

Transfer pricing: Possible implications of the amendments to the Income Tax Act

Celeste van der Lith

Mini-dissertation submitted in partial fulfilment of the requirements for the degree
Magister Commercii (Taxation) at the Potchefstroom Campus of the North-West
University

Supervisor:

Professor DP Schutte

November 2011

ABSTRACT

DEPARTMENT: TAXATION

DEGREE: MAGISTER COMMERCII TAXATION

Transfer pricing legislation was introduced into the Income Tax Act in 1995. The amendments of the transfer pricing legislation were introduced by SARS in the Explanatory Memorandum on the Taxation Laws Amendment Bill 2010, which came into effect from 1 October 2011.

The amended Section 31 of the Income Tax Act seeks to capture both direct and indirect transactions for transfer pricing purposes, thereby substantially widening the scope and implication of the Section. The special inclusion of indirect transactions within the scope of South African transfer pricing was partly driven by a recent United Kingdom court case on transfer pricing, namely, *DSG Retail Limited v HMRC* *STC (SCD)* 397 (Olivier & Honiball, 2011:662-663).

Practice Note No. 7 was issued by SARS in 1999 to provide guidelines on the procedure to follow to comply with the transfer pricing provisions before Section 31 of the Act was amended. Uncertainty exists as to the implication of the amended transfer pricing legislation. The purpose of the study is to determine the possible implications of the substantially amended transfer pricing legislation.

TABLE OF CONTENTS

CHAPTER 1: BACKGROUND, PROBLEM STATEMENT AND OVERVIEW.....	1
1.1 TITLE: Transfer pricing: Possible implications of the amendments to the Income Tax Act.....	1
1.2 KEYWORDS	1
1.3 DEFINITIONS	1
1.4 ABBREVIATIONS	3
1.5 INTRODUCTION	4
1.5.1 Background	4
1.5.2 Literature review of topic	6
1.5.3 Motivation of topicality	6
1.6 PROBLEM STATEMENT	8
1.6.1 Objectives	8
1.6.2 Main objective	8
1.6.3 Secondary objectives.....	9
1.7 RESEARCH METHOD.....	9
1.7.1 Literature review	9
1.8 OVERVIEW	10
1.8.1 Chapter 1 – Background, problem statement and overview	10
1.8.2 Chapter 2 – Comparing the wording of the Act pre- and post amendment to Section 31 of the Act	10
1.8.3 Chapter 3 – Comparison between the UK transfer pricing regulations with the South African transfer pricing legislation	10
1.8.4 Chapter 4 – Transfer pricing in Double Taxation Agreements	11
1.8.5 Chapter 5 – Other amendments to Section 31 of the Act	11
1.8.6 Chapter 6 – Summary, Conclusion and recommendations.....	11
CHAPTER 2: COMPARING THE WORDING OF THE ACT PRE- AND POST AMENDMENT TO SECTION 31 OF THE ACT	12
2.1 INTRODUCTION	12
2.2 “TRANSACTION, OPERATION, SCHEME, AGREEMENT OR UNDERSTANDING” REPLACING “GOODS AND SERVICES”	15
2.3 THE DEFINITION OF “TAX BENEFIT”	16
2.4 ONUS OF PROOF	17
2.5 THE TERM “PRICES” REPLACES “PROFITS”	18
2.6 THE ADJUSTMENT OF PRICES – ARM’S LENGTH PRINCIPLE.....	20
2.7 SUMMARY	22
2.7.1 Reasons for change.....	22
2.7.2 Implications of amended terms.....	23

CHAPTER 3: COMPARISON BETWEEN THE UK TRANSFER PRICING REGULATIONS WITH THE SOUTH AFRICAN TRANSFER PRICING LEGISLATION	24
3.1 INTRODUCTION	24
3.1.1 Background to the SA transfer pricing legislation.....	25
3.1.2 Background to the UK transfer pricing legislation	25
3.2 THE PARTIES AFFECTED BY TRANSFER PRICING	28
3.2.1 SA transfer pricing legislation	28
3.2.2 UK transfer pricing legislation.....	32
3.3 “GOODS OR SERVICES” VERSUS “TRANSACTIONS”	35
3.3.1 SA transfer pricing legislation	35
3.3.2 UK transfer pricing legislation.....	36
3.4 THE ARM’S LENGTH PRINCIPLE	37
3.4.1 SA transfer pricing legislation	37
3.4.2 UK transfer pricing legislation.....	37
3.5 SELF ASSESSMENT.....	39
3.5.1 SA transfer pricing legislation	39
3.5.2 UK transfer pricing legislation.....	39
3.6 DOCUMENTATION	41
3.6.1 SA transfer pricing legislation	41
3.6.2 UK transfer pricing legislation.....	49
3.7 TRANSFER PRICING METHODS	52
3.7.1 SA transfer pricing legislation	52
3.7.2 UK transfer pricing legislation.....	58
3.8 SUMMARY	59
3.8.1 Differences between UK and SA transfer pricing legislation.....	59
CHAPTER 4: TRANSFER PRICING IN DOUBLE TAXATION AGREEMENTS (“DTA’S”).....	62
4.1 INTRODUCTION	62
4.2 OECD GUIDELINES	63
4.3 SUMMARY	67
CHAPTER 5: OTHER AMENDMENTS TO SECTION 31 OF THE ACT	69
5.1 INTRODUCTION	69
5.2 THIN CAPITALISATION.....	69
5.3 SECONDARY TAX ON COMPANIES	73
5.4 TRANSFER PRICING LITIGATION	74
5.5 SUMMARY	77
CHAPTER 6: SUMMARY, CONCLUSION AND RECOMMENDATIONS.....	78
6.1 INTRODUCTION	78

6.2	IMPLICATIONS OF THE AMENDED SECTION 31 OF THE ACT	79
6.2.1	Comparing the pre- and post amendment of terms and definitions in the Act.....	79
6.2.2	Comparing UK transfer pricing to SA transfer pricing.....	81
6.2.3	Additional documentary requirements.....	84
6.2.4	Transfer pricing and double taxation agreements	85
6.2.5	Other amendments to section 31 of the Act	86
6.3	CONCLUSION	87
6.4	RECOMMENDATION FOR FUTURE STUDIES IN RESPECT OF TRANSFER PRICING.....	88
	REFERENCES	89

CHAPTER 1: BACKGROUND, PROBLEM STATEMENT AND OVERVIEW

1.1 TITLE: Transfer pricing: Possible implications of the amendments to the Income Tax Act

1.2 KEYWORDS

The following words and terms will apply in this study:

- Arm's length
- Connected persons
- Transaction, operation, scheme, agreement or understanding
- Prices
- Profit
- Tax benefit
- Transfer pricing

1.3 DEFINITIONS

Connected person: The meaning of a connected person is defined in Section 1 of the Income Tax Act No. 58 of 1962 ("the Act") as follows:

- In relation to a natural person, any relative and any trust (other than a portfolio of a collective investment scheme in securities) of which such natural person or such relative is a beneficiary;
- In relation to a trust (other than a portfolio of a collective investment scheme in securities) any beneficiary of such a trust and any connected person in relation to such beneficiary;
- In relation to a member of any partnership any other member, and any connected person in relation to any member of such partnership;

- In relation to a company any other company that would be part of the same group of companies as that company if the expression “at least 70 per cent” in the definition of “group of companies” in this Section were replaced by the expression “more than 50 per cent”;
- In relation to any person, other than a company as defined in Section 1 of the Companies Act, 2008 (Act No. 71 of 2008), anyone who individually or jointly with any connected person in relation to himself, holds, directly or indirectly, at least 20 per cent of the equity shares in the company or the voting rights in the company;
- In relation to any other company if at least 20 per cent of the equity shares in the company are held by that other company, and no shareholder holds the majority voting rights in the company; and
- In relation to any other company if such other company is managed or controlled by any person who or which is a connected person in relation to such company or any person who or which is a connected person in relation to that other company (Income Tax Act 58/1962).

Financial assistance: for the purposes of Section 31 of the Act financial assistance includes the provision of any

- loan, advance or debt; or
- security or guarantee (Income Tax Act 58/1962).

1.4 ABBREVIATIONS

Abbreviation	Meaning
DTA	Double Taxation Agreement
GAAR	Guide to the General Anti-Avoidance Rule
HMRC	Her Majesty's (HM) Revenue & Customs
OECD	The Organisation for Economic Co-operation and Development
SARS	South African Revenue Services
STC	Secondary Tax on Companies
UK	United Kingdom

1.5 INTRODUCTION

1.5.1 Background

Transfer pricing is defined by Arnold and McIntyre International Tax Primer (2002) as follows: “A transfer price is a price set by a taxpayer when selling to, buying from, or sharing resources with a related person” (Olivier & Honiball, 2011:620).

From the above, it is possible for a multinational group of companies to price intra-group transactions so that profits are taxed in low tax jurisdictions, while deductions are obtained in high tax jurisdictions, resulting in a loss of tax revenue by high tax countries. The regulation of transfer pricing between related parties is one of the many anti-avoidance measures which revenue authorities use internationally (Olivier & Honiball, 2011:620). Transfer pricing legislation is used by the revenue authorities internationally to adjust prices set by related parties.

Section 31 of the Income Tax Act, No. 58 of 1962 (hereafter referred to “the Act”) containing the transfer pricing legislation, was introduced into the Act with effect from 19 July 1995. The South African Revenue Service (“SARS”) has since issued Practice Note No. 7 on 6 August 1999. Thereafter no further changes to the legislation and the tax treatment of international transactions between connected persons were effected by SARS.

The recent amendments to Section 31 of the Act which comes into effect on 1 October 2011 may be indicative that SARS will allocate more resources to transfer pricing audits in the future. Therefore it requires a close scrutiny of changes made to terms and definitions in Section 31 of the Act.

The mentioned changes may bring about an additional burden of record keeping together with economic implications on the parties involved, if not compliant with changed legislation. Transfer pricing legislation contained in Section 31 of the Act, before the amendments, enabled SARS to adjust the consideration in respect of a supply or acquisition of goods or services in terms of an international agreement

between connected persons. SARS may adjust the consideration, for tax purposes, if the actual price is either less or greater than the price that would have been set if the supply or acquisition of goods or services had occurred between independent parties on an arm's length basis (SARS, 1999:6).

The Proposal in the Explanatory Memorandum on the Taxation Laws Amendment Bill (SARS, 2010a:74-75) refers to the revision of wording such as “goods and services” replacing it with a cross-border “transaction, operation, scheme, agreement or understanding” that have been effected between, or undertaken for the benefit of connected parties.

Section 31 of the Act will no longer refer to “price” but to “profit” to align it with the tax treaty wording. The insertion of the definition “tax benefit” may open broad interpretation issues between SARS and the taxpayers.

Under the previous transfer pricing legislation SARS could adjust the price of the transactions not at arm's length and the taxpayer would with the amended legislation be obliged to account for transfer pricing at arm's length, therefore voluntarily adjust pricing not at arm's length.

