benefits from use.
- The information on company income tax returns and the related foreign party is not sufficient.
 - Information is often obtained from third parties, such as databases, customs data, the patents office, tax treaty intelligence, press reports, internet searches and tax administrations. However, without the knowledge of the ownership of intellectual property rights associated with various goods, it can be difficult to accurately assess the value of these rights (OECD, 2012:23-24);
 - Understanding the number and type of multinational enterprises operating in SARS's jurisdiction, as well as the types of transfer pricing risks associated with these enterprises, is a major challenge (OECD, 2012:69). It is hard for SARS to devise and implement relevant transfer pricing rules due to the lack of background knowledge;
 - Multinational enterprises provide as little information as possible to auditors (OECD, 2012: 72). This makes it tough for SARS to identify potential intellectual property transfer pricing concerns;
 - Multinational enterprises provide huge volumes of information, ensuring that transfer pricing concerns are hidden in a mountain of information (OECD, 2012: 72);
 - Information provided based on Double Tax Agreements could take very long to reach SARS and hamper the effective assessment of a transaction (OECD, 2012: 72).
- SARS and South Africa's shortage of transfer pricing skills and the shortage of the industry knowledge required to assess difficult transfer pricing transactions (SARS, 2012a: 25–26).

- A lack of capacity and capability is a critical matter in this context (OECD, 2012: 69);
- Transfer pricing resources are both scarce and expensive in South Africa (OECD, 2012: 71).
- Assessing transfer pricing transactions that involve a great degree of complexity (UN, 2012b:22).
 - The rules outlining the arm's length principle are becoming more difficult and complex, involving a great deal of cost to acquire expensive databases and skills (UN, 2012b:22);
 - Limited resources might be available to undertake the assessment of a transfer pricing transaction, as it is a long, time consuming process that often ends up in estimates with conflicting enterprises (UN, 2012b:22);
 - Certain cases end up in disputes between two revenue authorities and often between unequal economic powers. This causes strain on the resources of the country (UN, 2012b:22).
- The growth in the 'E-commerce' economy (intangible-related transactions) (UN, 2012b:22).
 - The application of traditional international tax concepts to the internet and e-commerce transactions is problematic and unclear due to fast changing web-based business models (UN, 2012b:22).
- Insufficient current experience in negotiating transfer pricing matters with other competent authorities (UN, 2012c:15).
- The taxpayer omits or hides information in an attempt to avoid proper assessment of its transfer prices established (OECD, 2010d: 203).

The pricing of a controlled transaction involving intangible property could be highly uncertain in terms of the value of the intangible at the onset of the transaction. The standard approach is to evaluate what arrangement an independent party would have made in comparable circumstances. In the instance of an uncooperative taxpayer, it could be difficult to determine which profits were reasonably foreseeable when the transaction was entered into (OECD, 2010d: 203) .This makes the comparability test fairly impossible. A lack of, or the omission of information once again places SARS in a difficult position in terms of accurately assessing the transfer price or transaction.

From the foregoing discussion it is evident that that there is a growing awareness of the risk of significant tax loss through transfer pricing transactions related to intellectual property.

These challenges could be mitigated by nurturing and developing the skills and experience needed to ensure successful transfer pricing assessments (OECD, 2012: 76).

3.4 Recommendations to improve the assessment of transfer pricing transactions of intellectual property

The current methodology used in the assessment of transfer pricing transactions involving intellectual property was discussed and the challenges that would face SARS in adequately and successfully assessing these transactions were outlined. It is essential to look at how SARS could overcome these obstacles. SARS identified potential measures to be implemented to address the challenges discussed under the previous heading. The OECD also undertook a project to identify the challenges faced by developing countries in this scenario and provided some insights as to how these obstacles can be overcome. In the section to follow, recommendations to the challenges described in the previous section are suggested.

There is a lack of a comparable database relevant in the South African context:

- SARS is currently providing input to the reporting standard to determine the new format of the company tax return, and to make sure sufficient input detail is provided as required by the transfer pricing unit. Using the detail provided on the new tax return, a database will be developed containing information about local companies and their goods and services provided. The comparability analysis will be predominantly geared for the South African context and will reduce the referral to foreign databases (SARS, 2012b:33).
- Bilateral and multilateral Advanced (Transfer) Pricing Agreements (APAs) should be offered to South African multinational companies to adopt the use of multiple year data by SARS (SARS, 2012b:33). APA's are pricing methodologies agreed to in advance, with reference to certain kinds of transactions. These agreements provide greater certainty on the taxation of cross-border transactions and assist in avoiding double taxation. (UN, 2012b:15).
- South Africa could investigate the option of relying on comparable databases from other comparable economies and make certain reliable and reasonable adjustments (UN, 2012d:40). Certain adjustments might be required to ensure the data is reliable and accurate, but it is worthy to consider the following facts before adjustments are made:
 - The quality of the data being adjusted;
 - The purpose of the adjustment performed;

- Not every transaction being compared is capable of being adjusted. Some transactions concerning goodwill or intangibles may not be capable of adjustment;
- Reliability and accuracy of the adjustment;
- Documentation of the adjustments to ensure it is reliable (UN, 2012d:46).
- The use of internal comparables (transactions between one party to the controlled transaction and an independent party) should be explored, or a manual identification of third parties regarded as potential comparables for the controlled intellectual property transactions (UN, 2012d:33,42).

The information on company income tax returns and the related foreign party is not sufficient to adequately assess a taxpayer's tax liability:

- The use of third party data (Reserve Bank, banks, etc.) should receive greater emphasis to validate the information declared by taxpayers (SARS, 2012b:33);
- Statutory documentation should be introduced and disclosure requirements enforced (SARS, 2012b:33);
- Double taxation agreements should include effective exchange of information provisions (OECD, 2012:69).

SARS has a shortage of transfer pricing skills required to assess transfer pricing transactions:

- Intensive practical training courses need to be identified and attended by transfer pricing units;
- Seconding options to and from other tax jurisdictions need to be explored in an effort to learn and distribute transfer pricing skills and expertise. (SARS, 2012b:33) On the ground, technical assistance should be provided by tax specialists from more experienced and successful tax administrations. This assistance should be demand-led, based on the need at that time (OECD, 2012: 70). As such, South Africa already welcomed a senior transfer pricing specialist from the UK, on a 5 year basis, to assist in areas such as:
 - Guidance on drafting transfer pricing legislation;
 - Setting up a panel of transfer pricing specialists from other tax administrations to anonymously answer technical transfer pricing queries;
 - Initiating a web-based knowledge and commercial data set;

- Providing guidance on risk analysis of multi-national companies transfer pricing transactions;
- Encouraging a forum of experts to discuss transfer pricing issues (OECD, 2012: 70).

Assessing transfer pricing transactions that involve a great degree of complexity:

- Transfer pricing income allocation could be done, using a different method to the arm's length principle. Global formulary apportionment could be considered (UN, 2012c:2). This method requires that the global profits of a multinational company be allocated, based on a multi-factor weighted formula between the companies in the Group. This formula uses, for example, property, payroll and sales, or other factors that are defined when the formula is formulated (UN, 2012a: 9);
- Local tax administration could also consider adopting 'safe harbor rules'. If a taxpayer's reported profits are found to be within a certain range, percentage, or under a certain amount, the taxpayer can rely on this as an alternative to establish an amount by applying transfer pricing methods (UN, 2012c:11).

The growth in the E-commerce economy (intangible-related transactions):

- The same suggestions mentioned under the above section could be considered under this heading.

Insufficient current experience in negotiating transfer pricing matters with other competent authorities:

- Developed countries have greater networks of information exchange and double taxation treaties. They generally have more experience in negotiating exchange of information articles in their treaties with other countries (OECD, 2011b:76). The local tax administration should approach tax administrations in developed countries to learn from them how to employ these skills to negotiate mutually beneficial outcomes, and adapt these skills to the environment of a developing country.

The taxpayer omits or hides information

- An audit of a taxpayer'
- return should be conducted in situations where SARS suspects a lack of, or omission of information. SARS should then recommend that the taxpayer amend the compensation

paid or received in accordance with SARS's perception of the information independent parties would have used in similar circumstances.(OECD, 2010d: 203);

- Transfer pricing legislation should be strengthened in South Africa to address the various issues surrounding transfer pricing (OECD, 2012: 71);
- Tax specialists from more successful and experienced tax administrations should be approached to assist with negotiating exchange of information articles in treaties and tax information exchange agreements with other countries. In this manner valuable skills could be taught to local tax administrations, and enhance the quality of information obtained from taxpayers. Potential development areas could include:
 - Developing a larger network of information exchange and double taxation agreements;
 - Transferring the knowledge gained through experience in how to negotiate an effective exchange of information article in treaties;
 - Closer international collaboration with other developing countries in comparable situations, and more widely on the international field (OECD, 2012: 76).

3.5 Conclusion

The secondary objective in section 1.3.2.2 (page 5) was achieved in this chapter. The chapter discussed the approach followed by SARS, the OECD and the UN in assessing the transfer price of a handover of intellectual property to an offshore destination. The scrutiny focused on the traditional transactional methods used for determining transfer prices and the meaning of transfer pricing as defined in the Act and the amendment to section 31 of the Act. The place of effective management was also briefly summarized along with other important principles such as connected person and arm's length principle. The method suggested by the OECD for assessing transfer prices involving intangible assets also came under scrutiny.

The approach followed by SARS in assessing transfer prices of intellectual property proved to have some flaws. The main challenges facing SARS were looked into and identified as a lack of comparables data, insufficient or irrelevant information and a lack of skills and experience. Finally the chapter examined possible remedies in which these challenges can be addressed and SARS and the OECD have launched various projects in response to this.

Taking these flaws into consideration, the next chapter will consider the following secondary objective (section 1.3.2.3, page 5): the limitations experienced in collecting timely, targeted

and comprehensive information and recommendations that could assist in making information gathering a less painful and more fruitful exercise.

CHAPTER 4: LIMITATIONS OF OBTAINING ACCURATE, TIMELY AND COMPREHENSIVE INFORMATION

4.1 Introduction

In chapter 3, the secondary objective outlined in section 1.3.2.2 (page 5) was achieved by a discussion of the approaches followed by SARS, the OECD and the UN to assess the transfer price of the assignment of intellectual property to an offshore destination. Various weaknesses experienced by SARS in effectively assessing these transfer prices were also outlined in detail, along with suggestions to alleviate these weaknesses.

This chapter considers the next secondary objective (section 1.3.2.3, page 5). It analyses the limitations experienced by SARS to obtain relevant information to perform efficient and timely assessments of transfer prices. This chapter also outlines possible avenues by which these limitations could be relaxed.

The methods employed by the local tax administration to obtain relevant and comprehensive information to effectively and accurately finalise tax audits are studied by referring to the SARS Strategic Plan, Practice Notes issued by the SARS and the Tax Administration Act. Suggestions to improve information gathering methods as provided by the OECD are also studied in this chapter.

Article 26 of the Model Tax Convention is considered in terms of its practicality and enforcement in double tax agreements entered into by South-Africa and how it will impact on the improvement of information gathering measures. This consideration will also focus on the opinions raised by the author J. W. Fiechter.

Finally the options available to local tax administration to improve information gathering procedures are probed at by providing a summary of the above areas under scrutiny.

4.2 How does the South Africa Revenue Service obtain information?

Timely information is essential and enables SARS to quickly identify risk areas and to decide whether and how to react (OECD, 2011b:6). SARS's main source of information gathering begins with an initial review of the tax return submitted by the taxpayer, either manually or through e-filing. Based on this review, a decision is made to request additional information by means of a traditional audit of the taxpayer's transactions and or the request to the

taxpayer to complete additional questionnaires, if a transfer price risk is suggested (OECD, 2012:21).

In South Africa the Commissioner relies mainly on the information obtained through audits and the information provided on company income tax returns. Various treaties signed with other countries also include Article 26 of the OECD Model Tax Convention on the Exchange of Information. These measures to obtain information could, however, not be sufficient for:

- Reducing the time between the creation and promotion of aggressive tax planning schemes and their identification;
- Enabling SARS to develop a targeted response (OECD, 2011b: 16).

Government launched a campaign to build nationwide infrastructure to boost the economy and to alleviate poverty. To achieve this, an investment of R800 billion is needed over the next three years (SARS, 2012b:16). Ensuring tax compliance by supplying the necessary funds and to minimise South Africa's borrowing requirements places a huge burden on SARS. Obtaining timely, targeted and comprehensive information is one of the projects launched by Government. It is also an area of weakness SARS identified for improvement in order to obtain tax compliance assurance (SARS, 2012b:16).

To achieve a greater measure of tax compliance, SARS managed to:

- Increase the access to third party data;
- Increase the volume of declarations validated by third parties;
- Reduce the opportunity for false or inaccurate declarations by pre-populating declarations from third party data;
- Become more data and information rich (SARS, 2012b:25).

According to Practice Note 7 (SARS, 1999: 22), the IT14 tax return for companies requires a taxpayer to retain all documentation related to transactions with connected persons. If a taxpayer does have transactions that trigger transfer pricing implications, it is naturally expected of the taxpayer to retain all relevant documentation and have it readily available for inspection by SARS.

The documentation that would obviously be expected to be available for inspection will include commercial agreements with third parties, financial information, budgets, forecasts and any other documents that would substantiate the transfer price (SARS, 1999:24).

Practice Note 7 (SARS, 1999:25) also promotes the adoption of foreign country comparables, such as Australia, the United Kingdom and the United States, in a taxpayer's transfer pricing analyses. Proof of the consideration of geographic differences should also be voluntarily available.

Integrated information

One specific method SARS incorporated to obtain comprehensive and targeted information is through the use of integrated information. The use of integrated information allows for integrated audits, investigations across tax types and the enhancement of the detection of cross-border illicit transactions (SARS, 2012b:31). This method allows various units focusing on different areas of tax compliance to contribute to and have access to a central source of taxpayer information.

Comparables principle

Assessing transfer prices for the allocation of intellectual property to an offshore destination should be based on a comparables principle, as suggested by the OECD for developed countries (section 1.1.2, page 2). However, there is a lack of such a comparables database in South Africa. Strengthening and leveraging South Africa's international treaty network to cooperate and exchange information with other tax and customs jurisdictions, was identified as another means of obtaining information (SARS, 2012b:32). Developed countries have greater networks of information exchange and double taxation treaties. They generally have more experience of negotiating exchange of information articles in their treaties with other countries (OECD, 2011b:76). SARS is aiming to achieve the same level of success as in developed countries.

Projects

As mentioned before, SARS has a limited level of success in assessing transfer pricing. This is due to limited information obtainable on a company income tax return and from the foreign party under investigation. In an attempt to rectify this handicap, SARS instituted various projects:

- Partaking in the new reporting standard roll-out to ensure that the format of the new company income tax return provides as much detail as necessary to ensure successful assessments;

- Using the additional information that will be provided in the new format of the companies' income tax return, a database will be compiled of local companies and the goods and or services they provide;
- Validate all third party data declared in the new income tax return. (SARS, 2012b:33). To improve risk management and ensure tax compliance, particularly in corporate income tax areas, potential collaboration with credit bureaus will be explored to obtain additional third party validation (SARS, 2012b:34).

Sources to obtain information

There are various sources through which SARS can obtain information (SARS, 1999:31):

- Enquiries with the taxpayer to obtain an understanding of its transfer pricing practices;
- Other taxpayers in a similar industry;
- Financial databases;
- Industry information available to the public;
- Internet (to obtain information about other foreign comparables);
- Through the use of EOI clauses incorporated in tax treaties;
- The Commissioner is also at liberty to make use of publicly undisclosed information where it is deemed necessary.

Integrating external data

SARS is endeavoring to continue on its path of integrating internal and external (third) party data across multiple tax types. To achieve this, the following projects are underway:

- SARS is busy with a continuous redesign of its registers and information systems. It hopes to establish a holistic perspective of the taxpayer and trader;
- An exercise whereby SARS will leverage data submitted on one tax product to validate information submitted on another taxpayer;
- The expansion of third party data across all tax types;
- Validation of third party data by combining old and new sources (new sources such as credit bureaus);
- Utilise information obtained through work with other departments (Department of Home Affairs, Department of Trade and Industry, Department of Labour, etc.) to supplement its own information (SARS, 2012b:38).

Data validation

Other than obtaining additional information, it is important for SARS to establish and maintain its own systems of data collection. To this end, a process will be developed through which data will be validated and verified, as it is a challenge to ensure the quality of data when revenue administrators are dependent on third parties to provide information (SARS, 2012b: 42).

A key challenge for all countries is to obtain sound, quality information that is valid, reliable and timely (SARS, 2012b:42). South Africa is no exception. The tax administrators in South Africa use various ways and means to obtain and improve information collection. A few of the methods that SARS uses, as well as the new initiatives to obtain that information on and to enhance the level of tax compliance, has been discussed. This will ensure that the assessment of tax types, such as transfer pricing transactions involving intellectual property, achieve a much higher success rate.

Tax Administration Act

As part of the discussion in this chapter, it is worth mentioning that The Tax Administration Act (TAA) also empowers SARS to obtain and inspect the records of a taxpayer. Sections 31, 33, 41, 42, 45, 46, 47, 48 and 49 of the TAA reflect on the circumstances when SARS may inspect the records of a taxpayer. These sections provide a SARS official with the necessary authority to “inspect the books and records” of a taxpayer. Section 31 dictates that records, accounts and documents should be readily available for inspection by a SARS official for as long as the taxpayer is required to retain supporting documentation. According to section 45(1) the SARS official may visit the taxpayer’s premises at any time during normal business hours. However, the SARS official may not enter a taxpayer’s home unless a portion of the home is used for the purposes of its trade. As per section 46(1) a SARS official is permitted to request relevant material from a taxpayer within a reasonable timeframe. This request can also be issued to a third party if there are sensible grounds for the request.

4.3 Suggestions by the OECD to obtain timely, accurate and comprehensive information

The OECD identified the problems that many countries face in collecting information and recommended various ways in which tax administrators can improve on the methods they

employ to obtain the information required to perform successful transfer pricing assessments.

Traditional audits

A key issue raised by the OECD is that traditional audits alone are not sufficient to satisfy the need for information. Although this remains the primary source for obtaining information, it is not necessarily enough to identify any aggressive tax planning schemes. The information obtained through an audit is limited:

- An audit can only provide so much information and, in instances where complex, international arrangements are involved, aggressive tax planning schemes might not be identified by the audit process;
- A significant time lag could be experienced between the creation, promotion and use of a tax scheme. Its detection through an audit can therefore be several years down the line;
- An audit will not always present the tax administrator with sufficient evidence to determine whether the tax scheme is an isolated incident, or a more recurrent trend (OECD, 2011b:12).

Suggestion by the United Nations

The UN (2012f:2) suggests a list of documents be directly requested from a taxpayer to determine the transaction price in an international transference of intangible assets. This does not necessarily mean that the tax authority is guaranteed receipt of the information, but it is a starting point. This list includes:

- Contract regarding the transfer of the asset;
- Price of the asset;
- Details of the manufacturing or creation of the asset;
- Details of the transaction made with related and or unrelated parties;
- An organogram and a description of all the involved parties;
- Data used for the determination of the international sales price;
- Pricing policy among the related parties;
- Accounting standards related to the specific transaction;
- Details of business activities performed among the parties related to the transaction;
- Ownership relations among the related parties;
- Documentation that was not submitted along with the tax return;
- Any other information relevant to determining an arm's length price.

Complementary disclosure initiatives

Various countries identified the deficiency in information obtained through a traditional audit and explored complementary disclosure initiatives to improve the detection of aggressive tax planning schemes. Some of the disclosure initiatives adopted in certain OECD countries include:

- Early mandatory disclosure rules;
- Additional reporting;
- Questionnaires;
- Co-operative compliance;
- Rulings;
- Penalty linked disclosure rules (OECD, 2011b:13);
- Transfer Pricing Disclosure Form (UN, 2012f:1).

Early mandatory disclosure rules require a tax shelter or tax avoidance scheme to be disclosed in advance of the tax return being filed. The early disclosure is triggered when a transaction or scheme meets certain standards. At the very basic level, it needs to be specified who has to report, what must be reported and when disclosure is required. Among others, the United Kingdom elected to make use of early mandatory disclosure rules and their relevant design choices were formulated as follows (OECD, 2011b:13-14,20):

TABLE 4.3.1 – Mandatory disclosure rules in the United Kingdom

COUNTRY	WHO	WHAT	WHEN	EFFECTS OF NON-DISCLOSURE
United Kingdom	Normally, promoter user if in-house scheme or when promoter is based offshore, or is protected by legal professional privilege	Hallmarked schemes (6 hallmarks for promoter schemes; 4 for in-house schemes)	Within 5 days of the earlier of: (i) promoter making firm approach to another person to make scheme available for implementation by that person or others, or (ii) scheme being made available for implementation by another person if	Daily penalties of maximum GBP 600, imposed initially by the court and, secondarily, by Her Majesty's Revenue and Customs. If failure continues after imposition of initial daily penalty, the court can determine higher penalty of

			promoter, within 5 to 30 days of entering into first transaction forming part of the scheme, if user.	maximum GBP 1,000,000. If initial daily penalty appears inappropriately low after taking into account fees or advantage sought.
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(OECD, 2011b:13-14,20)

This initiative proved to be very successful in the UK. The table below, as published by Her Majesty's Revenue and Customs, discloses the level of success in each financial year since implementation in August 2004 (HMRC, 2013:1&2).

TABLE 4.3.2 - HMRC Disclosure Statistics from 01 August 2004 to 31 March 2013

Financial Year		Number of schemes disclosed	
From	To	Direct tax	Indirect tax (VAT)
01 August 2004	31 March 2005	503	680
01 April 2005	31 March 2006	607	91
01 April 2006	31 March 2007	346	65
01 April 2007	31 March 2008	273	29
01 April 2008	31 March 2009	130	16
01 April 2009	31 March 2010	176	12
01 April 2010	31 March 2011	118	13
01 April 2011	31 March 2012	129	<10
01 April 2012	31 March 2013	80	<10

(HMRC, 2013:1&2)

Additional reporting obligations are imposed on taxpayers in some countries. The additional reporting obligations could require a taxpayer to:

- Notify tax authorities of the deduction to be claimed for certain interest expenses payable to a connected party;
- Provide notice to tax authorities on potential capital losses;
- Provide a reconciliation and explanation of significant differences between tax and accounting (OECD, 2011b: 14).

Mandatory **questionnaires** are utilised in some countries for targeted groups deemed to be risky. Based on the information obtained, taxpayers are selected for audit (OECD, 2011b:14).

The principle of **co-operative compliance programs** centers around the fact that there is a rudimentary relationship between the taxpayer and the tax administrator, by which each does what it is legally bound to do (OECD, 2011b:14). This principle is based on mutual trust among taxpayers, tax advisers and tax authorities and depends on disclosure and transparency by taxpayers. In this way, a partnership is created where tax risk management and tax compliance are improved and all parties reap the benefits. Countries that have successfully employed this strategy include, amongst others, Spain (Forum for Large Taxpayers) and the United Kingdom (Tax Compliance Risk Management Process) (OECD, 2011b:15).

Selective co-operative compliance is achieved by **rulings** mechanisms on issues chosen by the taxpayer. Rulings do not operate as comprehensive disclosure mechanisms, but can be used as a tool to gain more information (OECD, 2011b:15).

Penalty-linked disclosure rules encourage taxpayers to voluntarily disclose tax planning schemes. This enables taxpayers to reap the benefit of a reduced penalty and or interest charge for entering into such a scheme (OECD, 2011b:15).

A **Transfer Pricing Disclosure Form** is another disclosure initiative implemented by the United Nations as a means of obtaining relevant information. The questions on the form provide scope for obtaining relevant information. It also serves to flag taxpayers that would potentially require further investigation. Naturally, more information on the taxpayer's transactions would then be required and the initiatives mentioned by the OECD could fulfill this need (UN, 2012f:1).

Opinion held by the OECD

The opinion held by the OECD (OECD, 2004:70) is that revenue authorities need to assume a more administrative approach, encouraging taxpayers to voluntarily comply with tax and other relevant laws. This can be achieved if the revenue authorities portray a co-operative environment that adheres to the regulations of that specific country.

According to the OECD (OECD, 2002:6), achieving an outstanding rate of tax compliance is expected of all revenue authorities, especially when it comes to tax compliance. To this end,

a certain measure of resources is supplied to tax authorities with the aim of achieving a high level of tax compliance. As such, the major compliance risks need to be identified, the group of taxpayers to whom this relates, and how the best possible outcome can be achieved, based on these risks. Obtaining relevant and sufficient information through the techniques described in this chapter can contribute to revenue authorities achieving these goals.

The OECD performed a survey on various countries to determine the practical challenges countries face when assessing transfer pricing transactions. An overview of its results highlighted the following challenges faced by tax administrators:

- Transfer pricing risks are among the largest tax risks that tax administrators are managing;
- Cases are complex and involve extensive fact gathering;
- Some countries reported settling their transfer pricing cases within 12 months, but most reported that more than 540 days elapsed before settlement;
- In some countries very little tax is recovered from their transfer pricing audits, whereas others recover very large amounts from most of their audits;
- Obtaining information across borders is a particular issue for some countries, whereas others have very effective internal relationships and double taxation treaties;
- The stock of open cases is high, in excess of the number of cases settled in one year;
- A relevant practical issue for auditors is the ease of access to and the quality of key supporting documentation;
- The risk assessment process is central to the success of transfer pricing programs, but countries approach this in very different ways. The differences in approach are driven to some extent by the different environments in which they are operating and the particular constraints in which they have to work (OECD, 2012:16-17).