Harsh penalties can be levied by SARS equal to twice the tax chargeable if a taxpayer, for example, made an incorrect statement on its return where previously SARS could not impose penalties in terms of Section 76 of the Act.

1.5.2 Literature review of topic

A summary of the changes to Section 31 of the Act in the Explanatory Memorandum of the Taxation Laws Amendment Bill, 2010 provides some insight into the SARS view point.

The SARS has largely relied on the guidelines provided by The Organisation for Economic Co-operation and Development (“OECD”) and international practices in deciding on the implementation of the amendments to the Act.

Reviews of the abovementioned documents together with past communication by SARS, including Practice Note No. 7 and various tax articles provide insight into the possible implications and additional requirements to be placed on parties involved in transfer pricing transactions.

1.5.3 Motivation of topicality

Section 31 of the Act that regulates transfer pricing transaction was introduced into the Act with effect from 19 July 1995 and will be replaced with effect from 1 October 2011. There is, however, uncertainty about the practical implication and interpretation of this amended Section of the Act.

According to the 2010 Global Transfer Pricing Survey produced by Ernst and Young, increasing numbers of respondents are experiencing the pains of transfer pricing audits globally. The survey further found that the increasing pressure on governments to raise revenues and the dedication of additional transfer pricing enforcement resources are likely to lead to reinvigorated scrutiny in all markets (Ernst & Young, 2010a:11).

Transfer pricing is complex and involves multiple international and domestic transactions, methodologies and comparisons. Preparing transfer pricing documentation which not only acts as a deterrent to the revenue authorities (by indicating prima facie compliance) but which also successfully discharges the

taxpayer's burden of proof in litigious circumstances is time-consuming and expensive (Olivier & Honiball, 2011:641).

SARS has moved more towards a self-assessment of the tax system in the last couple of years, where the taxpayer is required to account for his/her tax correctly and supporting documents are required to be submitted only at the request of SARS.

This may place SARS in a position to impose penalties as connected person taxpayers are now obliged to transact based on arm's length terms (Olivier & Honiball, 2011:665).

It is therefore very important for taxpayers to understand the changes made to the transfer pricing legislation in order to be compliant with the Act and avoid the levying of harsh penalties by SARS.

Transfer pricing legislation in other countries has been applied by revenue authorities for many years. The United Kingdom ("UK") has introduced a self-assessment tax system for transfer pricing since 1 July 1999. By referring to the OECD guidelines and comparing the amended Section 31 of the Act to the practical application of the UK transfer pricing legislation the study will clarify requirements and prepare taxpayers, as to what they can expect from SARS in applying the new legislation.

In the Summary of Additional Tax Proposals 2010/2011 issued by SARS, SARS identified transfer pricing as a sophisticated tax avoidance scheme which presents a substantial loss to the fiscus (SARS, 2010c:6).

SARS made significant changes to the wording of Section 31 of the Act (effective from 1 October 2011) and refers to the so called "anti-avoidance" terms in the Act, which if not interpreted and complied with, may in addition to adjustment of prices of transactions, lead to harsh penalties.

There is considerable uncertainty about the possible implication of the amendments to Section 31 of the Act and what SARS will expect from taxpayers, in order to be compliant.

1.6 PROBLEM STATEMENT

The amendment of Section 31 of the Act creates uncertainty regarding the tax implications and additional burden of proof placed on taxpayers to defend arm's length international transactions with connected persons.

1.6.1 Objectives

1.6.2 Main objective

Revenue authorities internationally have measures in place to regulate transfer pricing between related parties. South Africa has not made any amendments to transfer regulations since 1995.

When amending transfer pricing legislation most countries refer to the OECD guidelines to apply to domestic transfer pricing legislation or guides as in the case of South Africa. Countries such as the UK have adopted a tax self-assessment of transfer pricing transactions by taxpayers with accounting periods ending on or after 1 July 1999.

The main objective is to identify the potential implications of the substantially amended Section 31 of the Act by:

- Comparing the pre- and post amendments of terms and definitions in the Act.
- Comparing the UK transfer pricing regulation with the amended South Africa transfer pricing legislation.

The purpose of the above comparison is to incorporate a practical view of the potential application of the amended transfer pricing legislation.

1.6.3 Secondary objectives

The secondary objective is to discuss possible additional documentary requirements placed on taxpayers to produce to the SARS to support arm's length transactions with connected parties as well as to discuss the implication of the amended transfer pricing on other taxes and Double Taxation Agreements ("DTA's").

1.7 RESEARCH METHOD

1.7.1 Literature review

By comparing the wording of the Act pre- and post the proposed amendments to the Act, referring to SARS Practice Note No. 7, the Explanatory Memorandum of the Taxation Laws Amendment Bill 2010, the amended terms in the transfer pricing provisions in order to identify the potential practical problems of application will be discussed.

The OECD guidelines are widely used by other countries in regulating transfer pricing transactions and will, together with review of tax articles, provide further insight into the possible practical implication of the amended Section 31 of the Act.

The application of the UK transfer pricing regulation will be compared to Practice Note No. 7 in order to discuss the potential implication of the amended South African transfer pricing legislation.

1.8 OVERVIEW

1.8.1 Chapter 1 – Background, problem statement and overview

This chapter states the purpose of this study, introduces the problem, and evaluates the significance of the study. It also presents the research objectives and research methodology.

1.8.2 Chapter 2 – Comparing the wording of the Act pre- and post amendments to Section 31 of the Act

In this chapter a literature review of the SARS Practice Notes, Explanatory Memorandums and other publications will be conducted to discuss the changes of terms and wording of the amended Section 31 of the Act.

This chapter serves to provide background to the “old” transfer legislation and to provide an overview of the changed wording and terms to understand the potential implications for the amendments made.

1.8.3 Chapter 3 – Comparison between the UK transfer pricing regulations and South African transfer pricing legislation

The conducting of a comparison between the application of the UK transfer pricing legislation and potential application of the amended Section 31 of the Income Tax Act will be done in this Section.

Practice Note No. 7, the only interpretation note issued by the SARS on transfer pricing, will be used as the basis for the comparison of the South African transfer pricing legislation with the UK transfer pricing legislation.

A literature review of the UK tax authority’s publications and tax articles issued will be conducted to assess the implication of the amended South African transfer pricing legislation.

1.8.4 Chapter 4 – Transfer pricing and Double Taxation Agreements

The arm's length principle of transfer pricing is stipulated in tax treaties and Article 9 of the OECD Model Tax Convention. The application of the amended Section 31 of the Act on the principles of transfer pricing contained in tax treaties, is discussed in this chapter.

1.8.5 Chapter 5 – Other amendments to the Income Tax Act

A brief summary will follow of other changes to Section 31 of the Act including thin capitalisation and STC.

1.8.6 Chapter 6 – Conclusions

Based on the literature reviews conducted and the comparison of Practice Note No. 7 and the UK transfer pricing legislation, this chapter provides findings on the implications of the amendments of Section 31 of the Act and the additional supporting documents to be kept to support “arm's length” transactions.

CHAPTER 2: COMPARING THE WORDING OF THE ACT PRE- AND POST AMENDMENT TO SECTION 31 OF THE ACT

2.1 INTRODUCTION

The transfer pricing mechanism is a tool commonly used to transfer the tax base from countries with high taxation to countries with low taxation. In the European Union, these financial operations generate significant tax revenue losses. In an attempt to limit the handling of corporate tax systems, many public authorities have introduced regulations on transfer pricing, but the effectiveness of these rules has proven limited, and they have contributed to the increasing complexity of tax laws and to the appearance of additional cost for companies (Matei & Pîrvu, 2011:101-109).

Since South Africa's re-emergence in the international market, there has been a market expansion of international trade and commerce. An increasing proportion of this international activity is carried on between members of multinational companies. As the globalisation of business activity continues to accelerate, protecting the South African tax base is vital to South Africa's wealth and development (SARS, 1999:5-6).

Protection of the tax base came in the form of new legislation namely Section 31 of the Act, effective from 19 July 1995 to counter transfer pricing practices which may have adverse tax implications for the South African fiscus. The measures to combat transfer pricing schemes are in essence contained in Sections 31(1) and (2) of the Act.

Section 31(1) of the Act defines the terms used in this Section. Section 31(2) of the Act empowers the Commissioner to adjust the consideration (for the purposes of the Act and the calculation of taxable income) in respect of international agreements to reflect an arm's length price for the goods or services supplied in terms of that international agreement (SARS, 1999:6-7).

South Africa's transfer pricing rules apply to supplies of goods or services (including intellectual property) between connected persons at a price that is not an arm's length price. They apply where one party is a resident of South Africa or a permanent

establishment in South Africa and the other party is either a non-resident or a foreign permanent establishment. SARS is empowered to adjust the consideration for the transaction to reflect an arm's length price for such goods or services (Dachs, 2010:1).

With the amended Section 31 of the Act effective from 1 October 2011 the current focus on goods and services will be revised. The focus will instead be on cross-border transactions, operations, schemes, agreements or understandings that have been effected between, or undertaken for the benefit of, connected persons.

The taxable income of the parties that have benefited must be calculated as if the terms and conditions had been at arm's length. The connected parties are required to comply with the arm's length principle if terms or conditions made or imposed in transactions, operations, schemes, arrangements or understandings differ from the terms and conditions that would have otherwise existed between independent persons acting at arm's length, and the difference confers a South African tax benefit on one of the parties.

Taxpayers are therefore required to account for transfer pricing on an arm's length basis, without SARS intervention. SARS also has the power to adjust the terms and conditions of a transaction, operation, scheme, arrangement or understanding to reflect the terms and conditions that would have existed at arm's length (SARS, 2010a:74-75).

Following a comparison between the wording of Section 31 of the Act pre-and post the amendments to the Act:

Table 1

Section 31 of the Act PRE - 1 October 2011	Section 31 of the Act POST - 1 October 2011
• Where any <i>supply of goods or services</i> has been effected between • a resident; and • any other person who is not a resident • a person who is not a resident; and	• Where any <i>transaction, operation, scheme, agreement or understanding</i> has been directly or indirectly entered into or effected between or for the benefit of either or both

• a permanent establishment in the Republic of any other person who is not a resident; or • a person who is a resident; and • a permanent establishment outside the Republic of any person who is a resident; • between those persons who are connected persons in relation to one another; and • at a <i>price</i> which is either – • less than the price which such goods or services might have been expected to fetch if the parties to the transaction has been independent persons dealing at arm's length (such price being the arm's length price); or • greater than the arm's length price, • <i>the Commissioner may</i>, for the purpose of this Act in relation to either the acquirer or supplier, in the determination of the taxable income of either the acquirer or supplier, adjust the consideration in respect of the transaction to reflect an arm's length price of the goods or services	• a person that is a resident; and • any other person that is not a resident; • a person that is not a resident; and any other person that is not a resident that has a permanent establishment in the Republic to which the <i>transaction, operation, scheme, agreement or understanding relates</i>, • and those persons are connected persons in relation to one another; and • <i>any term or condition of that transaction, operation, scheme, agreement or understanding</i> is different from any term or condition that would have existed had those persons been independent persons dealing at arm's length; • and results or will result in any <i>tax benefit</i> being derived by any person that is a party to that transaction, operation, scheme, agreement or understanding, • <i>the taxable income</i> of each person that is a party to that transaction, operation, scheme, agreement or <i>understanding that derives the tax benefit must be calculated</i> 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.
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The following changes to the wording of Section 31 of Act will be discussed in more detail:

2.2 “TRANSACTION, OPERATION, SCHEME, AGREEMENT OR UNDERSTANDING” REPLACING “GOODS AND SERVICES”

According to SARS Practice Note No. 7 (1999:5) the term transfer pricing describes the process by which connected persons set the prices at which they transfer goods or services between each other.