To ensure that transfer pricing cases are successfully assessed, and to ensure a higher level of tax compliance, the OECD recommended that the right cases be selected, based on a predetermined risk assessment measure. To select the more significant risky transactions, certain information is required. Information sources recommended by the OECD include:

- Tax returns, accounts, transfer pricing documentation and questionnaires;
 - As mentioned earlier, some tax administrators require the tax return to be supplemented by a questionnaire that provides more information on transfer pricing. The questionnaire asks for more detailed information, such as detail of

- transactions with related entities in low tax jurisdictions. This assists in the risk assessment process;
- Other tax administrators rely on their own assessment of transfer pricing risk, based on accounts, tax returns and other information they can obtain before even approaching a taxpayer;
 - The information in the tax return is clearly complemented by information available from other sources, such as information provided about 'controlled foreign companies' and information from external sources (OECD, 2012:21).
- Third parties – in order to improve the assessment of transfer pricing risk, tax administrators should also look to obtain information through other avenues;
 - Databases: by taking information from a range of publicly available sources, and by identifying companies that carry out broadly similar activities to the company under review. An assessment of the results will enable tax administrators to establish whether the company falls outside the range of apparent comparables and whether it is worth further investigation;
 - Customs data: Data collected for assessing customs duties could be used to obtain detail of cross border transactions, including those among connected parties. However, royalty flows will not show up in customs data and, without knowledge of the ownership of intellectual property, it is difficult to assess the accuracy of valuations;
 - Patent office: A good suggestion for tax administrators is to encourage a better working relationship between the transfer pricing team and the patent and trademarks office of a country. This will enhance the identification of situations where intellectual property was transferred offshore and it will provide a better understanding of the type of intellectual property being developed by a business;
 - Tax treaty intelligence: The identification of transfer pricing risks is simplified if information is received from other tax jurisdictions, either spontaneously or by request. Spontaneous exchange of information, due to a double taxation agreement, is encouraged, so information is exchanged at the earliest opportunity. This ensures that a transfer pricing audit is opened before the closing of a deadline;
 - Press reports, trade magazines and other information in the public domain: These sources provide useful information on a particular company and its trade sector. By analysing the results of the company and its relevant trade sector, tax administrators can identify a trend in sales and profitability and determine any potential transfer pricing risk (OECD, 2012:23);

- Internet searches: The Internet can provide information on particular companies and industries. Government agencies databases open to the public can also be accessed through the Internet and used to obtain more information, for example the Securities and Exchange (SEC) database in the United States (OECD, 2012:24).

The OECD described various ways in which a country and its tax administrators can obtain more information regarding an entity to enhance the tax compliance in a country. General information gathering sources were identified, as well as sources more directly aimed at identifying transfer pricing risk and, in certain cases, transfer pricing risk related to intellectual property. Although National Treasury in South Africa has prohibited the transfer of intellectual property offshore (Regulation 10(1)(c) of the Exchange Control Regulations, 1961), it is still advisable for local tax administrators to explore ways and means of gathering additional information to identify aggressive tax planning schemes by multi-national companies.

4.4 Practicality and enforcement of Article 26 of the OECD Model Tax Convention

A successful transfer pricing risk assessment and audit is dependent on the actual facts. The initial fact finding process is an essential part of a successful transfer pricing audit and its overall outcome (OECD, 2011:32). A vital part of the fact finding process relies on effective double taxation agreements, specifically the negotiation of Article 26 of both the OECD and UN Model Tax Convention. Fruitful negotiation will ensure that contracting countries will spontaneously, or on specific request (even if the contracting state has no domestic interest in such information), supply information that could make or break a transfer pricing audit.

Article 26 of the OECD and UN Model Tax Convention (MTC) is, on the whole, similar. The exchange of information clause provided for in Article 26 of both the OECD and the UN MTCs was most likely formulated to circumvent the fact that one State may not voluntarily enter the jurisdiction of another to investigate the affairs of a taxpayer. This form of territoriality is overcome by Article 26, which allows for administrative assistance by an exchange of fiscal information in any of the Contracting States, which encourages cooperation among administrative authorities. Information regarding residents and non-residents may be requested. The scope of Article 26 also includes taxes not necessarily covered under the treaty between two Contracting States (Olivier & Honiball, 2008:361).

Article 26 of the OECD MTC allows for the exchange of information in different ways:

- On request
 - Information regarding the affairs of a taxpayer may be requested directly by a Contracting State (OECD, 2006:7).
- Automatically
 - Information is automatically sent among Contracting States who adopted the Exchange of Information (EOI) clause (Olivier & Honiball, 2008:364).
- Spontaneously
 - In circumstances where a Contracting State stumbles on information during a domestic investigation, which might be relevant to another Contracting State (OECD, 2006:7).
- Other techniques
 - Simultaneous examinations (Olivier & Honiball, 2008:364);
 - Visit by authorised representatives of the competent authorities (OECD, 2006:8);
 - Industry wide exchange of information (Olivier & Honiball, 2008:364).

According to the OECD (OECD, 2006:3), Article 26 of the MTC is not the only exclusive exchange of information model available to Contracting States. The 2002 Model Agreement on Exchange of Information on Tax Matters (Model Agreement) is another tool used to ensure information is exchanged. However, a significant difference between the two models needs to be recognised. The Model Tax Convention allows for Contracting States to exchange information on request, spontaneously or automatically. The Model Agreement only promotes exchange of information on request.

The exchange of information clause is deemed to have a reciprocal effect between two Contracting States. It does not always work that way and does not give support to developed countries that refuse to provide information to developing countries, purely because they do not have a comparable administrative capacity (United Nations, 2008:4). South Africa is a developing country with various links to developed countries and this reciprocal approach is very relevant in obtaining information regarding a taxpayer's affairs.

Over the past few years, various countries removed controls on foreign investment and relaxed foreign exchange controls (OECD, 2006:4). (South Africa will also eventually follow suit (SARB, 2013:2-3)). Due to the fact that tax administrators are confined to their jurisdictions, the need for transparency and co-operation among tax authorities increased to ensure sustainable tax compliance in the various jurisdictions. A key element of is the exchange of information clause negotiated among certain Contracting States (OECD, 2006:4).

Summary of Article 26

Paragraph 1 of Article 26 does not limit the exchange of information to taxpayer specific information, but can also include a whole economic sector. Other sensitive information related to tax administration and compliance improvement may be exchanged. Such information can include risk analysis techniques, tax avoidance or evasion schemes and even information about aggressive or abusive tax schemes (United Nations, 2008:7).

The OECD (OECD, 2006:4) regards the exchange of information clause to have two purposes. Firstly, to determine the facts based on the rules of the application of the exchange of information, and secondly, to assist in enforcing domestic tax law.

Information obtained under Article 26 must be treated with utmost confidentiality. However, any information received due to the application of this clause can be disclosed to parties involved in the assessment, enforcement or determination of appeals (United Nations, 2008:10). This means if any Contracting State comes across any potential tax evasion schemes where intellectual property was relocated, that Contracting State can and should communicate such information to South African authorities to mitigate any tax revenue losses in terms of transfer pricing.

In South Africa, section 69 of the TAA dictates the preservation of the secrecy of taxpayer information and describes exceptional circumstances where information may be disclosed. This section in the TAA repealed section 4 of The Act, which, in essence, also prohibited the disclosure of taxpayer information and provided another list of special circumstances under which information could be divulged. It is important here that the provisions of any double taxation agreement override domestic law (Stiglingh *et al.* (2012:583). In other words, the exchange of information clause in international arrangements will override South Africa's secrecy legislation in terms of The Act and the TAA.

Paragraph 3(c) of Article 26 of the OECD MTC also prohibits the exchange of information relating to a professional secret or trade process, which can be extended to include information related to certain intellectual property. The reason behind this is to avoid economic hardships from befalling a taxpayer by revealing sensitive information to competitors. This means that any books, records or documents containing sensitive information may only be exchanged once the sensitive information has been excised from the documentation.

It remains at the discretion of the requested Contracting State to exchange information of this nature. If the requested Contracting State does supply the information, the other Contracting State is still bound to confidentiality (United Nations, 2008:16). Depending on the relationship between South Africa and the other Contracting State, if the requested Contracting State invokes paragraph 3(c), the exchange of vital information regarding tax evasion schemes with intellectual property in multi-national companies could remain undetected by local authorities.

The UN deems Article 26 of such vital importance that it discourages countries from concluding a tax treaty where the exchange of information clause cannot be included, for whatever reason (Olivier & Honiball, 2008:361). Most tax treaties entered into by South Africa, include the exchange of information clause, for example, the treaty with France, but not the treaty with Switzerland or Singapore, due to their bank secrecy laws (Olivier & Honiball, 2008:362).

Banking secrecy in certain popular Intellectual property holding locations

Where did the banking secrecy in Switzerland begin? According to Fiechter (2008:56), it started before the outbreak of World War II, by tightening and enacting banking secrecy as a movement to shield Jewish property from being detected by the Nazis . This proved to be a myth invented by the banks in 1966. However, since then, banking secrecy has been regarded as a sound business model with wonderful humanitarian goals.

The second reason for its existence is grounded in Switzerland's many years of political, social, economic and monetary stability, which has boosted the confidence of many nations and customers.

Many European countries significantly raised their taxes in the shadow of World War I and high net worth assets were transferred to Switzerland. This enabled the Swiss financial sector to play a major role in capital markets and to be established a position to lend money to several governments. The Swiss banking secrecy is also a result of a feeling of sympathy for foreigners evading high tax rates in their own countries (Fiechter, 2008:56).

Based on the reasons motivated above, Switzerland has never included any exchange of information clause in any of its double-taxation treaties with other states. Its argument is that including the clause would not serve any purpose, as long as other third party countries did not include a similar clause. As a consequence, countries like Luxembourg and Switzerland

introduced a reservation on Article 26 of the OECD Model Tax Convention (Fiechter, 2008:56).

The banking secrecy in Switzerland poses challenges to other foreign tax authorities, as was evidenced in the *Credit Suisse/Germany* case. The Credit Suisse Group, AG, is a financial services company, headquartered in Zurich, Switzerland. Matussek (2013:1) explained in a newspaper article that employees from Credit Suisse were raided earlier in that year, after suspecting they assisted 201 German clients to evade taxes. In 2011, the same institution had to pay €150 million to settle a similar probe. Fiechter (2008: 60) elaborated on this, stating the German tax authorities bought CDs containing the relevant data from thieves. These CDs contained around 1,500 names of the bank's clients.

In another instance, Herve Falciani, a former employee of Swiss subsidiary, HSBC, stole the information of 24 000 HSBC customers who hold Swiss accounts with the bank, HSBC. This exposed international clients to potential tax prosecution in their resident countries, according to a newspaper article written by Jordans (2010:1). This data was seized by the authorities and passed over to tax authorities. Some of these account holders faced prosecution by tax authorities, where they failed to declare their assets in their resident countries.

On 27 January 2009, a new double tax agreement was entered into between South Africa and Switzerland, which includes an exchange of information proviso (South Africa, 2009:17). However, the protocol to the treaty stipulates that bank secrecy laws may only be ignored in cases where tax fraud is involved. The previous double tax agreement between South Africa and Switzerland had no exchange of information proviso (Brand & Mendes, 2010).

Singapore's banking secrecy is due to its strategic geographic location on traditional international trade routes, and targeted incentives in terms of financial services. The tradition of strict confidentiality in Singapore enabled it to attract foreign companies and run a successful private wealth management industry.

Singapore is not a tax haven and negotiated comprehensive double tax agreements with other states. However, Singapore managed to retain its banking secrecy, even if it did not make a reservation to Article 26 of the OECD Model Tax Convention. Instead, it negotiated a standard domestic interest clause. This means it neither exchanges information on taxes it does not itself levy nor information to which tax authorities are not entitled (Fiechter, 2008:57).

Banking secrecy in the tax haven, Lichtenstein, is also taken very seriously. The bank, LGT Treuhand, however, attracted much controversy when account holders' information was leaked in 2008. In an *Azure Tax* (2010:1) article, it was described how an employee from LGT Treuhand stole a disk containing the information of 1 400 foreign account holders and sold it to German tax authorities. All Germans who had not declared all their assets in Lichtenstein were duly prosecuted. Copies of this disk were also sold to British, French, American, Australian and Italian governments. In the absence of proper exchange of information clauses, tax revenue fell through the cracks without ever being missed. This case reiterates how taxpayers take advantage of banking secrecy and how important exchanges of information clauses are in double tax agreements between Contracting States.

Luxembourg is another low-tax jurisdiction which was in argument over its banking secrecy in the early '90s. Luchtman & Van Hoek (2005:1) wrote about a number of employees of Kredietbank Luxembourg, who stole microfiches, documents and money from their employer. The microfiches contained sensitive information about Dutch and other foreign account holders.

The information was handed over to foreign authorities and the employees were convicted of violating the Luxembourg banking secrecy legislation. Criminal investigations were opened against Belgian account holders who failed to declare all their assets held in Luxembourg. The charges were, however, dropped because of the manner in which the information was obtained. This is, once again, an example of how banking secrecy promotes tax evasion in the absence of sound exchange of information practices with other countries.

The limitations imposed by domestic secrecy laws were addressed by the OECD's inclusion of Paragraph 5 to Article 26. Paragraph 5 stipulates that a Contracting State cannot refuse to supply information purely because the information is held by a bank or other financial institution (Olivier & Honiball, 2008:362). Treaties that negotiated mutual legal assistance are normally aimed at obtaining information related to criminal matters, but is just as easily used for information in tax crimes (OECD Commentary (Article 26, Paragraph 5)). Information requested by a Contracting State can, however, be refused based on the grounds listed in Paragraph 3 to Article 26 (Olivier & Honiball, 2008:363).

The purpose of Article 26 stretches far wider than mere tax compliance, as it also aims to mitigate tax evasion (Olivier & Honiball, 2008:362). Article 26 also serves to curtail capital flight, which is often the subject of tax avoidance or evasion. It is therefore also quite relevant to the discussion of the transfer of intellectual property to offshore low tax jurisdictions (United Nations, 2008:4). According to the United Nations (2008:5 & 7), in tax

matters, information should be supplied to the widest possible extent to comply with a standard of 'foreseeable relevance'. However, the exchange of information should be restricted to specific, individual cases and should not be based on a 'fishing expedition'. Both Switzerland and Singapore only provide administrative assistance on request (Fiechter, 2008: 61).

The exchange of information clause does, however, face various limitations. Other than the limits set out in Paragraph 3 of Article 26 of the MTC, certain practical limitations are also encountered in the enactment of this clause. These limitations include communication breakdowns due to different functional languages, non-compliance with the Convention and costs incurred to enable the exchange of information (Fiechter, 2008: 58).

Impediments of the clause

According to Fiechter (2008:59-60), the measure of information exchanged among treaty countries is rather limited. The efficiency of the clause is hindered by the following:

- Accepted activities by tax authorities for the assessment of taxes include tax audits, examinations, various investigations, requests to taxpayers for documents and information, as well as requests for information from third parties. However, banking secrecy rules in certain countries limit the level of activities in the assessment of taxes;
- National structure – it is easier to research information requests in small, centralised countries like Luxembourg, than in big, federal countries like Germany;
- Languages – language often poses a barrier in the exchange of information. English, French and German were proposed as standard languages in use within the EU;
- Time problem – the time taken to answer requests causes big disparities within the EU Member States. If it takes too long before any response to a request is received, severe problems arise and the whole process is rendered ineffective;
- Figures – Automatic and spontaneous exchanges are used more often and the flow of information among neighbouring countries was found to be greater. The Santiago Report indicated the following figures, among others:
 - Germany: an average of 400 requests a year between 2002 and 2007;
 - UK: 150 requests in 2001 and 325 in 2007;
 - Luxembourg: between 10 and 15 requests per year, but in 2006 it sent information regarding bank accounts in 2 300 000 cases;
 - Switzerland: 30 requests of mutual assistance regarding tax fraud reported in the last few years.

- Failure to provide information – there is a general feeling of distrust among the exchanging states.

Alternative information gathering methods

Due to the limitations imposed by the exchange of information clause, various other means of obtaining information were explored over the years. Other methods of acquiring information that proved to be very effective include:

- Whistle blowing – the revelation of illegal activities by an individual. This is normally rewarded by a percentage of the amount collected by the tax authorities. The criminal provisions of banking secrecy laws in Switzerland and Singapore heavily condemn such practices (Fiechter, 2008:60);
- Illegal acquisition of data by tax authorities – this has been a practice in recent years and is evidenced by cases such as the *Credit Suisse/Germany case*¹, *HSBC-Falciani case*, *LGT Treuhand case* and *Kredietbank Luxembourg case* (Fiechter, 2008:60). (These cases were discussed earlier in this sub-chapter.);
- Voluntary disclosure – this is largely the result of the illegal acquisition of data by tax authorities, imposing such a fear on taxpayers that they voluntarily plead and negotiate tax evasion charges (Fiechter, 2008:60);
- Questioning a person – a person that may have knowledge or information should be questioned to gather valuable information. (OECD, 2006:18);
- Testimony – if a person is reluctant to co-operate voluntarily, that person can be requested to appear at a certain place and time to deliver testimony (OECD, 2006:18);
- Appropriate measures – where a person does not show up at a required time and place to deliver testimony, appropriate measures should be taken to compel the person to co-operate (OECD, 2006:18).

Conclusion

Fiechter (2008:63) is of the opinion that the exchange of information provision will be long outlived by banking secrecy, as it continues to offer a safe haven to citizens of states that invade their privacy. Countries adopting banking secrecy rules have gained the trust of the taxpayer and they will therefore continue to support these countries.

Article 26 of the Model Tax Convention of both the UN and OECD were created with the noble goal of enhancing global transparency in taxpayers' affairs and to mitigate tax evasion. Although the principle of 'exchange of information' sounds very simple, it is actually not.

Various limitations hinder the effective administrative assistance sought by the clause. Many countries that have banking secrecy rules in place are reluctant to include such a clause in its treaties agreed with Contracting States. However, some Double Tax Agreements (DTAs) do include the EOI clause, but with certain conditions. Clearly, the enforcement and practical implementation of Article 26 is no easy task.

South Africa should endeavour to have an EOI-clause included in all DTAs signed with other Contracting States. At the same time, other creative and legal ways of obtaining information pertaining to tax evasions schemes and tax payers' affairs should be researched and developed.

4.5 Options to be considered by South African tax administrators to obtain comprehensive information.

The most beneficial options available to SARS to gather as much relevant and meaningful information as possible in the plight against aggressive tax planning schemes by multi-national companies, now remain to be considered. South Africa is already on a route of updating and enhancing its information gathering procedures. Greater tax compliance by taxpayers is achieved and encouraged by implementing methods such as:

- Integrated information – information obtained regarding one tax type is used to investigate various other tax types;
- An enhanced international tax treaty network which includes comprehensive exchange of information clauses;
- Information obtained regarding a taxpayer's affairs is validated by third parties, such as banks (section 4.2, page 50).

Tools in the fight against tax evasion

The OECD countries also developed a few strategies believed to be effective tools against tax evasion schemes and tax fraud. These strategies received differing reactions in various countries. The deviating reaction is attributable to differences in administrative, legal and cultural frameworks, as well as conflicting behavioral features of taxpayers (OECD, 2011b:16).

The Early Mandatory Disclosure Rules were found to be very effective in the countries in which they have been employed. The reasons for the success can be attributed to:

- Significant reduction in time taken to detect tax evasion schemes;
- Effectiveness of the risk-based investigations;
- Rapid response through compliance action and legislation;
- Promptness in dealing with tax planning schemes. This reduces the time during which promoters can earn professional fees and users can accumulate tax advantages from the tax schemes (OECD, 2011b:16).

Additional Reporting Obligations have indicated a significant improvement in audit efficiency in the countries that employed this strategy. Resources are focused on returns that warrant further investigation due to the specific nature of the content. This means audit teams can focus their attention on potential problem issues (OECD, 2011b:17).

Short and well-focused questionnaires (see section 4.3, page 54) were found to be very effective to obtain relevant information. The reason for this was:

- Flexibility;
- Increased audit efficiency;
- Enhanced disclosure;
- Potential to reduce compliance cost to taxpayers (OECD, 2011b:17).

Co-Operative Compliance Programs led to greater teamwork among taxpayers and tax authorities in the countries where this strategy was implemented. The more transparent the taxpayers were, the better informed tax authorities were. Better information resulted in more effective risk assessment and allocation of resources. Early disclosure resulted in prompt responses and remedial legislation (OECD, 2011b:18). Tax authorities were encouraged by the OECD (2002:6) to utilise tools at their disposal, such as Compliance Research Projects and Compliance strategies to achieve a high level of tax compliance. At the core of this is full transparency and disclosure of taxpayer's information.

In countries that are willing to accept a ruling (see section 4.3, page 54) on a transaction that could be of a tax avoidance nature, the common experience is that more relevant information is generated. This is because taxpayers are more likely to consult with tax administrators on future transactions and investments. In some countries, rulings have allowed for potential policy and compliance responses at a very tender stage (OECD, 2011b:18).

Countries employing Penalty-linked Disclosure Rules evidenced a minimal improvement in obtaining timely information on aggressive tax planning schemes. The type of incentive

given to taxpayers appeared to influence the extent of the success of this strategy (OECD, 2011b:18).

According to the research performed by Fiechter (2008:57), international negotiations concerning exchange of information between national tax authorities has been ongoing since the start of the 20th Century. A directive concerning mutual assistance among member states in direct taxation was passed in 1977. A joint Council of Europe/OECD Convention concerning mutual assistance in tax matters was passed in 1988. In 2003, the EU implemented a Savings Tax Directive. In 1996, the OECD launched a project on harmful tax practices and blacklisted all the non-cooperative tax havens that were not willing to implement the exchange of information clause in their Double Taxation Treaties by January 2006.

The international financial crisis placed more emphasis on this move towards transparency. At the end of 2010, most countries that had been placed on the grey list (countries that did not have an Exchange of Information clause, but did withdraw its reservation of Article 26 of the OECD Model Convention) complied with the minimum requirements. In other words, they signed DTAs or protocols to existing DTAs, including the exchange of information clause.

The UN and the OECD place great value on the worth of the exchange of information clause of Article 26. From there, the pressure placed on all nations to include such a clause in all their double tax agreements concluded. Although various limitations and administrative hurdles are encountered with the implementation of this clause, it is evident that more benefit is to be derived from this clause than loss, and many nations will be able to save valuable tax revenue. South Africa could also greatly benefit from this clause. If intellectual property is transferred offshore, the clause will enable the early detection of tax losses and enhance the prevention of tax revenue losses.

Disclosure and information gathering initiatives lead to various benefits for both local tax authorities and taxpayers. Local tax authorities are able to obtain information sooner, as well as obtain more comprehensive information. This could lead to a higher success rate when it comes to assessing transfer pricing of items such as intellectual property. Benefits to taxpayers include increased certainty, a reduction in compliance cost, and confidence in the reputation and public image of tax authorities (OECD, 2011b:18).

Overall, South Africa should explore all options available to gather comprehensive and complete information. This will achieve improved risk assessment procedures, leading to

fewer routine audits, increased transparency, and a positive impact in general (OECD, 2011b:18).

4.6 Conclusion

In this chapter the following secondary objectives (section 1.3.2.3, page 5) were considered:

- A summary of the confinements faced by tax administrators in the gathering of timely, targeted and comprehensive information;
- Commendations to effectively address these confinements.

Many countries struggle with the fight to obtain targeted and comprehensive information to ensure the successful assessment of taxation and a high level of tax compliance. The OECD identified and discussed various recommendations regarding manners employed by member countries to fulfill their need for information. In an attempt to address this problem, Article 26 of the UN and OECD Model Tax Convention was enforced on all member countries.

Finally, the information gathering methods described above are briefly summarised in terms of its effectiveness and relevance to obtain the required information based on the experiences of various countries. SARS should consider these recommendations based on how beneficial it could be and how it could contribute to achieving a successful level of tax compliance.

Obtaining timely, targeted and comprehensive information is important to enable tax administrators to achieve a higher success rate when assessing taxation and international taxation transactions. Taxpayers will reap the benefits of properly targeted disclosure initiatives, as they help to fill the gap between the creation or promotion of aggressive tax planning schemes and the identification thereof by SARS.

Tax audits will still play a significant role in obtaining required information, but will be more focused on risk, based on the information obtained through these strategies. The strategies suggested in this chapter need to be considered by local tax administrators in the context of the South-African tax system, administrative practice and culture (OECD, 2011b:19).

Knowledge is power. Obtaining the required information enhances the level of assurance SARS can obtain regarding the economic substance of taxpayers and their presence in other countries. This also enhances the effective tackling of aggressive tax planning schemes.

International guidelines on substance requirements are becoming more important to tax authorities worldwide, as many international companies operate subsidiaries offshore in low-tax jurisdictions to benefit from the lower taxes payable in those countries. A transfer of intellectual property is only considered to be a valid transaction if the asset was transferred to a company in a foreign destination that holds economic substance. In the following chapter the secondary objective will be aimed at:

- Exploring the term *economic substance* through a review of the dictionary meaning, interpretation of tax law and the tax courts;
- Summarising the *economic substance* parameters in popular intellectual property holding countries.