In terms of the Explanatory Memorandum on The Taxation Laws Amendment Bill (SARS, 2010a:75) it is proposed that from the effective date (1 October 2011) there will no longer be reference to “goods or services” in the amended Section 31 of the Act, but “transaction, operation, scheme, agreement or understanding that have been effected between, or undertaken for the benefit of, connected persons”.

The major difference from the existing law is that the amended rules will apply where any term or condition of that transaction, agreement or understanding differs from any term or condition that would have existed had those parties been independent persons dealing at arm's length and where this results in a tax benefit being derived.

The taxable income of the person deriving the tax benefit will be calculated as if that transaction or agreement had been entered into on arm's length terms and conditions (Dachs, 2010:1).

The terms “transaction, operation, scheme, agreement or understanding” are defined in Section 80L of the Act which forms part of the General Anti-Avoidance Rules to counter tax avoidance.

In the Draft Comprehensive Guide to the General Anti-Avoidance Rule (“Draft GAAR”) it was noted that the meaning of the terms “transaction”, “operation” and “scheme” have been judicially considered, and the established principles continue to apply. In cases such as *Meyerowitz v CIR* and in *CIR v Louw*, the wide meanings of the terms were commented on (SARS, 2011:13-14).

A significant change was effected by SARS changing the very specific wording “goods” and “services” to “any transaction, operation, scheme, agreement or understanding” to a much wider meaning and which will now include indirect transactions.

According to Honiball (2010:14-15) the specific inclusion of indirect transactions within the scope of South African transfer pricing was partly driven by a recent United Kingdom court case, namely, *DSG Retail Limited v HMRC (2009) STC (SCD) 297*. Honniball further noted that this case is authority for the proposition that transfer pricing provisions may be invoked to attack indirect transactions where these transactions, if entered into between independent third parties, would result in a different allocation of profits between connected persons involved.

One major concern raised in the new rules is that the above described changes will make it considerably easier for the SARS to disregard or re-characterise the particular transaction, operation, scheme, arrangement or understanding entered into by the taxpayer. However, as SARS has already indicated that it will continue to follow the OECD Transfer Pricing Guidelines when implementing the new transfer pricing rules, a re-characterisation of a particular transaction, operation, scheme, agreement or understanding entered into by the taxpayer, would only be possible in exceptional cases (Sonnenbergs, 2010:9).

2.3 THE DEFINITION OF “TAX BENEFIT”

In order for Section 31(2) of the Act to apply, the transaction, operation, scheme, agreement or understanding that has been entered into on terms or conditions that are different from the terms and conditions that would have been entered into in an arm’s length environment must have resulted in or will result in a “tax benefit” by any party to the transaction, operation, scheme, agreement or understanding.

The wording of the new Section 31 of the Act has also been used in other Sections of the Income Tax Act. The definition of a “tax benefit” is also defined in Section 80L of the Act and “includes any avoidance, postponement or reduction of any liability of

tax”. The concepts of “any avoidance, postponement and reduction of any liability for tax” have been considered judicially and the established case law continues to find application under the Draft GAAR.

In *CIR v King* it was held that the tax liability addressed by a Draft GAAR is not an existing liability for tax but an anticipated liability. *Smith v CIR* confirmed this interpretation and expanded on it in the light of changes made to the Section in question between the two cases. In the latter case, Steyn CJ held that: “The ordinary natural meaning of avoiding liability for a tax on income is to get out of the way of, escape or prevent an anticipated liability” (SARS, 2011:17).

The term “tax benefit” was included in the amended Section 31 of the Act, but no definition of the meaning of the term was provided by SARS. Therefore no guidelines except for the definition in Section 80L of the Act on how SARS will interpret a “tax benefit” exist. The possible meaning and application of the term in comparison with the UK tax legislation will be considered.

2.4 ONUS OF PROOF

Before the amendment of Section 31 of the Act, SARS may adjust the consideration for tax purposes, if the actual price is either less or greater than the price that would have been set, if the supply or acquisition of goods or services had occurred between independent parties on an arm’s length basis (SARS, 1999:6). SARS bears the onus to prove, on a balance of probabilities, that a tax benefit was derived as a result of an arrangement being entered into or carried out, having regard to the assistance provided in terms of Section 80F of the Act. In doing so, SARS does not need to define an alternative or comparable arrangement (SARS, 2011:18).

Accordingly, determining the existence of a "tax benefit" typically requires an identification of the income that might otherwise have accrued to the taxpayer. The introduction of the necessity of a "tax benefit" therefore requires SARS to identify the income that would have accrued to the taxpayer, if the transaction, operation, scheme, agreement or understanding had been entered into on the terms and conditions that

would have existed had the parties been independent persons dealing at arm's length, thereby effectively putting the burden of proof regarding the non-arm's length nature of a transaction, operation, scheme, agreement or understanding on SARS (Brodbeck, 2010).

Before the amendment of transfer pricing legislation in terms of Section 31 of the Act, the discretion to adjust the consideration in respect of a transaction rest with SARS. The amended Section 31 of the Act puts the obligation on the connected person taxpayer to transact based on arm's length terms.

In the discharging of its burden of proof it is clearly in a taxpayer's best interests to:

- develop an appropriate transfer pricing policy;
- determine the arm's length amount, as required by Section 31; and
- voluntarily produce documentation to evidence their analysis.

Section 82 of the Act places the burden of proof regarding exemptions, non-liability for tax, deductions or set-offs on the taxpayer (SARS, 1999: 33).

2.5 THE TERM “PRICES” REPLACES “PROFITS”

In terms of Section 31 of the Act before the amendment refers to the terms “prices” of goods and services transferred between connected persons that should reflect an arm's length “price”. Whereas the previous transfer pricing rules examine the pricing of the supply of goods or services, the new rules will test the terms and conditions of all relevant transactions or agreements. This introduces a far wider ambit to the transfer pricing rules (Dachs, 2010:1).

The reason for change in the Explanatory Memorandum on the Taxation Laws Amendment Bill of the wording of Section 31 of the Act is that emphasis on “price” as opposed to “profits” does not neatly align with tax treaty wording, potentially creating difficulties in the mutual agreement procedures available under tax treaties (SARS, 2010a:75). OECD guidelines are internationally acknowledged and should be

followed in the absence of specific guidelines in tax treaties entered into by South Africa (SARS, 1999:6).

The wording of Section 31 of the Act before the amendment provided that SARS could determine the taxable income of a South African importer or exporter as if the commodity had been purchased or sold at a price determined in accordance with the “Associated Enterprises” article of the relevant tax treaty (Olivier & Honiball, 2011:622).

The OECD refers to transfer pricing in Article 9 under the heading “Associated Enterprises” to mean:

- a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
- b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises.

According to the Articles of The Model Convention with respect to Taxes on Income and on Capital (“OECD MTC”): “Any profits which would then, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly” (OECD, 2003:12).

According to Kaplan (2009:7) revenue authorities are looking for the sudden implementation of service charges which were not stated in previous years, or significant increases in service charges as compared with the previous year. Chief

Financial Officers (“CFO”) need to be aware of how services should be charged between group companies and what type of mark-up, if any, should be applied.

2.6 THE ADJUSTMENT OF PRICES – ARM’S LENGTH PRINCIPLE

In terms of the pre-amended Section 31(1) and (2) of the Act, SARS may adjust the prices, for tax purposes, if the actual price is either less or greater than the price that would have been set if the supply or acquisition of goods or services had occurred between independent parties on an arm’s length basis.

The amended Section 31 of the Act requires that if terms or conditions made or imposed in transactions, operations, schemes, arrangements or understandings differ from the terms and conditions that would have otherwise existed between independent persons acting at arm’s length, and the difference confers a South African tax benefit on one of the parties, the parties that have benefited must calculate the taxable income as if the terms and conditions had been at arm’s length.

Taxpayers are therefore required to account for transfer pricing on arm’s length basis, without SARS intervention. SARS also has the power to adjust the terms and conditions of a transaction, operation, scheme, arrangement or understanding to reflect the terms and conditions that would have existed at arm’s length (SARS, 2010a:76).

The problem to be resolved is how a multinational company should determine what price would have arisen if transactions between its members were subject to market forces. The solution advanced by the arm’s length principle is that a comparable transaction between independent parties (an uncontrolled transaction) should be used as a benchmark against which to appraise the multinational company prices (the controlled transaction).

Any difference between the two transactions can then be identified and adjusted. An arm’s length price that will reflect the economic contributions made by the parties to the transaction can be determined for the controlled transaction (SARS, 1999:8).

One issue in transfer pricing is comparability, which involves the factors that determine the tested transaction and how these can be compared with the independent but equivalent situations observed between arm's length parties (Zetter; Blumenfeld; Butler & Singhal, 2009:17-19).

In Practice Note No. 7 (1999:8-9) SARS regards comparability as fundamental to the application of the arm's length principle. The preferred arm's length methods are based on the concept of comparing the prices/margins achieved by connected persons in their dealings to those achieved by independent entities for the same or similar dealings. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be highly comparable.

To be comparable means that none of the differences (if any) between the situations being compared, could materially affect the condition being examined in the method (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. If suitable adjustments cannot be made, then the dealings cannot be considered comparable (SARS, 1999:9).

SARS recognizes that since precise calculations cannot be made and the application of any method involves elements of judgment, there is, depending on the circumstances of the particular case, a need to avoid making adjustments to account for minor or marginal differences in comparability.

In order to perform comparability calculations, judgment is required on the part of both the taxpayer and SARS. Accordingly, taxpayers and SARS need to approach each case, by having due regard for the unique business and market realities applicable to each individual case (SARS, 1999: 8-9).

2.7 SUMMARY

2.7.1 Reasons for change

SARS' reasons for the amendment of Section 31 of the Act are, among others, that the literal wording focuses on separate transactions, as opposed to overall arrangements driven by an overarching profit objective. According to SARS, this narrow focus gives rise to artificial arguments by certain taxpayers seeking an excessive emphasis on literal terms of the transaction, as opposed to a focus on the overall economic substance and commercial objective of the arrangement. A further reason is that the emphasis on "price" as opposed to "profits" does not neatly align with tax treaty wording, potentially creating difficulties in the mutual agreement procedures available under tax treaties (SARS, 2010a:75).