The chapter will therefore aim to clarify the understanding of *economic substance* in terms of the transfer of intellectual property and the appropriate assessment of transfer prices related to these transactions.

CHAPTER 5: ANALYSIS OF THE MEANING OF *ECONOMIC SUBSTANCE* AND THE APPLICATION THEREOF

5.1 Introduction

In the previous chapter, the ways in which information can be attained to enable the accurate and efficient assessment of transfer prices of intellectual property was identified and analysed (Secondary objective - section 1.3.2.3, page 5).

In this chapter, the following secondary objectives are considered (sections 1.3.2.4 & 1.3.2.5, page 5 & 6 respectively):

- What does *economic substance* mean (section 1.3.2.4, page 5)?
- What are the *economic substance* parameters that popular intellectual property holding countries put in place (section 1.3.2.5, page 6)?

Due to economic pressure and the aim to enhance shareholder wealth, companies often explore aggressive tax planning schemes to benefit from lower tax rates in low-tax jurisdictions. To address this, Controlled Foreign Company (CFC) legislation was introduced to serve as national anti-abuse legislation, encouraging local investment and preventing companies from establishing in offshore low tax jurisdictions.

According to section 9D of The Act, CFC legislation leads to the taxation of a resident on his share of the income of a foreign company when residents hold more than 50% of the participating or voting rights in a foreign company. A CFC is in essence a foreign non-operational company, established to own the foreign, income-producing assets of a resident in an attempt to benefit from the lower tax rate regime in the foreign country. The distinction between a non-operational company and an actual operational company that was not created to avoid tax is therefore significant.

Section (9)(b) of The Act refers to an operational company as a *foreign business establishment*. A foreign business establishment is a company that has *economic substance*. If a company can prove that it has *economic substance*, or is a *foreign business establishment*, it is excluded from the application of section 9D(2) of The Act, because the resident is deemed not to be involved in a tax avoidance scheme. *Economic substance* is something physical or existing that contributes to the development of wealth for its owner, in other words, a commercially justified business.

But how does this all fit in with the transfer of intellectual property to an offshore destination? If a multi-national company transfers its intellectual property to an offshore company in a low-tax country, but the foreign company lacks economic substance, local tax administrators can apply CFC-legislation to the taxable revenue of the company. However, if the foreign company does have economic substance, the tax revenue is lost to South Africa.

Determining an accurate and relevant transfer price for an intellectual property that was transferred to an offshore location is also dependent on the *economic substance* of the transaction. The allocation of risk between two entities indicates which entity has more control and should be attributed a greater portion of the profit. If the allocation of risk is not consistent with the *economic substance*, tax administrators are bound to question the validity of the transfer prices of transactions in the Group (OECD, 2010e:6).

The importance of *economic substance* therefore also came to the fore. This chapter aims to provide an understanding of the concept, highlight its relevance, and briefly look at the measures other countries put in place to address the risks associated with *economic substance*.

A brief summary of the general *economic substance* parameters at a company level proposed by the OECD will be presented in this chapter, as well as a quick look at the basic requirements laid down by most tax administrators to determine whether a company has sufficient *economic substance* to avoid CFC-legislation being applied to the taxable revenue of the company in the low-tax country.

A brief summary of specific substance requirements at a company level in various European countries will also be looked at. In essence, it seems South Africa is on track with the requirements in the rest of the world.

5.2 Ordinary dictionary meaning of the phrase

The term *economic substance* is not defined in The Act and tax administrators have to refer to alternative sources to define this term. For the purpose of this chapter, the term is split into its two separate words and from there a meaningful explanation of the concept is offered.

Dictionary meaning

Economic is defined in the Oxford advanced learners dictionary of current English (1995:367) as “of or relating to trade, industry and the development of wealth”. Synonyms of

the word can be found in the online Thesaurus available in Microsoft Word, which provides further clarity: “financial, monetary, fiscal, pecuniary, commercial, profitable, cost-effective, money-making, etc.”

Substance, on the other hand, is defined in the Oxford advanced learners dictionary of current English (1995:1192) as “real physical matter that can be touched, not just seen, heard or imagined”, or “the most important or essential part of something; the essential meaning”. Synonyms of the word found in the online Thesaurus available in Microsoft Word provide further insight: “material, matter, ingredient, constituent, element, stuff, body, affluence, property, etc.”

It can therefore be surmised that *economic substance* relates to something physical or existing, which contributes to the development of wealth for its owner in other words, a commercially justified business.

5.3 Guidance provided by the courts in emphasising the importance of economic substance

Taxpayers continuously attempt to minimise their taxes while concerned states try and protect their tax base. This exercise involves differentiating commercially justified businesses from artificial ones (Jourdan, 2012:38).

This chapter refers to guidance provided by the international courts. South-Africa has its own established rules in terms of a *permanent establishment*. However, when intellectual property is transferred to a popular offshore destination it is essential to be aware of the minimum requirements for substance in that country and what that foreign country defines as the minimum requirements for a company to be classified as having *economic substance*.

International case law – Cadbury Schweppes

The application of Controlled Foreign Company (CFC) rules in various European states is very wide and is left to case law and dismissals from national courts and the European Court of Justice (ECJ) to define these rules. The importance of the *substance* requirement in foreign legal entities was emphasised by the milestone result obtained in the Cadbury Schweppes Plc and Cadbury Schweppes Overseas Limited v Commissioners of Inland Revenue (2006) case (Jourdan, 2012:38).

Cadbury Schweppes Plc is the holding company of the Cadbury Schweppes Group, which includes two subsidiaries established in Dublin, Ireland, where the tax rate was 10% in 1996.

The two subsidiaries referred to are Cadbury Schweppes Treasury Services (CSTS) and Cadbury Schweppes Treasury International (CSTI).

These two subsidiaries are responsible for raising and providing finance to the Group. Based on the view of the National Courts, these companies were established specifically in Dublin to take advantage of the favourable tax regime there. (Cadbury Schweppes Plc and Cadbury Schweppes Overseas Limited v Commissioners of Inland Revenue (2006)).

In 2000, the United Kingdom Commissioner of Inland Revenue applied the CFC-legislation applicable in the United Kingdom, to the Irish companies and claimed a tax liability of £ 8.6 million on the profits generated by CSTI in 1996. The Cadbury Schweppes Group appealed to the Special Commissioners of Income Tax and claimed that applying the CFC-legislation to their companies was in contravention of community law, which allows for the freedom of establishment. The Special Commissioners then asked of the Court of Justice whether Community law precluded CFC-legislation (Cadbury Schweppes Plc and Cadbury Schweppes Overseas Limited v Commissioners of Inland Revenue (2006)).

The Court of Justice ruled that a company or person cannot take advantage of Community law under improper or fraudulent circumstances. It was argued that if a company is established in a Member State to benefit from more favourable tax rates, it is not necessarily an indication that the freedom of establishment was abused. In conclusion, it was found that the fact that Cadbury Schweppes Plc established CSTS and CSTI in Dublin to benefit from the lower tax rates, is not indicative of abuse, and that Cadbury Schweppes Plc was entitled to rely on Community law (Cadbury Schweppes Plc and Cadbury Schweppes Overseas Limited v Commissioners of Inland Revenue (2006)).

The Court of Justice further found that the CFC legislation restricted the freedom of establishment within the meaning of Community law. The Court of Justice pointed out that the application of CFC legislation was justified in situations where the arrangement was wholly artificial and aimed at dodging national tax liability. In other words, CFC legislation should be applied in situations where there is not an actual establishment with the intent of carrying on a genuine economic enterprise in the Member State in which it was incorporated (Cadbury Schweppes Plc and Cadbury Schweppes Overseas Limited v Commissioners of Inland Revenue (2006)).

The appeal of Cadbury Schweppes Pls to the Special Commissioners of Income Tax and, subsequently, to the Court of Justice, was successful. This was due to the fact that they had real economic substance in Dublin and were carrying on genuine trade activities, although

benefitting from the lower tax regime was part of the intention for incorporating CSTS and CSTI in Dublin. Tax avoidance was therefore not the intent of the Group, but rather practical tax planning.

The Group was correct in claiming that they had the freedom to establish their companies wherever they wished to do so, as it is part and parcel of a well-run group of companies to do proper tax planning and strategise to create maximum shareholder wealth. If they were able to benefit from lower tax rates while doing legitimate tax planning, they should not be penalised for it.

On the other hand, where a group of companies establish fictitious enterprises in foreign states purely to avoid tax, without any actual trade taking place, it is completely appropriate to penalise such behavior with a tax liability incurred through CFC legislation.

Multi-national companies that transfer intellectual property to offshore locations are also influenced by this dismissal in the Cadbury Schweppes case. Companies transferring intellectual property to artificial enterprises in foreign States to benefit from lower tax regimes not only need to heed the transfer pricing implications, but should also be aware that CFC legislation could be triggered where a resident holds more than 50% of the voting and participation rights of a foreign company (section 9D of The Act).

International case law – Group Litigation Orders

In another subsequent case, CFC Group Litigation Orders (GLO) (2008), the European Court of Justice confirmed that CFC legislation is justified if it specifically targets “wholly artificial arrangements designed to circumvent the legislation of the member state concerned”. In the CFC GLO case, the national court asked the Court for a preliminary ruling on various questions posed to the Court relating to dividends and CFC-legislation. Question three related specifically to the application of CFC legislation. The question posed to the Court basically sought to confirm that the inclusion of profits generated by a CFC in a Member State, where those profits are subject to a lower level of taxation in the Member State than the tax rates in the State of the resident company, are stopped, unless the inclusion is based on an entity that is a wholly artificial arrangement, established purely for the intention of avoiding the national tax liability.

The measures to include the profit of a CFC must not be applied where it is objectively proven by third parties that, despite the existence of a tax motive, the CFC is actually established in the host Member State and carries on activities of a genuine economic nature.

The national court further sought confirmation from the high court that, where national tax legislation imposes compliance requirements in situations where the resident company pursues exemption from taxes paid by the CFC on the State of residence, it would not be stopped. The aim of these requirements would be limited to verifying that the CFC is an actually established company involved in genuine economic trade, without incurring unnecessary administrative constraints.

The conclusion in both the above court cases resulted in many EU member states changing their legislation to exclude the inclusion of the proportionate revenue of a CFC in a resident company's taxable income, if it is proven to be a foreign business establishment or company with *economic substance*. This result also limited aggressive tax planning in terms of multinational companies transferring their intellectual property to countries with a more beneficial tax regime, but without having a company with *economic substance* being established in the host country.

Conclusion

Although South-Africa has well established *controlled foreign country* rules the rules in popular intellectual property holding companies are different. Foreign countries have different minimum requirements for a company to be regarded as having *economic substance* and could be significantly different to local legislation. This could impact on the legality of the transaction, i.e. that the intellectual property was not legally transferred to an offshore destination. This means no transfer pricing issues exist as no actual export of the intellectual property took place. This will also mean that the CFC-legislation will not be applicable. So in other words, for South-Africa to protect its tax base it is essential to be able to prove that no valid export of intellectual property took place.

5.4 Guidance provided by South African tax legislation to explain the meaning of *permanent establishment*

South Africa also has CFC legislation comparable to the legislation implemented in Europe. South African legislation requires that a portion of a CFC's revenue be included in the taxable income of a resident, regardless of whether the resident actually received any income from the CFC.

As in the European court cases discussed under the previous heading, South African tax legislation allows for the exemption of the inclusion of a CFC's income, if it can be proven that the CFC is a foreign business establishment, with certain exceptions. Generally, s9D of

The Act refers to a foreign business establishment as a fixed place of business through which the business of a company is partly or wholly conducted.

Section 9D of The Act clearly defines a *foreign business establishment* as follows: "a fixed place of business located in a country other than the Republic that is used or will continue to be used for the carrying on of the business of that controlled foreign company for a period of not less than one year, where-

i) that business is conducted through one or more offices, shops, factories, warehouses or other structures.

ii) that fixed place of business is suitably staffed with on-site managerial and operational employees of that controlled foreign company, who conduct the primary operations of that business.

iii) that fixed place of business is suitably equipped for conducting the primary operations of that business.

iv) that fixed place of business is located outside the Republic, solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere of government in the Republic.

v) that fixed place of business is located outside the Republic solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere of government in the Republic"

It is clear that the legislation in South Africa follows the same logic that was presented in the *Schweppes Cadbury* and the *GLO* cases. This infers that the income from a CFC should only be included in a resident's taxable income if there are "wholly artificial arrangements designed to circumvent the legislation of the member state concerned".

As mentioned earlier (section 5.1, page 74), a foreign business establishment is a company that has *economic substance*. If a company can prove it has *economic substance*, or that it is a *foreign business establishment*, it is excluded from the application of section 9D (2) of The Act, because the resident is deemed not to be involved in a tax avoidance scheme.