The amended Section 31 of the Act requires that the terms or conditions of all cross-border transactions between connected persons must be as if between independent persons dealing at arm's length as discussed above. No such requirement existed before 1 October 2011 (Olivier & Honiball, 2011:665).

This is a fundamental change from the current legislation and places a huge burden on taxpayers. What is of great concern is the new wording of the Section, which removes the previous discretionary application, both in relation to transfer pricing and thin capitalisation. The wording now clearly requires taxpayers to test the arm's length nature of the transaction, and, to the extent the transaction may not be an arm's length one, to make an appropriate adjustment. No longer are taxpayers able to wait for SARS to consider the matter. This is another fundamental shift. In terms of the previous legislation, the onus of proof to adjust the price of a transaction initially sat with SARS in terms of the discretionary wording. Only once SARS had made a determination under its discretion, did the onus move to the taxpayer to rebut the view held by SARS. This move, together with the extremely outdated Practice Note No. 7, will create a significant risk to taxpayers who do not assess the arm's length nature of their connected party transactions on an annual basis (Ernst & Young, 2010b:1).

2.7.2 Implications of amended terms

With the amended Section 31 of the Act transfer pricing applies to any cross-border transaction, operation, scheme, agreement or understanding that has been directly or indirectly entered into. This amendment substantially widens the scope and application for transfer pricing purposes by seeking to capture both direct and indirect transactions.

The most far-reaching difference between the pre- and post Section 31 of the Act, is the requirement that the terms or conditions of all cross-border transactions between connected persons must be as if the terms or conditions of transactions were between independent persons dealing at arm's length. No such requirement existed before the amendment of the Act.

A connected person must transact based on arm's length basis, otherwise SARS will be obliged to reassess the transaction. The amended Section 31 of the Act is a taxing provision in its own right and penalty provisions contained in Section 76 of the Act can apply if the connected person taxpayer do not comply (Olivier & Honiball, 2011:665).

CHAPTER 3: COMPARISON BETWEEN THE UK TRANSFER PRICING REGULATIONS WITH THE SOUTH AFRICAN TRANSFER PRICING LEGISLATION

3.1 INTRODUCTION

Transfer pricing was in the past widely used by multi-national companies to reduce taxable profits, overcome exchange control restrictions or avoid customs duties. The anti-avoidance provisions contained in the Act to combat this practice were difficult to apply.

In 1995, the Katz Commission recommended the adoption of the UK rules and adherence to the OECD guidelines. Section 31 of the Act applies the arm's length principle. The effect of applying the transfer pricing rules may be to decrease deductions or increase profits it may also involve avoidance of Secondary Tax on Companies ("STC") or penalties. There are quite burdensome disclosure requirements. The burden of proof is on the taxpayer to displace any adjustment made by SARS (Horak, 1998).

Section 31 of the Act broadly followed the same wording of Section 770 of the UK Income and Corporation Taxes Act, 1988, as it reads at the time of the introduction of Section 31 of the Act in 1995. Section 31 of the Act, gave SARS discretion as to when it could adjust prices which were not regarded as being at arm's length (Olivier & Honiball, 2011:623).

Section 31 of the Act was amended and effective 1 October 2011. For the purposes of this study, the UK transfer pricing legislation will be compared to the legislation before the amendment of Section 31 of the Act, using the guidelines provided in Practice Note No. 7 in order to determine the possible implications of the amendments of SA transfer pricing legislation.

3.1.1 Background to the SA transfer pricing legislation

Legislation regulating transfer pricing was introduced with effect from 19 July 1995 and is contained in Section 31 of the Act. SARS issued Practice Note No. 7 in 1999 as a practical guide to taxpayers about the procedures to be followed in the determination of arm's length prices, taking into account the South African business environment. It also sets out SARS' views on documentation and other practical issues that are relevant in setting and reviewing transfer pricing in international agreements.

In terms of Section 31 of the Act as it has been applied up to 30 September 2011, SARS had the power to adjust considerations when goods or services are supplied or acquired in terms of an international agreement between connected persons if the price of the goods or services is either less or greater than the price that would have been set if the supply or acquisition of goods or services had occurred between independent parties on an arm's length basis.

SARS follows the OECD guidelines in the absence of specific guidance in terms of Practice Note No. 7, although South Africa is not a member of the OECD (SARS, 1999:6).

3.1.2 Background to the UK transfer pricing legislation

The UK's current transfer pricing legislation is to be found in Part 4 of the Taxation (International and Other Provisions) Act 2010 (TIOPA10/Part 4) which applies for accounting periods ending on or after 1 April 2010 (and income tax years 2010/11 onwards). Her Majesty's Revenue and Customs ("HMRC") issued a large amount of guidance material in HMRC's International Manual's ("INTM") on its interpretation of the law and how it assesses transfer pricing risks.

The UK legislation puts the onus on taxpayers to include in their self assessment any upwards adjustments to their commercial profits that arise from the application of the arm's length principle. It applies to a very wide range of transactions, including:-

- The purchase and sale of goods;

- The provision of management and other services;
- Rents and hire charges;
- Transfers of intangible property, such as trademarks, patents and know-how;
- Sharing of expertise, business contacts, supply systems, etc.; and
- Provision of finance, and other financial arrangements.

The rule does not apply in connected party cases where the only effect of non-arm's length pricing is to overstate a taxpayer's profits for UK tax purposes. The rule applies where the effect of connected party pricing is the understatement of a taxpayer's profits (or overstatement of losses) for UK tax purposes (UK, INTM431050).

The new United Kingdom transfer pricing legislation replaced the old legislation found from the Income and Corporation Taxes Act, 1988 ("the ICTA") section 770 onwards, and brought in some key changes. There is now a requirement to submit a return in accordance with an arm's length principle in respect of intra group transactions, and the new legislation has a much wider scope.

The legislation applies where the provision between two connected persons differs from the arm's length provision, and profits used to calculate United Kingdom tax are reduced (or losses are increased) as a result of that provision. The broad effect is to treat connected persons as if they had done business with each other on the same basis as independent persons dealing at arm's length, i.e. the "arm's length principle" (UK, INTM432010).

The wording of this legislation is aligned with Article 9 (the "Associated Enterprises Article") of the OECD Model Tax Convention on Income and on Capital. Schedule 28AA introduced the idea of "provision made or imposed as between any two persons", and this formulation reflects the broader concerns of Article 9, which talks of "conditions made or imposed between two enterprises".

However, close conformity to OECD Transfer Pricing Guidelines does not mean that in every case HM Revenue & Customs will be taking a "broad view" rather than looking at the prices of individual transactions. On the contrary, Schedule 28AA of

the ICTA is based on transactions, since the “provision” referred to above has to be made or imposed “by means of a transaction or series of transactions” and the OECD Transfer Pricing Guidelines approve transactional methods of ascertaining an arm's length price (UK, INTM432010).

Paragraph 1 of Schedule 28AA of the ICTA contains the basic transfer pricing rule, which is based upon the arm's length principle and applies if an actual provision (refer to INTM432040) has been made or imposed between any two affected persons by means of a transaction or series of transactions and one of those persons was directly or indirectly participating in the management, control or capital of the other, or a third person was participating in the management, control or capital of both the affected persons (refer to INTM432090).

The basic rule requires the actual provision to be compared to the arm's length provision (which would have been made between independent enterprises) and, if the actual provision confers a potential United Kingdom tax advantage on one or both of the affected persons, an adjustment is to be made to the taxable profits of the tax-advantaged persons. Considering the provision between two connected persons extends to asking whether such provision “would” have been made between independent enterprises. However, this can only be done to the extent that is recommended in the OECD guidelines.

The amount of the adjustment is that required to bring the profits up to what they would have been if the arm's length provision had applied. An adjustment under Schedule 28AA paragraaf 1 of the ICTA, may only increase taxable profits or reduce a tax loss. This “one way street” approach is a core feature of the United Kingdom legislation (UK, INTM432030).

3.2 THE PARTIES AFFECTED BY TRANSFER PRICING

3.2.1 SA transfer pricing legislation

Whether the parties are called “related parties”, or “connected persons” as is the case in South Africa, this implies a non-arm’s length commercial relationship between transacting entities and forms the cornerstone upon which revenue authorities seek to justify the application of anti-avoidance legislation.

In South African domestic tax law, transfer pricing provisions are applied to adjust prices in respect of transactions between resident and non-resident connected persons. It is essential to establish whether the transacting parties are connected persons when entering into transactions. According to Sonnenbergs (2011) South African taxpayers face a treacherous task of navigating extremely complicated, clumsy and disjointed legislation to determine their tax fate. Internationally, best practice requires legislation, and in particular anti-avoidance legislation, to be clear and understandable. In this, South Africa is unfortunately still lacking (Sonnenbergs, 2011:1).

Section 31 of the Act before 1 October 2011 applied to “connected persons”, which are separate legal entities, supplying or acquiring goods or services.

A “connected person” is defined in Section 1 of the Act and the definition is very wide, which ensures that SARS has the power to adjust transfer prices widely not only in an intra-group context (Olivier & Honiball, 2011:625).

Section 1 of the Act defines a “connected person” in relation to each category of person. Practice Note No. 7 provides the meaning of each category of person and examples thereof as follows:

In relation to a natural person:

Any relative of such person (including by adoption), i.e. children and parents, grandchildren, grandparents, brothers and sisters, great-grandchildren, great

grandparents, uncles and aunts, nephews and nieces, the person's spouse and any person who is a relative of the spouse, the spouse of any of the above-mentioned relatives and any trust of which such natural person or any relative or spouse referred to above, is a beneficiary. A beneficiary means any person named, in the will, trust deed or letter of wishes, as a beneficiary or as a person upon whom the trustee or the trust has a power to confer a benefit from the trust.

In relation to a trust:

Any beneficiary of such trust, i.e. any person named as a beneficiary in the trust deed or letter of wishes, or any other person in favour of whom the trustee of the trust exercises the trustee's discretion and any connected person in relation to such beneficiary, for example any of the beneficiary's relatives and any trust of which a relative may be a beneficiary.

A trust and connected persons in relation to the beneficiaries of the trust are connected persons. In relation to a connected person in relation to a trust (other than a unit trust scheme in property shares, as authorised under the Unit Trust Control Act, 1981 (Act No. 54 of 1981), any other person who is a connected person in relation to such trust.

It is important to note that all persons who are connected persons in relation to a trust are connected persons in relation to each other.

In relation to a member of any partnership:

Any other member of such partnership and any connected person in relation to any member of such partnership. For example any of that member's relatives and any trust in which a relative may be a beneficiary.

In relation to a company:

This includes its holding company, as defined in Section 1 of the Companies' Act, 1973 (Act No. 61 of 1973), and its subsidiary, as defined in Section 1 of the Companies Act.