The Act contains various general anti-avoidance rules in section 80A-80L. The GAAR are aimed at regulating tax avoidance arrangements. As such, section 80C of The Act describes the circumstances under which a transaction is regarded, as not having *commercial substance*. When an arrangement results in a significant tax benefit, but does not have the equivalent business risk or net cash flow other than the tax benefit, it is regarded as a transaction without *commercial substance*. The tax administration then has the discretion to disallow the results of the transaction.

5.5 Brief analysis of the *economic substance* parameters applied by foreign jurisdictions

The European Court of Justice found that the application of CFC legislation should not be too general in its application, as this is contrary to European Court law when applied to actual establishments that have sound *economic substance* in the foreign country. Based on this finding, many countries redesigned their CFC legislation to be aimed specifically at 'wholly artificial arrangements' (Jourdan, 2012:38).

Based on the viewpoint held by the OECD (2010b:14), an entity is normally allocated a greater share of the profits rewards associated with those risks over which they have more control. In other words, the *commercial substance* of an entity is indicated by the entity having control over the risk, and the financial capacity to bear the consequences of the risk. *Control* refers to the ability to make decisions that will put the capital at risk and decisions on how to manage the risk. It should be decided whether the risk needs to be managed internally, or whether an external provider should be used. So, to *control* an entity, there needs to be employees capable of performing the *control* or management function (OECD, 2010e:8).

A brief summary of the *economic substance* requirements in popular intellectual holding companies is described below. The most common foreign destinations include; Hong Kong, Luxembourg, Madeira, Mauritius, Singapore and Switzerland.

In the various states of the EU the requirements are also different. The paragraphs below look at the requirements in; the United Kingdom, Sweden, Germany, France and Spain.

5.5.1 General substance requirements in popular intellectual property host countries

In most countries, a transfer of intellectual property to an offshore destination does not raise any eyebrows, if the transfer is made to an actual company with economic substance. In essence this means the company is not only an investment centre, but also an enterprise with economic activity with the intention of making a profit. An economically viable enterprise will generally fulfill the following requirements:

- Payroll requirements;
- Minimum capital requirements;
- Minimum revenue thresholds;
- Minimum amount of investments or spending;

- Reporting requirements;
- Requirements in relation to activities or number of activities;
- Other (depending on the particular jurisdiction) (Huibregtse *et al.*, 2011:2).

The following pointers also refer to general substance parameters:

- The roles and responsibilities assigned to which person in which jurisdiction;
- Based on the business risks to which the enterprise is exposed, does the person have sufficient equity and insurance coverage?;
- Can a local core business be carried out based on the measure and level of skill of staff members (Brackx & De Haen, n.d:1)?

Tax authorities also place emphasis on the following:

- The presence of local directors and the existence of an active bank account;
- The satisfaction of local compliance formalities;
- Whether meetings are physically held locally;
- Whether the operating expenses are recorded in the local Statement of Financial Performance (Brackx & De Haen, n.d:1).

The most popular intellectual property holding countries include:

- Hong Kong;
- Luxembourg;
- Madeira;
- Mauritius;
- Singapore, and;
- Switzerland

The OECD (2010e:42) explains that *economic substance* is established by a review of the facts and circumstances. The economic and commercial substance of a transaction, its object and effect for both business and practical implementation, and the behavior of the parties, should be taken into consideration. This can even be extended by evaluating the functions performed by each entity, the assets it used, as well as the risks undertaken.

Based on the above discussion, it is clear that tax authorities have a comprehensive checklist of requirements that need to be fulfilled for a company with global presence to prove its economic viability. Multinational enterprises need to take heed of these stringent *substance* parameters when deciding on a company structure.

According to the United Nations (2012d:19), it is necessary to examine the behaviour of connected persons over a stretch of time to determine whether it has been consistent with the allocation of risk, and whether any changes in these patterns were formulated in a contractual arrangement.

5.5.2 Substance requirements in favourable intellectual property locations

According to the OECD (2010e:41-42), a tax administration may decide not to recognise the structuring of an arrangement where the entity fails to convince the tax administration of its *economic substance*. It is imperative for a multi-national company doing its tax planning, to take these factors into consideration to avoid any undue transfer pricing liabilities, or to avoid incurring unwanted penalties and interest.

A multi-national country transferring intellectual property to a company situated in a foreign country needs to be certain that the company that the intellectual property is moved to has *economic substance* as defined in that country. Only if the receiving company complies with the basic substance requirements will a transaction be regarded as actually taking place. South-Africa has its own set of controlled foreign company legislation. However the multi-national company could argue that there is *economic substance* in terms of the requirements of the foreign country even if the principles in South-African legislation are not met. It could be worth re-looking current, local legislation to ensure that as many companies as possible are caught in the South-African *economic substance* net to ensure all transactions are taxed accordingly.

Some jurisdictions are popular locations for multi-national companies to transfer their intellectual property to in an attempt to benefit from lower tax regimes. However, these favoured destinations have specific requirements for a company to be recognised as holding *economic substance*.

The discussion below is a summary of the core characteristics regarded as indicating *economic substance* (at a company level) in these favoured low tax jurisdictions.

- **Hong Kong**

There are no clearly defined *economic substance* requirements in Hong Kong. However, if the Chinese requirement is applied, an enterprise would have to prove that it has a *commercial nature* (Huibregtse *et al.*, 2011:6).

Although there is no clear requirement in Hong Kong, the local tax authorities applied the general anti-avoidance statute in a number of cases. This resulted in a decline in aggressive tax planning (Chan & Yip, 2009:73).

- **Luxembourg**

In Luxembourg, one of the defining requirements is that the enterprise should have been established or acquired after 31 December 2007. Other than that, the general substance requirements are applied (Huibregtse *et al.*, 2011:6).

In an article written by Beernaerts and Lam (2011:1-3), the practical application of *economic substance* in Luxembourg was discussed. The writers claimed there is no strict definition for the term *economic substance*, as there is no general rule on which it can be based. An entity is resident in Luxembourg if it has a registered office or central administration in the country. Luxembourg bases its *substance* requirements on two circulars related to transfer pricing. The circular dealing with *substance* lists the following as minimum requirements to establish the *economic substance* of a company resident in Luxembourg:

- The majority of the members of the board can be either residents or non-residents, but they must carry out a professional activity in Luxembourg;
- The company must have capable staff to carry out and record the transactions of the company;
- Key management decisions need to be made in Luxembourg;
- At least one general meeting per year must be held at a location as indicated in the by-laws;
- The company must have at least one bank account in its own name with a credit institution based in Luxembourg.

- **Madeira**

Madeira has more specific substance requirements. The company should have at least one employee or director on the payroll. If the company has less than six employees, tax administration requires that the company should have an investment of at least EUR 75,000 in Madeira (Huibregtse *et al.*, 2011:6).

Additional requirements to substantiate *commercial substance* in Madeira:

- Trade should commence within six months for international services;

- Industrial and shipping business should commence within one year of licensing (Newmadeira-investment servicos, n.d.).

- **Mauritius**

Mauritius has no specific substance requirements. In this instance, the general substance requirements will be applied where the *economic substance* of an enterprise is in doubt (Huibregtse *et al.*, 2011:6). (General substance requirements referred to in the list of considerations under paragraph 5.5.1, page 81)

According to an article written by Nolan & Pelegrin (2011), Mauritius ranked third in Sub-Saharan Africa on the “overall regulatory ease of doing business”. Mauritius has a good reputation and its offshore financial services are deemed to be user-friendly and well regulated. It is also ideally located, with ease of access to Europe, Asia and Africa. In addition, it boasts a business-friendly economy to international clients with interests in African and Asian markets. Compliance and reporting regimes are similar to those of companies in Hong Kong and the United Kingdom. African companies and corporate entities therefore use Mauritius as a platform to expand their global business connections.

Many South African companies designated business activities to Mauritius, as these companies are regarded as having the necessary *economic substance* to manage these functions. This makes it the ideal location to establish and incorporate a group holding company to manage subsidiaries in Africa, India and Asia (Nolan & Pelegrin (2011

- **Singapore**

Singapore is more pedantic in applying *economic substance* rules. Singapore has strict requirements for incentives regarding business spending, creating jobs and the valuation of intellectual property brought into the country (Huibregtse *et al.*, 2011:6).

An increased focus on *economic substance* was experienced in Asia during 2010. Intermediate holding companies regarded as lacking *economic substance* and created merely to reap treaty benefits, gained more attention from tax authorities in China, India, Indonesia and South-Korea. Tax authorities now try and curb this kind of abuse and put in place stricter measures to determine *economic substance* of holding companies in Singapore (Soh & Tan (2010)).

- **Switzerland**

In Switzerland it is imperative that the activities of the enterprise stretch beyond the passive administration of the company assets. In other words, profitable economic trade activities should be demonstrated to be classified as being of *economic substance* (Huibregtse *et al.*, 2011:6).

Interesting to note, is that Switzerland appears on various tax haven lists, such as the list compiled by the OECD and legislation introduced in the 111th Congress. The OECD list has changed over time and some of the countries on the current list did not appear on the earliest OECD list. Countries not appearing on the original list were more developed, larger countries of which some are OECD members. Switzerland is one of these countries (Gravelle, (2013:3-4). The *economic substance* of a holding company incorporated in Switzerland is therefore of importance to tax administrators seeking to curb tax avoidance practices.

5.5.3 *Economic substance* requirements in various member states of the EU

The *economic substance* requirements of the member states of the EU has been influenced a great deal by the conclusion reached in the Cadbury Schweppes case. Member states have re-looked their CFC-legislation and the impact the transfer of intellectual property to these CFCs has had on local tax administrations. As such, substance requirements (at a company level) are now more clearly defined in these member states.

The discussion below highlights the main focus areas that these EU states deemed to be of importance in their determination of *economic substance* and in many cases might not bear anything in common. This is purely because the tax authorities in the various countries deem different characteristics to indicate the existence of *economic substance*.

- **United Kingdom**

The United Kingdom included the term 'effectively managed' to their legislation. This means a company is only 'effectively managed' when the employees are proficient and have the power to carry on the business. This makes CFC legislation applicable where a lack of economic substance is identified in a foreign located company (Jourdan, 2012:38).

The Cadbury Schweppes case also stressed that staff, premises and equipment, as well as competent staff and directors, are necessary to establish *economic substance* and make the

key business decisions of a company. The activities of a company also need to be considered to make sure they yield a provable profit (Cadbury Schweppes Plc and Cadbury Schweppes Overseas Limited v Commissioners of Inland Revenue (2006)).

- **Sweden**

Sweden determined that CFC rules would not apply within the EES (European Economic Space) states, if the resident can prove that the CFC is genuinely established and that it conducts legitimate business operations. Factors indicative of this includes that the enterprise has its own premises, requisite equipment to enable it to carry out its activities, sufficient and competent employees, and that the day-to-day activities are performed independently without interference from the holding company (Jourdan, 2012:39).

Countries like Sweden have adopted the Anglo-American approach to preventing tax avoidance (Grauberg, n.d.:141-150). In other words, its tax-avoidance measures are based on those similar to the common practice in the United States and United Kingdom.

- **Germany**

Germany is very specific in terms of its substance requirements. Germany requires that the activities in the country of residence of the subsidiary are carried out regularly, that there is sufficient and competent managerial and support staff, and that income is earned through activities carried out by the enterprise itself.

Further to this, Germany's tax administrators require that if related party transactions are the main stream of revenue, the services should generate value for the related party and that the capital funding be in proportion to the value added (Jourdan, 2012:39).

Beernaerts and Lam (2011:3), in an article of *economic substance* in Luxembourg, also commented that Germany has a high level of demand for compliance when it comes to *economic substance*. An office space with all the appropriate technological equipment for the efficient running of the company's business will be an absolute minimum requirement and nothing less will be accepted by tax authorities.

- **France**

France only made small changes to its substance requirements in the aftermath of the Cadbury Schweppes Case. The substance requirements include that there be a physical

presence in the other state in terms of premises, equipment and staff, and that real economic trade be conducted (Jourdan, 2012:39).

Various rules of interpretation evolved from judicial practice in terms of the content and applicability of general anti-avoidance rules, including the economic substance doctrine. Principles developed over time to aid in the interpretation of taxpayers' transactions. These principles are adopted in countries like France by tax authorities and courts. In France, the interpretation of a transaction is based on legal substance, which is considered the best approach for giving an assessment under tax law. The interpretation of the tax authority in France may only be based on Article 64 of the French code of tax proceedings. This code is limited to events where the taxpayer's sole intention is to avoid tax and to tax objects specified by law (Grauberg, n.d.:141-150).

- **Spain**

Spain only requires economic substance to be proven when foreign entities are established outside the EU (Jourdan, 2012:39).