In terms of the Companies Act, a company is deemed a subsidiary of another company (the holding company) if the other company is a member thereof, and holds the majority of the voting rights therein; has the right to appoint or remove directors holding a majority of the voting rights at meetings of the board; or has the sole control of a majority of the voting rights therein, whether pursuant to an agreement with other members or otherwise; it is a subsidiary of any company which is a subsidiary of that other company; or subsidiaries of that other company, or that other company and its subsidiaries, together hold the rights referred to in the first bullet above.

A body corporate or other undertaking which would have been a subsidiary of a company had the body corporate or other undertaking been a company for purposes of the Companies Act is deemed to be a subsidiary of that other company.

A connected person to a company would include any other company, where both such companies are subsidiaries (as defined) of the same holding company, any person, other than a company as defined in Section 1 of the Companies Act, who individually or jointly with any connected person in relation to such person, holds (directly or indirectly) at least 20 percent of the company's equity share capital or voting rights. The person so contemplated, could be a natural person, trust, close corporation or any entity which is not a company for purposes of the Companies Act.

The connected person to a company will further include 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. An example of above from Practice Note No. 7 (1999:4) is where companies B and C each holds 50 per cent of the equity share capital of company A; both companies, B and C, will be connected persons in relation to company A.

Furthermore a connected person to a company would include any other company, if such other company is managed or controlled by any person (A) who or which is a connected person in relation to such company or any person who or which is a connected person in relation to A. Two companies will be connected persons in the event of one company being managed or controlled by a connected person in relation

to the other company, as well as where the companies are managed or controlled by persons who are connected persons in relation to each other. For example, two companies, one whose shares are held by a trust and the other, whose shares are held by the beneficiary of such trust, will be connected persons in relation to each other.

In this context, references to a company in the definition are not limited to a company, as defined in Section 1 of the Act. The definition of a company also refers to entities which are companies or corporations according to the ordinary meaning of the word. For example, a company incorporated under the law of any country other than the Republic, which does not carry on business in the Republic and which is not a shareholder of a South African company, could also be a connected person, for the purposes of the application of the connected person provisions (SARS, 1999:3-5).

To further illustrate the application by a simple example: company A (A) holds 60% of the shares in company B (B) and 40% of the shares in company C (C). The other 60% of the shares in C are held by one shareholder. We need to establish whether C is a connected person in relation to B. For purposes other than transfer pricing, B will be a connected person in relation to A, as A holds more than 50% of the shares in B. C will not be a connected person in relation to A as, despite A holding more than 20% of the shares in C, the other shareholder in C holds the majority. As A does not control C, C is not connected to B and B is also not connected to C (Sonnebergs, 2011:1).

In relation to a close corporation:

A connected person will include any member of such close corporation, any relative of such member, or any trust which is a connected person in relation to such member and any other close corporation or company which is a connected person in relation to any member or relative or trust contemplated in the first two mentioned circumstances.

In relation to a person who is a connected person in relation to any other person in terms of the foregoing provisions of this definition, such other person. This paragraph provides for the converse situation of all the above paragraphs. If A is, for example, a

connected person in relation to B, B is a connected person in relation to A (SARS, 1999:4-5).

Transfer pricing falls under SARS' microscope when it comes to "connected persons". Abuses usually occur whereby transactions take place between connected entities, one of which is located in a country that has a more favourable tax regime than South Africa. From above it is clear that the definition of a "connected person" is very wide. In a nutshell Jones (2009) states that a "connected person" is any person who stands to benefit from the actions of another who is connected through family relation, trust beneficiary, mutual partnership, or shareholding (Jones, 2009).

3.2.2 UK transfer pricing legislation

Paragraph 1 of Schedule 28AA of the ICTA refers to provisions made or imposed between any two (connected) persons, suggesting a broad scope for the schedule, as the term "persons" includes bodies corporate, partnerships and individuals. However, paragraph 1(2) and (3) require the actual provision to be compared with the arm's length provision that would have been made between independent enterprises.

Paragraph 2 of Schedule 28AA of the ICTA requires the schedule to be construed in accordance with the OECD model convention, as interpreted by the OECD transfer pricing guidelines. Article 9 of the convention sets out the arm's length principle by reference to conditions made or imposed between enterprises. Article 3 defines enterprise as "the carrying on of any business" (UK, INTM432090).

This suggests that Schedule 28AA of the ICTA should be applied only where both parties are enterprises, but that this term should be interpreted broadly. The term encompasses more than trading activities, but a natural interpretation implies an intention to make profit or gain, or to undertake activity in a businesslike or commercial way.

In most situations where Schedule 28AA of the ICTA potentially applies, there is likely to be little doubt that both the parties to a provision are enterprises. Situations

where this may be less clear include the potential application of the schedule to individuals and to charities. It is clear that both individuals and charities can act in a way that would cause them to be regarded as enterprises. This conclusion will follow whenever a trade is being carried on or in other cases where activity is carried on in an organised way with a view to profit or gain. The nature of the activity and whether it carries a commercial flavour will also be relevant.

It is necessary to consider whether a particular provision to which Schedule 28AA of the ICTA potentially applies, is one made between two enterprises. Hence it is possible that different conclusions will follow for different provisions made by the same person for example, some transactions may be made in a capacity unrelated to an enterprise that is being carried on while others may be made in the context of the enterprise.

Lending to connected companies may or may not constitute an enterprise. If the activity is undertaken in a businesslike way with a view to generating gains on shares in the company, this is likely to represent a form of enterprise. On the other hand, isolated loans where the intention is to provide long term funding for a family business may well not be made in the context of an enterprise (UK, INTM432090).

The provisions in Section 40 and Schedule 8 of the Finance Act No. 2 of 2005 applies to transfer pricing rules where “persons” who collectively control a company or a partnership have “acted together” in relation to the financing arrangements of that company or partnership.

Acting together, in this context, is a broad concept that applies to any circumstances that enable transactions to be made other than on an arm’s length basis, i.e. there is the potential for the result of a transaction or a series of transactions to be other than an arm’s length result (UK: Draft Guide on Acting Together and Collective Control: 1).

Isolated parties acting entirely independently will make transactions on an arm’s length basis. But, for example, if owners of a company or partnership participate in collective or co-ordinated transactions, which may also involve third parties such as

lenders, then they are acting together and the result of a transaction may differ from an arm's length result.

It is not necessary for discussion or direct agreement between persons for them to be "acting together", for example: A fully-g geared company agrees with each of three shareholders who each owns a third of the company's shares that they will all make equal loans to the company to provide additional investment (which is, in substance, equity). The company makes separate loan agreements with each of the three shareholders, who are "acting together".

Neither is it necessary for a person to have an ownership interest in the business or proportionate interests in equity and debt, for example: The 100% owner of a company could act together with a lender holding no equity in the company but 100% of its debt.

Conversely, the existence or acquisition of an ownership interest does not, in itself, constitute "acting together", for example: The commercial lending team of a bank makes loans to a company when the bank happens to hold shares in the company in its trading book and there is no involvement of the other shareholders in the company. The bank is not acting together with the other shareholders (UK: Draft Guide on Acting Together and Collective Control: 1).

The new rules apply in relation to the financing arrangements for a company or partnership. This is not limited to the provision of finance to the company or partnership. It is a broad concept including any financial transactions of the company or partnership, for example: A joint venture company owned by three shareholders agrees with its owners that it will make interest free loans to each of them. The owners have acted together in relation to the financing arrangements for the joint venture.

The directors of a joint venture may be employees or directors of the companies owning the joint venture. Whether parties are acting together is a matter of facts and circumstances. Where directors of the joint venture take decisions on financial

transactions by the joint venture, their status as employees / directors of the owners will not automatically mean that the owners of the joint venture will always be acting together in relation to those financial arrangements.

The financial transactions within the scope of the new rules can include leasing or hire purchase (UK: Draft Guide on Acting Together and Collective Control).

3.3 “GOODS OR SERVICES” VERSUS “TRANSACTIONS”

3.3.1 SA transfer pricing legislation

The term “goods” was very widely defined to include “any corporeal movable thing”, fixed property and any real right in any such thing or property. Mineral rights, trademarks, real estate and usufructs are examples of goods for purposes of this definition (Olivier & Honiball, 2011:624).

Services were similarly widely defined in Section 31 of the Act to include: anything done or to be done, including:

- The granting, assignment, cession or surrender of any right, benefit or privilege;
- The making available of any facility or advantage;
- The granting of financial assistance, including a loan, advance or debt, and the provision of any debt security or guarantee;
- The performance of any work;
- An agreement of insurance; or
- the conferring of rights to incorporeal property.

The definition of services, as contained in Section 31 of the Act, includes financial transactions and would thus apply to non-arm’s length interest, discounts and other payments. The consideration for the use of funds obtained from, or made available to, a connected person may be unacceptable to SARS for reasons other than a high debt: fixed capital ratio or a high rate of interest envisaged in SARS Practice Note No. 2. For example, the amount of the loan or terms of the agreement may not reflect what

would have been agreed if the persons had been unconnected and dealing entirely at arm's length. SARS may, therefore, apply the provisions of Section 31 to adjust or ignore such non-arm's length transactions for tax purposes (SARS, 1999:7).

It is evident from the above that the definition of "goods" and "services" does have a wide meaning: "any thing done or to be done, including", however the amended Section 31 of the Act now reads "any transaction, operation, scheme, agreement or understanding that has been directly or indirectly entered into" which widens the scope and application of Section 31 of the Act even more.

3.3.2 UK transfer pricing legislation

A provision has to be made by means of a transaction or a series of transactions. Paragraph 3 of Schedule 28AA of the ICTA, defines these terms for the purposes of the Schedule. The definition is wide and includes arrangements, understandings and mutual practices whether or not they are, or are intended to be legally enforceable.

A series of transactions is also widely defined and can include transactions entered into in pursuance of, or in relation to, the same arrangement. This would mean that, for example, regular purchases made by a distributor under a distribution agreement would constitute a series of transactions (UK, INTM432050).

It is not necessary for all transactions in a series to take place between the two related parties. It is possible to have transactions in a series in which a third party is involved or to which neither related person is a party. It is also possible to have a situation where there are no transactions in the series to which both persons are party (refer to INTM432055 for example).

The broader scope of the legislation means that some arrangements which were not transfer pricing transactions under Section 770 of the ICTA are now within the scope of Schedule 88 of the ICTA. This includes, for example, "thinly capitalised" taxpayers paying interest to third parties under finance arrangements guaranteed by affiliates.

3.4 THE ARM'S LENGTH PRINCIPLE

3.4.1 SA transfer pricing legislation

The first and overriding principle of transfer pricing is that transactions between connected persons are to be conducted at arm's length. This simply means that the transaction should have the substantive financial characteristics of a transaction between independent parties, where each party will strive to get the utmost possible benefit from the transaction (SARS, 1999:8).

South Africa has adopted the arm's length principle, which is the international norm. Other than tax considerations, factors such as governmental regulations (for example price or exchange controls) may distort the prices charged between connected persons. At the theoretical level, the challenge for developing and transitioning countries in the development of transfer pricing legislation is in essence the same as for OECD countries, protecting their tax base while not creating double taxation or uncertainties that could hamper foreign direct investment and cross-border trade.

The OECD acknowledges that the application of the arm's length principle can be complex and resource-intensive. Most OECD countries started modestly and built their transfer pricing legislation and practices progressively over a decade or two and are still in the process of improving them (OECD, 2011:2).

3.4.2 UK transfer pricing legislation

There is a general international consensus that, to achieve a fair division of taxing profits and to address international double taxation, transactions between connected parties should be treated for tax purposes by reference to the amount of profit that would have arisen if the same transactions had been executed by unconnected parties. The above is commonly referred to as the arm's length principle.

Similar to South Africa the United Kingdom in the transfer pricing international tax manuals recognises the complexities of applying the arm's length principle in practice

due to the closeness of the relationship between the parties. Especially where it is not possible to find wholly comparable transactions between unconnected parties. There are many factors to take into account. In determining of the arm's length principle the following statement is made in the United Kingdom's international tax manual "the exercise can be as much an art as a science" (UK, INTM431030).

The purpose of the UK legislation is to counter tax loss generated by non-arm's length pricing, but it takes no account of whether or not the setting of the original transfer prices has been tax motivated. The rule implements the arm's length principle as articulated in the Associated Enterprises Article of the OECD Model Tax Convention on Income and Capital and it operates by substituting, for the purposes of calculating taxable profits, arm's length terms in place of the actual terms of transactions between connected parties. The legislation provides for the arm's length principle to be applied to the composite effect of a series of transactions rather than looking at each transaction in isolation (UK, INTM431050).

The term "provision" is not defined in the legislation. It is, however, compared to the phrase "conditions made or imposed" in Article 9 of the OECD Model Tax Convention, and embraces all the terms and conditions attaching to a transaction or series of transactions. However, although the term "provision" is arguably wider than the phrase "conditions made or imposed", (Schedule 28AA, Income and Corporation Taxes Act, 1988 Paragraph 2) it can however never be interpreted with the wider meaning due to restrictions contained in the OECD Transfer Pricing Guidelines.

The arm's length provision is that which would have been made between independent enterprises. If no provision would have been made or imposed between independent persons, then the legislation allows the advantaged person's profits to be computed accordingly thus reflecting the arm's length position. In comparing the actual provision with the arm's length provision it is necessary to look at all of the terms and conditions of the transactions in question and to adjust them to arm's length terms if necessary (UK, INTM432040).

3.5 SELF ASSESSMENT

3.5.1 SA transfer pricing legislation

Under the provisions of Section 31 of the Act prior to the amendments the Commissioner could adjust the consideration where goods or services were supplied or acquired at a price not acquired or sold at arm's length prices. With the amended Section 31 of the Act the connected person are obliged to transact based on arm's length terms (Olivier & Honiball, 2011:665 & South Africa, 1962:31).

The new wording of Section 31 of the Act removes the previous discretionary application, both in relation to transfer pricing and thin capitalisation. The wording now clearly requires taxpayers to test the arm's length nature of the transaction, and, to the extent the transaction may not be arm's length, to make an appropriate adjustment. According to Ernst and Young (2010) taxpayers will no longer be able to wait for SARS to consider the matter (Ernst & Young 2010b).

3.5.2 UK transfer pricing legislation

The legislation is mandatory for transactions within its scope and refers to the computation of tax. As taxpayers are required to self-assess their liability to tax, this means that if they are affected and are potentially advantaged in respect of UK tax by the actual provision, then their tax returns must calculate their tax liability on the basis that their provisions with connected persons were priced in accordance with the arm's length principle (UK, INTM432090).

In terms of the UK INTM432100 the basic rule (Schedule 28AA) provides that an adjustment must be made by the taxpayer in preparing his tax return if the difference between the arm's length provision and the actual provision confers a potential advantage on them in relation to UK taxation. Paragraph 5 of Schedule 28AA of the ICTA provides that there is a potential advantage in relation to UK taxation if a person's taxable profits for a chargeable period are reduced, or losses, expenses of management or group relief are increased as a result of non-arm's length prices.

Often only one party to the transaction will be potentially advantaged by the actual provision. However, if both parties to the transaction are potentially advantaged by the actual provision, then both would need to make an adjustment. An adjustment under Paragraph 1 of Schedule 28AA of the ICTA can only increase taxable profits or reduce a tax loss, never the opposite.

In terms of INTM432000 which introduces Schedule 28AA of the ICTA, the current transfer pricing legislation requires that for accounting periods ending on or after 1 July 1999 (and years of assessment from 1999/2000), returns should be made in accordance with the basic transfer pricing rule. This refers not to the pricing of transactions between the parties, but the computation for tax purposes. This means that taxpayers will be required to make computational adjustments in cases where transactions, as recorded in the accounts, are not on an arm's length basis and the taxpayer is potentially advantaged in respect of the United Kingdom tax by the actual provision.

For periods ending on 31 March 2004 or before, there are neither supplementary pages to the return relating to transfer pricing nor specific instructions within it, other than the overall rule. The normal Self-Assessment rules in Part II of the Taxes Management Act ("TMA") 1970 and the Finance Act 1998, Schedule 18 apply. For periods ending on or after 1 April 2004 there is a tick box on the return form for taxpayers to confirm their eligibility for the small and medium sized enterprise exemption from the transfer pricing rule and a second tick box for taxpayers to claim compensating adjustments (UK: INTM432112 & UK: INTM432160).

Along with changes in taxpayer responsibilities regarding the basis on which the return is completed, self assessment brought in new rules regarding the creation and retention of records. There are rules of general application to all persons completing a self assessment return, plus specific record-keeping requirements to be observed where the return includes transactions with persons not at arm's length to the taxpayer. The generally and specific record keeping requirements in relation to transfer pricing is discussed under paragraph 3.6.2 below (UK, INTM433010).

3.6 DOCUMENTATION

3.6.1 SA transfer pricing legislation

The lack of specific documentation has put the burden of proof on tax authorities. The burden of proof is shifted to the taxpayers with the new transfer pricing legislation. The management accounting literature has traditionally focused on the managerial aspects of transfer pricing and largely ignored the tax function of transfer pricing.

There is an increasing awareness of international tax authorities of the potential use of transfer prices as a device for shifting profits into low tax jurisdictions. As long as tax and managerial objectives are not conflicting, the transfer pricing problem can be solved by using the same transfer price for tax reporting and for managerial purposes (Dürr & Göx, 2011:2).

It is important to distinguish between a global transfer pricing policy which merely records the transfer pricing practice of the group and a global transfer pricing policy which records such practice but also contains evidence that the practice yields an arm's length result in specific circumstances. This latter type of global transfer pricing policy more effectively addresses the issues of international double taxation, the different documentation requirements, etc.

A global transfer pricing policy can be compiled only after a global review has been conducted. A global transfer pricing review would normally be done from the point of view of the ultimate holding company's transfer pricing requirements. The global transfer pricing review that is done for the international holding company would have to be adapted for South African requirements (Olivier & Honiball, 2011:628).

The nature and degree of the evidence that taxpayers are expected to be able to provide, should relate to the risk. In particular, where the circumstances of a transaction mean that there is little or no risk that the result of the transaction is other than an arm's length result, then it will be sufficient to be able to provide evidence of

those circumstances to demonstrate an arm's length result. It should not be necessary to apply transfer pricing methods to the pricing of the transaction (OECD, 2011a).

In the Draft Taxation Laws Amendment Bill of 2010 it is proposed that South African transfer pricing rules be modernised in line with the guidance provided by the OECD.

In compliance with the EU Code of Conduct and the OECD Transfer Pricing Guidelines, the transfer pricing documentation must be:

- suitable and necessary to comply with the arm's length principle;
- sufficient to prove "reasonable effort" and the absence of disproportionate costs in regard to the specific transaction;
- complete in terms of all information that is reasonably available at the time of the transaction; and
- in line with the prudent business management principle.

The OECD Transfer Pricing Guidelines do not contain a prescriptive list of the types of documentation that countries may require taxpayers to provide. Countries have elected to require some or all of the following types of documentation:

- (a) A general description of the organisational, legal, and operational structure of the group of associated enterprises of which the taxpayer is a member, as well as any relevant change therein during the taxable period.
- (b) The group financial report or equivalent annual report for the most recent accounting period.
- (c) A description of the group's policy in the area of transfer prices, if any.
- (d) A list of advanced pricing agreements entered into by members of the group with respect to transactions to which the taxpayer is a party.

- (e) A general description of the nature and value of the controlled transactions in which the taxpayer is involved or which have an effect on the income of the taxpayer.
- (f) A description of the functions, assets and risks of group companies to the extent that they affect or are affected by the controlled transactions carried out by the taxpayer, including any change compared to the preceding period.
- (g) With respect to each material controlled transaction carried out by the taxpayer, a description of the transfer pricing method utilised by the taxpayer to demonstrate that the prices and other financial indicators associated with the transaction satisfy the requirements of the arm's length principle and a description of why such methods are the most appropriate transfer pricing methods within the meaning of Section 4, paragraph 1.
- (h) A comparability analysis supporting the taxpayer's application of the most appropriate transfer pricing method prepared in accordance with the provisions of Section 3.
- (i) Financial data showing the results of controlled transactions sufficient to demonstrate the taxpayer's compliance with Section 1 applying the most appropriate transfer pricing method within the meaning of Section 4, paragraph 1 (OECD, 2011b: 22).

According to the EU Code of Conduct, the Masterfile "should follow the economic reality of the business and provide a 'blueprint' of the multinational enterprises (MNEs) and its transfer pricing system that would be relevant and available to all EU Member States concerned"(Mastellone, 2011:3).

The Masterfile shall contain:

- (1) a general description of the multinational group;
- (2) an outline of the structure of the group:
 - organization, list, legal form of the members and their shares; and

- operative structure;
- (3) the general commercial strategy of the group;
- (4) the transactions carried out (described in a data flow diagram);
- (5) the intra-group transactions:
 - sale of material or immaterial goods;
 - supply of services;
 - supply of financial services;
 - services necessary to carry out the intra-group activity; and
 - agreements regarding the distribution of costs;
- (6) the company's functions, assets and risks;
- (7) intangible goods, royalties, etc.;
- (8) the company's transfer pricing policy and reasons why it complies with the arm's length principle; and
- (9) an outline of its relationships with the tax authorities of other Member States regarding Advance Pricing Arrangements (APAs) and rulings on transfer pricing.