In an article written by Calderon and Martinez-Matosas (2011:1), it was confirmed that Spanish tax authorities were adopting a stricter approach to the economic substance doctrine in international and intergroup transactions. This stricter approach conformed to standards developed by the OECD. The article ended with a warning to all taxpayers to heed the new approach towards structures and tax planning structures in Spanish companies.

5.6 Considerations for South African tax law in terms of *economic substance*

The above discussion took a look at the general meaning of *economic substance* at a company level. In the Cadbury Schweppes case, the courts concluded that the freedom of establishment was violated when a company could not establish subsidiaries in another country with a more desired tax rate without having to pay tax in the holding company's state based on CFC-legislation. The CFC GLO case echoed the same and emphasised that CFC legislation should be targeted to 'wholly artificial arrangements designed to circumvent the legislation of the member state concerned.'

According to Vanderwolk (2009:547 & 550), a Stop Tax Haven Abuse Act was introduced and proposed in the US, which entailed the codification of the *economic substance* doctrine. This doctrine drills down even further than company level and defines *substance* at a transactional level. The Codification Proposal included the following definition of *economic*

substance: ‘GENERAL RULES ... – (B) DEFINITION OF ECONOMIC SUBSTANCE. - ... (i) IN GENERAL. – A transaction has economic substance only if (I) the transaction changes in a meaningful way the taxpayer’s economic position, and (II) ... the taxpayer has a substantial purpose for entering into such transaction.’ The General Anti-Avoidance Rules in s80C of The Act has a similar provision explaining when a transaction does not have *economic substance*.

Vanderwolk (2009: 549) explains this definition as consisting of two legs. The first leg looks at whether the transaction had any economic effect apart from the tax consequences. The second leg seeks to determine whether the transaction had a business purpose or other non-tax reason for taking place. Vanderwolk continues this explanation (2009:552) by referring to the factors recommended for consideration. The three main considerations are listed below. However, this list is not exhaustive and a tax administrator should be familiar with all the considerations to make a successful assessment regarding the *economic substance* of a transaction.

Main considerations for the existence of *economic substance* (Vanderwolk (2009:552)):

:(A) Whether the transaction caused any change in the economic position of the parties to the transaction or any related parties, and the nature and extent of such change in economic position.

:(B) Whether the transaction created a possibility of profit or a risk of loss, or both, and the possible amount of such potential profit or loss, disregarding the effect of any tax benefits.

:(C) Whether the present value of the reasonably desired pretax profit from the transaction was substantial in relation to the present value of the expected net tax benefits that would result from the transaction if paragraph (1) of this subsection were not applicable. In determining pretax profit, fees and other transaction expenses shall be taken into account, and foreign taxes shall also be taken into account to the extent provided by the Secretary.’

The method for determining economic substance is a judicially created *economic substance doctrine*, as applied under *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978) and *Rice’s Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985). The ‘modern day’ economic substance doctrine employed by the United States is included under section 7701(o) (Cordonnier, 2013).

By employing the definition of *economic substance* and applying the factors for consideration, the tax administrator should be able to determine whether a transaction has *economic substance*, or not. If a transaction is found not to have economic substance, the recommended penalty, according to Vanderwolk (2009:548-549), is to deny the claimed tax benefit where a meaningless transaction is employed.

South Africa includes a similar concept in sections 80A-80L of The Act, but does not raise any penalty, as in the U.S. If a multi-national company transfers intellectual property to an offshore destination where the company does have *economic substance* (CFC legislation would not apply), but the actual transaction itself is found to have no economic relevance, other than to gain a tax benefit, the benefit could be disallowed, or a percentage penalty raised on the under-statement or over-statement of revenue (Vanderwolk, 2009:552). The requirements of section 31 of The Act in terms of transfer pricing will also be considered. In South-Africa, the benefit, in a similar situation, would also be disallowed and transfer pricing would be assessed.

The relevance of *economic substance* in the assessment of transfer prices of intellectual property cannot be emphasised enough. The correct appropriation of profits can be determined when *economic substance* is established and accurate transfer prices can be calculated. It is therefore important to have clear guidance on what constitutes a company with *economic substance*.

5.7 Conclusion

In this chapter, the following secondary objectives were considered (section 1.3.2.4 & 1.3.2.5, page 5 & 6 respectively):

- What does *economic substance* mean (section 1.3.2.4, page 5)?
- What are the *economic substance* parameters that popular intellectual property holding countries put in place (section 1.3.2.5, page 6)?

In a global arena where the focal point on *economic substance* is becoming ever more prevalent, especially for international companies with subsidiaries established in low-tax jurisdictions, it is important to know what *economic substance* is and the parameters set out to define and establish *economic substance*.

Case law, such as in the Cadbury Schweppes Case and the CFC GLO case, emphasised the importance of *economic substance* to European States and concluded that CFC

legislation should only be applicable where the company is found to be a 'wholly artificial arrangement'. South Africa's approach to the application of CFC legislation conforms with the principles founded in these two court findings.

Economic substance was discussed at a company level, as well as transaction level. At company level, it was concluded that there is a basic minimum requirement to establish *economic substance* and that many countries molded these requirements to suit their specific needs. Included in the basic parameters, among others, are the following (see section 5.5.1, page 81):

- Payroll requirements;
- To which people in which jurisdiction were roles and responsibilities assigned?
- The presence of local directors and the existence of an active bank account, etc.

At a transactional level, *economic substance* is based on whether there is a change in economic position and or whether there is a purpose for entering into the transaction, other than the tax benefit.

Clearly, tax administrators are attempting to fight global tax fraud and prevent 'treaty shopping' by challenging companies to show their overseas activities are genuine trade activities, undertaken by subsidiaries in the host countries, or otherwise deny them their tax breaks (Brackx & De Haen, n.d:1). It is therefore important that multi-national companies heed *economic substance* when planning their company structure. Equally important is that South African tax administrators take note of *economic substance* at transactional level, to determine whether transactions relating to intellectual property transfers to offshore destinations are not merely tax evasion.

In the following chapter, the final secondary objective is considered (section 1.3.2.6, page 6), where a conclusion is reached on the weaknesses of transfer pricing assessment in South Africa.

CHAPTER 6: CONCLUSION AND RECOMMENDATIONS

6.1 Introduction

The original contribution made by this study is a focus on intellectual property in the exchange control regime. Intellectual property was previously regarded as no more different than any other commodity in the market until all the recent case law and changes in Exchange Control Regulations.

The main objective of this study is to point out the areas of weakness that could lead to an erosion of South Africa's tax base once the exchange control regulations are relaxed, and to make suggestions for potential improvement (section 1.3.1, page 5). To effectively address this objective, a number of secondary objectives were formulated (section 1.3.2, page 5):

- (i) Summarise the definition of 'intellectual property' in terms of *capital*, as defined in The Act.
- (ii) Summarise the treatment of transfer pricing in South Africa in relation to intangible property and highlight some of the areas that prevent SARS from effectively assessing transfer pricing transactions.
- (iii) Briefly summarise the limitations in obtaining timely, targeted and comprehensive information from local companies and foreign jurisdictions and make recommendations to address these limitations.
- (iv) Summarise the term *economic substance*.
- (v) Summarise the parameters of *economic substance* implemented by other popular intellectual property company holding destinations.
- (vi) Briefly summarise and conclude on the weaknesses in transfer pricing assessment in respect of intellectual property if Government decides to relax exchange control regulations in future.

Summary of findings

In Chapter 2, the first secondary objective (section 1.3.2.1, page 5) was addressed, namely to summarise the definition of intellectual property in terms of *capital*, as defined in The Act. This objective was achieved by a discussion of the meaning of 'intellectual property' and *capital* by referring to The Act and the interpretation of intellectual property organisations. According to the World Intellectual Property Organisation (not dated: 1), intellectual property refers to a creation of the mind and includes creations such as inventions, literary and artistic

works, symbols, names, images and designs used in commerce. It can be divided into two categories: Industrial property and Copyright.

Government Notice number R445 of 8.6.2012 was issued on 8 June 2012, announcing the amendment to Regulation 10 of the Exchange Control Regulations. The amendment centred on the fact that *capital* shall include any intellectual property rights, whether registered or unregistered. (Exchange Control Regulation 10(1) (c) of The Exchange Control Regulations, 1961)

The Act does not define the term *capital*, but many judges in court cases over the years attempted to describe what constitutes *capital* or revenue. Stiglingh *et al.* (2011:40) advised that where the nature of copyright, inventions, patents, trademarks, formulae or secret processes needs to be determined, the best approach is to refer to the tests suggested for other assets. Each case is different and should be individually assessed. In general, the following rule applies: If a person acquired and held such assets as an income-producing investment, any amount received for the disposal of it would be *capital* in nature. However, if it was acquired for the purpose of profitable resale, the proceeds would be regarded as income in nature.

The Act, in paragraph 1 of the Eighth Schedule, provides the following definition of an asset: "property of any nature, whether, movable or immovable, corporeal or incorporeal". This excludes any currency, but includes any coin made mainly from gold or platinum. The definition includes a right or an interest of any nature in such property.

The Eighth Schedule of the Act further provides guidelines to determine whether a disposal did take place, the value at which such a disposal is deemed to have taken place and the calculation of the Capital Gains Tax effects. The disposal of intellectual property will result in various recoupments of taxable income in terms of section 11(gB) (registration expenses of intellectual property) and or section 11(gC) (acquisition of intellectual property) of the Act. Donations tax also comes into effect when intellectual property is transferred without adequate compensation. Naturally, transfer pricing rules will also be triggered.

In Chapter 3, the next secondary objective (section 1.3.2.2, page 5) was achieved, namely summarising the treatment of transfer pricing in South Africa in relation to intellectual property and highlighting risks that hinder the effective assessment of transfer pricing transactions. The chapter focused on transfer pricing and the main obstacles local tax administrators face in assessing intellectual property transfer transactions.

The chapter described how transfer pricing of the international transfer of intellectual property should be dealt with in terms of Practice Note 7 (SARS, 1999). Practice Note 7 refers to Chapter VI of the OECD Guidelines on Transfer Pricing (OECD, 2010d) to assess transfer pricing of intangible assets, but this guideline is aimed at developed countries rather than developing countries, such as South Africa. The rest of the chapter was devoted to the various challenges SARS faces in effectively and timeously assessing transfer prices in transactions of this nature. It also offers a few considerations to attack these challenges.

Chapter 4 dealt with another secondary objective (section 1.3.2.3, page 5), namely a summary of the limitations in obtaining timely, targeted and comprehensive information from local companies and foreign jurisdictions and making recommendations to address these limitations. Timely information is essential and enables SARS to quickly identify risk areas and decide whether and how to react (OECD, 2011b:6).

SARS's information gathering begins with a review of the tax return submitted by the taxpayer, either manually or through e-filing. Based on this review, a decision is made whether to request additional information by means of a traditional audit of the taxpayer's transactions, and or to request to the taxpayer to complete additional questionnaires, if a transfer price risk is suggested (OECD, 2012:21). SARS embarked on exploring additional ways to obtain relevant, timely and comprehensive information. Some of these projects were discussed in this chapter, as well as information gathering sources as proposed by the OECD.

The preceding chapter (Chapter 5) considered the next secondary objective (section 1.3.2.4 & 1.3.2.5, page 5 & 6 respectively). The objective was achieved by providing an explanation of the term *economic substance* and by summarising the parameters of *economic substance*, implemented by other popular intellectual property company holding destinations. *Economic substance* in South Africa is regulated by section 9D of The Act. The definition of a 'foreign business establishment' in this section illustrates the minimum requirements a company needs to adhere to to be deemed to have *economic substance*.

Its basic principle revolves mainly around the same finding in the Cadbury Schweppes case and the CFC GLO case, which concluded that CFC-legislation should be aimed at a company whose trade transactions are artificial. To prove that it is not artificial there should be *economic substance*, which entails management, control and day-to-day decisions concerning the business activities taken in the host country where the subsidiary is based (Brackx & De Haen, n.d:1).

In this chapter, the final objective (section 1.3.2.6, page 6) is considered, namely summarising and concluding on the weaknesses in transfer pricing assessment in respect of intellectual property, if Government decides to relax exchange control regulations in future.

6.2 Conclusion on the impact that the eventual abolishment of Exchange Control Regulations will have on South African tax legislation, especially in terms of Regulation 10(1)(c), with reference to intellectual property

The Exchange Control Regulations were promulgated on 1 December 1961, just after South Africa became independent from British Rule. Authorities feared a large scale outflow of capital, due to the outside world's view of the racial segregation policies at that time, as well as the after effects of the Sharpeville massacre. In response to this, National Treasury brought into being the Exchange Control Regulations, Orders and Rules (Deloitte, 2012b:7).