The country-specific documentation, which contains the information specifically related to the resident company involved in intra-group transactions, has the function of adapting the general description of the information provided in the Masterfile to the economic reality of the resident company. This minimum information that should be contained in the above-mentioned documentation is:

- (1) a general description of the company;
- (2) an outline of the areas of its business activity;
- (3) the operative structure of the company and of its business units;
- (4) general strategies of the company and changes from the previous business year;
- (5) intra-group transactions, including:
 - a description of the entities of the group with which the transactions are conducted;
 - a comparability analysis;

- an indication of the transfer pricing method adopted;
 - application criteria in respect of that method;
 - the results of the method adopted; and
- (6) the intra-group agreement for the distribution of costs (Mastellone, 2011:3).

In terms of the guidelines provided in SARS Practice Note No. 7, all the provisions in Sections 74, 74A, 74B, 74C, 74D and 75 of the Act comprehensively dealing with the information and documents of the taxpayer and the access of SARS to such information and documents, as well as the supporting documentation required when submitting returns, are also applicable to transfer pricing investigations. In addition, Section 69 of the Act also enables SARS to require any person to furnish the information he may require (SARS, 1999:22).

SARS, for the purposes of obtaining full information in respect of the income of a taxpayer or of any part thereof, may require the taxpayer or any other person to produce for examination by SARS, or by any person appointed by him, at such time and place as may be determined by SARS, any “documents” or “information” (as defined in Section 74(1)) of the Act which SARS may require. If any document is not in one of the official languages, SARS may, by written notice, require the taxpayer to, at his own expense, produce a translation into one of the official languages, prepared and certified by a sworn translator or another person approved by SARS.

Section 75(1)(f) of the Act requires all records (namely ledgers, cash-books, journals, cheque-books, bank statements, deposit slips, paid cheques, invoices, stock lists, all other books of account and data created by means of a computer relating to any trade carried on by the taxpayer), as well as recorded details from which the taxpayer’s returns were prepared, for assessment of taxes, to be retained for a period of four years from the date on which the return relevant to the last entry in any of the above-mentioned records was received by SARS.

The following documentation guidelines are supplied by SARS in Practice Note No. 7:

The documentation guidelines set out below broadly follow Chapter V of the OECD Guidelines. According to paragraph 5.4 of the OECD Guidelines, the taxpayer's process of considering whether transfer pricing is appropriate for tax purposes should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance. SARS would expect taxpayers to have created, referred to and retained documentation in accordance with this principle.

An important question is what documentation taxpayers should prepare if they are to demonstrate compliance with the arm's length principle. Unfortunately, it is not possible to specify a comprehensive pre-defined set of documentation requirements that meet the requirements of all taxpayers, because appropriate documentation depends on each taxpayer's specific facts and circumstances. Practice Note No. 7 sets out factors that should be considered by taxpayers in determining an appropriate level of documentation for their specific circumstances.

In determining an arm's length price, a taxpayer would generally go through a process which will usually include some form of a functional analysis and information gathering on relevant comparables. This would be expected to point to some appropriate method under which the arm's length price would be determined. Once the appropriate method has been determined, the process becomes one of applying the relevant data to determine the arm's length process (SARS, 1999:23).

As a general rule SARS considers that taxpayers should at the same time document the process they have followed and their analysis in determining transfer prices, in their efforts to comply with the arm's length principle. This should include some justification of why those transfer prices are considered to be consistent with the arm's length principle.

The arm's length principle imposes requirements on connected parties that independent parties dealing at arm's length would not have. For example, independent firms are not required to justify the price of their transactions for tax purposes, but members of multinational companies are required to justify the price adopted in their controlled transactions, to evidence compliance with the arm's length principle.

Taxpayers may therefore have to prepare or refer to written materials which they would not otherwise prepare or refer to, such as documents from foreign connected persons (SARS, 1999:23).

SARS will rely as much as possible on documentation that should be created in the ordinary course of business and of setting a transfer price. This documentation will generally address the following:

- a) identification of transactions in terms of international agreements entered into with connected persons and the extent of any other commercial or financial relations with connected persons which fall within the scope of Section 31 of the Act;
- b) copies of the international agreements entered into with connected persons;
- c) a description of the nature and terms (including prices) of all the relevant transactions (including a series of transactions and any relevant off-setting transactions);
- d) the method that has been used to arrive at the nature and terms of the relevant transactions (including the functional analysis undertaken and an appraisal of potential comparables);
- e) the reasons why the choice of method was considered to be the most appropriate to the relevant transactions and to the particular circumstances;
- f) an explanation of the process used to select and apply the method used to establish the transfer prices and why it is considered to provide a result that is consistent with the arm's length principle;
- g) information relied on in arriving at the arm's length terms such as commercial agreements with third parties, financial information, budgets, forecasts, etc.; and

- h) details of any special circumstances that have influenced the price set by the taxpayer.

At the outset of a transfer pricing review SARS would expect the taxpayer to identify:

- a) Which goods or service, if any, are considered most comparable to the goods or services being reviewed;
- b) its major competitors;
- c) the competitors the taxpayer considers most comparable; and
- d) the methodologies used and why they should be considered appropriate in the taxpayer's particular circumstances.

Taxpayers may be asked to provide SARS with relevant documentation created when the international agreement was contemplated and at the time when the agreement was entered into. Where there is inadequate contemporaneous documentation of arm's length international dealings, between connected parties, it will clearly be more difficult for companies to convince SARS that the dealings took place on an arm's length basis (SARS, 1999:24).

Taxpayers under investigation would be expected to provide relevant documents, explanatory material and other information to which the company has access or could reasonably be expected to have access. The nature of the documentation likely to be sought includes relevant pricing policies, product profitabilities, relevant market information (such as sales forecasts and market characteristics), the profit contributions of each party and an analysis of the functions, assets, skills and the degree and nature of the risks involved for the various parties (SARS, 1999:24).

In the event that contemporaneous documentation (which is a guide that is used to measure related-party transactions) does not exist, companies should review their pricing policies against the guidelines set out in this Practice Note and satisfy

themselves that they accord with the arm's length principle and that dealings with connected persons have been carried out on that basis. It is recommended that documentation be prepared in respect of transactions entered into from July 1995. For future transactions documents should be prepared not later than the date of submission of a tax return affected by these transactions (SARS, 1999:22-24).

3.6.2 UK transfer pricing legislation

In terms of INTM433020 general rules are laid down in statute, and the application of those rules to transfer pricing is a matter of interpretation. In interpreting those rules for transfer pricing purposes, HM Revenue & Customs will be guided by Chapter V of the OECD Transfer Pricing Guidelines. This is designed to assist tax administrations in developing their approaches to documentation rules, and taxpayers in identifying the records that would be helpful in demonstrating how their computations satisfy the arm's length principle (UK: INTM433020).

A company (or other enterprise) that makes a tax return that takes account of transactions to which transfer pricing rules apply, must therefore meet the general rules.

General rules about the records apply to an enterprise that is required to make a tax return for a period. These are contained in Paragraph 21 of Schedule 18 of the Finance Act, 1998 and Section 12B of the Taxes Management Act, 1970, which spell out the record-keeping obligations. Some further guidance on general record keeping is offered in Tax Bulletin TB37C (Part 2).

The records kept must be sufficient to enable the taxpayer to deliver a correct and complete return and the records must be preserved until the latest of:

1. six years from the end of the period concerned;
2. the date on which any enquiry into the return is completed; or
3. the date on which HMRC is no longer able to open an enquiry.

If a notice to deliver a tax return is issued more than six years after the end of the period, any records still in the possession of the company must be preserved until the later of (b) or (c) above (UK: INTM433020).

The records to be kept and preserved include:

1. records of all receipts and expenses in the course of the company's activities;
2. records of all sales and purchases made in the course of any trade involving dealing in goods; and
3. supporting documents relating to items in (a) and (b) such as accounts, books, deeds, contracts, vouchers and receipts.

The obligation to preserve records may be satisfied by preserving the information contained within them, as described in Paragraph 22 of Schedule 18 of the Finance Act, 1998.

When an enterprise makes a tax return, it needs to apply transfer pricing rules to certain transactions which are taken into account in making the return. Those are largely transactions falling within the scope of Schedule 28AA of the ICTA, broadly transactions between related enterprises.

Where transfer pricing rules apply, transactions are treated for tax purposes as if they were between independent enterprises (the arm's length principle). The rules for the application of Schedule 28AA of the ICTA require that the legislation should be applied in a way that best secures consistency with principles set out by the OECD in Article 9 of the Model Tax Convention on Income and on Capital, and in the OECD Transfer Pricing Guidelines.

The HM Revenue & Customs stipulates the content and form of the records and evidence a business needs to make available in order to demonstrate that the results of transactions with related businesses are determined for tax purposes according to transfer pricing rules (and, in particular, the application of the "arm's length" principle). This covers the application of transfer pricing rules both to cross-border transactions and to domestic transactions.

Transfer pricing documentation consists of a mixture of records and evidence in relation to a period covered by a tax return, and may be created at various times. This variety affects the exposure of a business to the risk of a penalty in relation to documentation. There are four classes of records of evidence that will need to be considered viz. primary accounting records, tax adjustment records, records of transactions with associated businesses and evidence to demonstrate the “arm’s length” result.

The records of transactions occurring in the course of the activities of a business that the business enters in its accounting system are referred to as “Primary accounting records”. These records are needed to produce accounts, and in particular a balance sheet and a statement of profit or loss, and need to be retained for any audit of the accounts. There are legal requirements concerning the time for which such records need to be retained. The requirements would still be necessary in the absence of any tax rules.

These records include the results (in terms of value) of the relevant transactions. In the context of transfer pricing rules, these are the “actual” results. They may or may not be “arm’s length” results.

“Tax adjustment records” are the records that identify adjustments made by a business on account of tax rules in order to move from profits in accounts to taxable profits, including the value of those adjustments. These adjustments might include the adjustment of “actual” results to “arm’s length” results on account of transfer pricing rules.

In order for a business to identify transactions to which transfer pricing rules apply “Records of transactions with associated business” must be kept. The business must keep evidence in which the business demonstrates that a result is an “arm’s length” result for the purpose of transfer pricing rules. Primary accounting records would generally be created at the time the information entered the business accounting system. This would be before a tax return was made for the period in question. If a

business were to meet its obligation to make a correct tax return, tax adjustment records and records of transactions with associated businesses:

- would not need to be created at the same time as primary accounting records; but
- would need to be created before a tax return was made for the period in question.

“Evidence to demonstrate an “arm’s length” result would need to be made available to HMRC in response to a legitimate and reasonable request in relation to a tax return that had been made. Although the business would need to base relevant figures in its tax return on appropriate evidence, the material recording that evidence would not necessarily exist at the time the return was made in a form that could be made available to HMRC. Indeed, if HMRC never made a request, the evidence might never exist in such a form (UK, INTM433030).