Until 1995, these Regulations served to prevent and restrict capital outflow and to manage the country's foreign exchange reserves. After the democratic elections in 1994, there was a decreasing need for these restrictions and, over time, the South African Government gradually abolished exchange control (Deloitte, 2012b:7).

In the past, intellectual property never really received focus in the exchange control regime. For more than forty years, it was never even mentioned in the Exchange Control Regulations or Rulings. Intellectual property was deemed no different than any other commodity by the market and the relevant exchange control requirements were taken to be fulfilled when full proceeds were received (Deloitte, 2012b:7).

In 2012, the Exchange Control Regulations were amended by the South African Reserve Bank, to specifically include intellectual property as *capital* in Regulation 10(1)(c). SARB also advised that the sale, assignment or cession and or waiver of rights in terms of non-residents would require specific prior approval from National Treasury (Deloitte, 2012b:7).

In a 2004 court case, *Couve v Reddot International (Pty) Ltd* (2004), the court agreed that intellectual property is *capital*. In a subsequent court case in 2011, *Oilwell v Protec International Ltd and Others* (2011), the court found the previous ruling was incorrect and that intellectual property is not *capital* for the purposes of Exchange Control Regulations. This conclusion meant that intellectual property could be exported without prior consent from National Treasury, as long as the fair value was received (Deloitte, 2012b:8).

National Treasury was not in agreement with this. In 2012, the Regulations were amended to specifically include intellectual property rights, whether registered or unregistered, as *capital* and determined that prior consent was required before exporting it to a non-resident destination. It is inevitable, in the light of the changes made to Regulation 10(1)(c), to deduce that exchange control suddenly gained an interest in intellectual property (Deloitte, 2012b:8).

The export of intellectual property clearly became a threat to South Africa's foreign exchange reserves, to such an extent that National Treasury deemed it necessary to modify the exchange control regulations. This can only mean that a great deal of South African developed and invented intellectual property has been leaving South African shores over the past few years. It is important to note that the subsequent tightening of the exchange control regulations is in contravention of the South African Government's declaration to gradually abolish exchange controls (Deloitte, 2012b:8). Although National Treasury tightened the exchange control regulations dealing with the transfer of intellectual property to an offshore location, Government's declaration to eventually abolish all exchange control regulations in the reformed South Africa, remains. If the South African Government seeks to be true to this declaration, it means the exchange control regulations in particular those regulating the transfer of intellectual property, will eventually have to be abolished. Local tax administrators need to be prepared for that day. They need to explore avenues in which undue loss of tax revenue can be restricted if intellectual property transfers to non-residents become the order of the day.

The weaknesses in the tax net concerning intellectual property transferred to an offshore destination were emphasised during the small window period between the dismissal in the Oilwell case and the amendment to Regulation 10(1) (c) of the Exchange Control Regulations. These weaknesses are now, once again, mitigated by the tightening in exchange control. However, if the exchange control is abolished, these weaknesses will be at the order of the day.

The first area to be impacted by the abolishment of exchange control regulations is transfer pricing. Due to the fact that the international relocation of intellectual property is controlled by National Treasury, very few transactions of this nature currently take place. SARS is therefore not wholly focused on addressing the risks around establishing a suitable arm's length price for the international removal of intellectual property. In Chapter 1 (section 1.1.2, page 2), the lack of a comparables database, insufficient information on tax returns, and a

shortage of skills were listed as challenges in determining a suitable arm's length price for intellectual property.

The lack of domestic comparables containing South African specific or even African specific comparable data will impact the establishment of a suitable arm's length price for the assessment of intellectual property transfer prices. The most suitable comparables database will most probably be a European database (Deloitte, 2012a: 48–120). This will, however, require adjustments in terms of market, economic and political differences to improve comparability. Chapter 3 explored the adjustments that would need to be considered in achieving a domestic comparable (section 3.2.5, page 33, section 3.3, page 39 & section 3.4, page 45).

This could have the result that, after these adjustments, the comparables data is no longer comparable to the controlled transaction, rendering it useless. Achieving reliability and finding comparable data will be a great challenge for South Africa (UN, 2012g: 2). A specific problem that will impact SARS regarding transfer pricing in terms of intangible assets (or intellectual property), are issues such as local marketing intangibles, the concept of economic versus legal ownership and the valuation of the asset (UN, 2012g: 3).

Another impact on SARS, will be attracting and retaining human resources with the necessary skills and expertise to effectively and adequately calculate arm's length prices for the move of intellectual property to an offshore destination (SARS, 2012a: 25–26). SARS only started to aggressively audit transfer pricing in the past few years, due to a lack of resources and skills challenges (UN, 2012g: 1).

The second area to be impacted by the abolishment of exchange control regulations is the matter of attaining enough relevant and useable information. Although this is already an issue under the current regulations, it will be equally important in the challenge of determining a relevant arm's length price (OECD, 2011b:6).

Taxpayers normally avoid responding to SARS questions and providing the information required. This results in very long, drawn out audits. Instead of providing the relevant information, or arguing the technical points raised by SARS, taxpayers make use of advisors or advocates to avoid responding to SARS (UN, 2012g: 1).

The last area of impact will be that of *economic substance*. A resettlement of intellectual property to a company in a foreign country is only deemed to be legal and valid if the receiving company has *economic substance*. If the company has *economic substance*, the

application of transfer pricing becomes applicable. South Africa does not have legislation specifically formulating the concept *economic substance*. However, the definition of a 'foreign business establishment' in section 9D of The Act is used as an alternative. Once exchange control is abolished, the importance of establishing *economic substance* will become more prevalent. South Africa might not be geared to effectively assess each transaction, to determine whether the application of transfer pricing is relevant to each unique displacement (Huibregtse *et al.*, 2011:1).

6.3 Recommendations for improvement of or change to South African legislation

Assessing the transfer pricing transactions related to the transmission of intellectual property to a non-resident, poses various challenges to local tax administrators (secondary objective –chapter 3), especially in the absence of exchange control regulations. Due to this, a great deal of information is essential to ensure transactions are effectively and accurately assessed (secondary objective – chapter 4). To ensure arm's length transactions take place between the company in South Africa and the host company, it is equally important to have a well-defined regulation prescription to determine *economic substance*, both at entity and transactional level (secondary objective – chapter 5).

The OECD introduced various recommendations to overcome these challenges. Somewhere in the future, if the exchange control regulations in terms of Regulation 10(1)(c) are relaxed, SARS and the South African Reserve Bank (SARB) will still aim to maintain their goals of protecting the tax base, attracting foreign investment and facilitating cross border trade (OECD, 2012:68). Strengthening the legislative tax environment could help a great deal in still achieving and maintaining these goals. A few suggestions for consideration are presented in the following paragraphs:

Train and develop human resources (secondary objective achieved in chapter 3)

A Forum was set up by 34 African Tax Commissioners, called the African Tax Administration Forum (ATAF). The Forum promotes learning and skills in African tax administrations. South Africa is a member of this Forum, along with other countries, among others, Sudan, Tanzania and Zambia (ATAF, n.d.a). This Forum includes transfer pricing teams with the right mix of skills and tax administrations. The Forum structured them in such a manner to obtain maximum effectiveness from their transfer pricing experts. By obtaining membership to this Forum South Africa is able to:

- Draw on the experience and knowledge of transfer pricing teams in developed and developing countries;
- Access technical assistance provided by tax administrations that have the relevant expertise to provide technical specialists through seconding, based on the need;
- Bring colleagues from other countries into its transfer pricing teams, to learn new skills and techniques;
- Provide input to the register of resources compiled by ATAF. This will enable countries with scarce skills to assist South Africa in its areas of weakness, and vice versa (OECD, 2012:69-70);
- Become eligible for nomination to the ATAF Council;
- Contribute to research, development and capacity building projects relevant to South Africa's needs;
- Access up-to-date articles and information on the secure ATAF site (ATAF, n.d.b).

The SARS should also encourage the employment of skilled individuals who have the necessary degrees and qualifications from tertiary institutions. Already employed individuals in SARS should be motivated to further study by offering bursaries, promotions and other relevant incentives.

Formulate strong and relevant transfer pricing rules and practices (secondary objective achieved in chapter 3)

South Africa has its own set of transfer pricing rules and refers to Chapter IV of the OECD Guidelines whenever transfer pricing of intellectual property needs to be assessed. This is not enough. The OECD Guidelines are framed with developed countries in mind and not applicable to South Africa in establishing comparables. Local tax administration should endeavor to formulate its own transfer pricing rules and regulations through consultation with the resources provided by ATAF and its own experience and skills. These practices should be relevant to the South African context and take into consideration the challenges unique to our country (OECD, 2012:70).

In the Transfer Pricing Manual released by the UN (2012g: 1) it was noted that South Africa intends to provide an update to Practice Note 2 and Practice Note 7. SARS should address the issue of a relevant comparables database and how to adjust it to be acceptable and relevant to the African and South African context in these practice notes. Establishing a significant arm's length price should be investigated and formulated specific to intellectual property.

Risk assessment of transfer pricing transactions (secondary objective achieved in chapter 3 and chapter 4)

Due to the lack of experienced and skilled professionals in South Africa, who are able to effectively assess transfer pricing transactions of intellectual property, it is essential that the local tax administration identify the highest risk cases and utilise scarce resources to the maximum in these cases. South Africa should explore ways in which cases can be more meticulously assessed in a shorter space of time to determine which cases are worth investigating (OECD, 2012:71).

Formulating innovative ways of obtaining more information in a shorter space of time, and translating that information into such a format that an effective and quick assessment of risks can be performed, is essential. The SARS could investigate the costs involved in approaching external specialists to assist with this task. These specialists could then be given the assignment of coming up with new, inventive and cost effective ways of obtaining the information in the format required.

Access to commercial information and comparables

ATAF is investigating the potential of purchasing rights to use a commercial database for collective use by its members, and the possibility of members developing their own databases. South Africa already embarked on an exercise of compiling a database of taxpayers' information and could eventually use this database to obtain comparables when assessing transfer pricing transactions of intellectual property (SARS, 2012b:33).

SARS compiled a schedule of all foreign patents, filed in the name of foreign entities that belong to foreign investors (Zantwijk, 2007:1). This list should be maintained and regularly updated with relevant information to enable tax administrators to identify potential tax fraud in terms of intellectual property.

SARS could set up a division to gather information on markets, trends, availability of product substitutes, actions of competitors and the development of product variations for additional applications. The information obtained could be used to determine relevant and accurate arm's length prices for intellectual property (UN, 2012h: 28).

Through its involvement with ATAF, South Africa is in a position to negotiate with other member countries to formulate a comparables database relevant to the African content and

economy. This could enable a better transfer pricing methodology, suited to the African content and not based on European standards, as dictated by the OECD.

6.4 Possible topics for further study

- Investigate additional devices that regulators in South Africa can apply to restrict tax arbitrage, resulting from the handover of foreign registered intellectual property, other than the transfer pricing provisions;
- Explain of the meaning of the term 'other property of a similar nature', as referred to in section 11 (gA) of the Income Tax Act No. 58 of 1962, as amended;
- Investigate how the loss of individual- and corporate income tax revenue due to the shifting of profits and income into tax havens can be mitigated;
- Determining 'beneficial ownership' based on the interpretation of Articles 10, 11 and 12 of the model Tax Convention is complicated. How can the requirements be broadened to simplify the identification of a 'beneficial ownership' relationship?
- How can a vendor employ substance requirements to protect him from adverse VAT consequences if there is a case of non-compliance to formal requirements against him?

6.5 Conclusion

South Africa faces potential losses to its fiscus if government finally abolishes exchange control regulations. The weaknesses in the assessment of transfer prices pertaining to intellectual property will become more prevalent in the absence of the exchange control regulations. *What are the areas of weakness the South African Revenue Service needs to address in the assessment of transfer pricing transactions involving intellectual property, should Government decide to abolish exchange control regulations?*

Three main areas of weakness were identified, discussed and the challenges surrounding these weaknesses were defined. The three major weaknesses were identified as:

- Determining a method to calculate a relevant, applicable and accurate arm's length price for the conveying of intellectual property to an offshore destination;
- Obtaining all the required information to assist in the calculation of an applicable arm's length price;
- Formulating parameters to identify a company with *economic substance* and identifying when the transfer pricing principle is relevant to a transaction.

These weaknesses were discussed at length in the preceding chapters. Various recommendations were also presented in these chapters as suggestions to lessen these weaknesses. The recommendations highlight ways in which the erosion of South Africa's tax base could be prevented when exchange control regulations are abolished.

Local tax administrators should review these concerns and digest the recommendations offered. This will ensure that, when exchange control is a thing of the past, the weaknesses currently pertaining to intellectual property transfer pricing transactions will no longer be eminent. In other words, SARS can already start to challenge these problems and will not be able to claim that it had not been aware of it. The suggestions provided could also be put to good use to manage these risks and prevent any undue losses in South African tax revenue.

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