3.7 TRANSFER PRICING METHODS

3.7.1 SA transfer pricing legislation

According to KPMG (2011) there are three comparability adjustments that taxpayers may claim to ensure conformity with the arm's length principle. In an ongoing effort to modernise South Africa's transfer pricing regulations and tackle potential tax collection deficits, SARS is focusing on those problematic areas where it believes there is non-compliance by taxpayers and significant potential for increased collections for the fiscal year. Minister of Finance, Pravin Gordhan, singled out transfer pricing as a key focus area for SARS in his 2010 Budget Speech, specifically where it involves shifting profits to jurisdictions outside South Africa (KPMG, 2011).

This led to proposed changes to the South African transfer pricing rules, namely Section 31 of the Act, which was set out in the Draft Taxation Laws Amendment Bill of 2010. As noted in the Explanatory Memorandum, the 2010 legislative amendments

introduced certain modernisation changes to transfer pricing rules in accordance with the OECD on which these regulations are based.

KPMG emphasised the importance of taxpayers updating their transfer pricing reports. This is, according to KPMG, especially important in industry and benchmarking analyses, as these are the foundation of a transfer pricing framework. Updated reports will explain any deviations companies experienced from their particular industry's historical trends because of the recession. These explanations would typically include general commercial and industry conditions affecting the members of the multinational companies, including the current business environment and its predicted changes (KPMG, 2011).

In determining whether certain transactions are comparable, both Section 31 and Practice Note No. 7 of the Act and the OECD Guidelines include provisions taxpayers must make to determine the relevant risks that would affect the prices or profits attributable to such transactions (KPMG, 2011).

Paragraph 8.1.2 of the Practice Note No. 7 issued on 6 August 1999 states that:

"To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the method (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. If suitable adjustments cannot be made, then the dealings cannot be considered comparable".

Section 31 of the Act and the Practice Note do not provide specific guidance on the non-recurring and exceptional items of income/expenses for which the taxpayer can make adjustments to improve comparability.

Paragraph 1 of Article 9 of the OECD Model Tax Convention is the foundation for comparability analyses because it introduces the need for:

- A comparison between conditions (including but not limited to prices) made or imposed between associated enterprises, and those made between independent enterprises to determine whether re-writing the accounts for the purposes of

calculating tax liabilities of associated enterprises is authorised under Article 9 of the OECD Model Tax Convention (see paragraph 2 of the Commentary on Article 9); and

- A determination of the profits, which would have accrued at arm's length, in order to determine the quantum of any re-writing of accounts.

The South African transfer pricing regulations, in paragraph 8 of the Practice Note No. 7, specify factors for evaluating comparability and provide the framework for making comparability adjustments. However, there is no guidance on what kind of quantitative and qualitative adjustments the taxpayer can make. This challenge becomes more difficult because of a lack of quality comparable data in the public domain, leaving room for subjectivity in any transfer pricing analysis (KMPG: 2011).

The UK case of *DSG Retail Ltd vs HMRC (2009) UK FTT 31 (TC) 1* reveals that the OECD Guidelines did not require that the only comparables that might be considered were those in identical circumstances to the taxpayer. Rather, it required that only material differences be taken into account through a process of adjustment.

The following is an analysis of certain comparability adjustments that taxpayers may claim to ensure conformity with the arm's length principle:

- **Adjustment for fixed overheads and start up inefficiencies**

It is a common phenomenon for an entity to earn lower profits or even incur substantial losses in the start-up phase because of high fixed overheads, start up inefficiencies and inadequate revenue. At the initial stage, an entity focuses its efforts on setting up operations, recruiting and training staff, building a sales and distribution network and implementing market penetration strategies.

An entity may also have to give additional incentives, offer discounts, float promotional schemes and incur heavy marketing and advertising expenditure to attract customers.

- **Adjustment for non-recurring and exceptional items of income and expenses**

Another adjustment, which is typically at the forefront of benchmarking analyses, is the adjustment for non-recurring and exceptional items. The Practice Note requires that the material effects of differences in comparables concerning the taxpayer should be eliminated by making adjustments in a reasonably accurate manner. The taxpayer may earn lower profits because of exceptional/non-recurring expenses (eg. an increase in a provision for doubtful debts due to a change in accounting policy). Similarly, comparable companies may earn higher profit because of exceptional income (KPMG: 2011).

- **Adjustment for difference in risk profile**

In a South African context, this is arguably the most debated adjustment with regard to transfer pricing. It is a well-established economic principle that there is a strong positive correlation between risk and reward, i.e. higher risk is assumed with the expectation of increased returns. Therefore, an enterprise's profit links directly to the risk it undertakes (KPMG: 2011).

Comparable companies typically bear the full range of entrepreneurial risks. Accordingly, an appropriate adjustment should be made to the margins earned by comparable companies to make an equitable comparison. In the absence of any guidance available in the South African transfer pricing regulations, taxpayers resort to varying methodologies to compute risk adjustments.

The Delhi Bench of the Tribunal in the case of *Mentor Graphics (Noida) (P.) Ltd. Vs Dy. CIT [2007] 109 ITD 101* held that adjustments should be made for risk factors and other factors such as working capital and research and development costs. South African regulations, through the revised Section 31 of the Act or an explanatory Practice Note, should provide guidance on the methodology to perform quantitative adjustments along with practical examples. Adequate guidance on this front will go a

long way towards reducing disputes and protracted litigations between taxpayers and SARS (KPMG, 2011:1-2).

The transfer pricing regulations adopted by most countries are based on the arm's length principle as defined by the OECD. The changes to the South African transfer pricing rules, which were set out in the Draft Taxation Laws Amendment Bill of 2010 introduced certain modernisation changes to transfer pricing rules in accordance with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations on which these regulations are based.

There are three methods of calculating a transfer price according to the OECD:

- *Comparable uncontrolled price:* This method provides the best evidence of an arm's length price. Ideally a comparison is made to the price of a similar product sold or purchased by an unconnected enterprise (an external comparable). Alternatively, a comparison can be made if the product in question is sold or purchased outside the group to an unconnected enterprise (an internal comparable);
- *Cost plus method:* This method is typically used to calculate the transfer price for finished goods where a mark-up is added to the production cost of the goods. The cost is based on cost accounting records and, ideally, the relevant mark-up should be determined by a comparison with the profit earned on a similar product by an unconnected enterprise. Although this method would appear to be an accurate method of establishing a transfer price, in reality it is easy for companies to manipulate the costs used. Cost can be based on the actual cost, standard costs or marginal costs. Then there are various ways of dealing with fixed assets and research and development costs; and
- *Resale price method:* This method is similar to the cost plus method, but is instead found by subtracting a gross margin from the ultimate selling price to an

unconnected enterprise. Once again, the relevant gross margin should ideally be determined by a comparison with the profit earned on a similar product by an unconnected enterprise. This method is typically used where very little value is added by the company that sells the product outside the group. The more value added by the seller, the more difficult it will be to establish a gross margin (Harrowven, 2010).

It is also useful when it is difficult to determine actual cost figures, such as where technological know-how is concerned. A transfer price for the payment of royalties can be based on the profit made from using the know-how. This was the method used by the Canadian subsidiary of GlaxoSmithKline. The price was set so that the subsidiary earned a gross margin of 60%, which was comparable to that earned by European distributors of Zantac (Harrowven, 2010).

All three traditional methods have one overriding problem in that external data may not be available for a product. This is particularly the case for companies operating in smaller countries. The OECD guidelines mention two non-traditional methods of establishing a transfer price, although there might be more.

The Profit split method looks at the overall profit made on a transaction by the group, and then divides it between each group company according to the relative values of their contributions. This split will take into account the functions performed, assets used and risks taken by each company. This method is useful where the companies involved in a transaction are too integrated for them to be looked at from the viewpoint of just one company. It is also useful where the transaction makes use of unique intangible assets where it would be impossible to make an unconnected comparison (Harrowven, 2010).

Due to the complexity of transactions, the profit split may often be in two stages. The first stage will allocate the profit related to routine functions such as manufacturing and distribution, and may be calculated using one of the three traditional methods. The second stage will then allocate the profit attributable to intangible property based

on the contribution of each company; for example, according to the number of employees provided.

The Transactional net margin method, although requiring an unconnected net profit (or operating profit) margin, will often be available when a gross profit margin is not. The unconnected net profit margin is then applied to an appropriate base such as costs, sales or assets employed (KPMG, 2011).

Although not one of the three traditional methods, the transactional net margin method is one of the most widely used transfer pricing methods because it is relatively accurate and easy to apply. For example, it is widely used by Dutch companies because of the unavailability of the comparable data needed for other methods (Harrowven, 2010).

Companies may find that a transaction is subject to transfer pricing rules in one country, but not in another. Take, for example, a UK company with a 30% shareholding in a Polish company. The UK transfer pricing regulations generally only apply if there is control, so a 30% shareholding would be outside the scope of UK transfer pricing legislation. It is also worth noting that most transactions carried out by small or medium-sized UK companies are exempt from the transfer pricing rules, even where there is control (Harrowven, 2010).

3.7.2 UK transfer pricing legislation

The HMRC follows the OECD Guidelines with regards to pricing methods. HMRC generally prefers transactions over profit methods. There has been, however, a recent move by the HMRC towards testing results against system profits. This may all be in line with the OECD developments in this area. Following the recent tax case, HMRC are believed to more routinely challenge the robustness of external comparable uncontrolled price data unless there has been a testing of the relevant parties bargaining positions in coming to license agreements (Ernst & Young, 2011:160).

3.8 SUMMARY

3.8.1 Differences between UK and SA transfer pricing legislation

The parties affected by transfer pricing

The UK refers to provision made or imposed between any two (connected) persons, suggesting a broad scope for the schedule, as the term “persons” includes bodies corporate, partnerships and individuals (UK, INTM432090).

Section 1 of the Act defines a “connected person” for SA tax purposes which do not only include companies but also individuals and trusts. Transfer pricing therefore not only applies to companies but also includes transactions entered into by individuals and trusts.

Goods or services versus transactions

In terms of the UK transfer pricing legislation a transaction has a very wide definition, including arrangements, understandings and mutual practices (whether or not they are legally enforceable). The term 'series of transactions' is defined so as to make it difficult to structure business arrangements in a way that will prevent there being transactions for transfer pricing purposes (UK, INTM464120).

Section 31 of the Act before the amendments referred to “goods” or “services” and the terms were defined in the Act. Section 31 of the Act from 1 October 2011, applies to any transaction, operation, scheme, agreement or understanding that has been directly or indirectly entered into between connected persons or that has been directly or indirectly entered into for the benefit of either or both connected persons. This significant change effected by SARS broadens the application of SA transfer pricing to direct and indirect transactions (Olivier & Honiball, 2011:662).

The arm’s length principle

In terms of INTM431030 issued by HMRC the arm’s length principle is “to achieve a fair division of taxing profits and to address international double taxation, transactions between connected parties should be treated for tax purposes by reference to the amount of profit that would have arisen if the same transactions had been executed by

unconnected parties”. The purpose of the UK legislation is to counter tax loss generated by non-arm's length pricing. The UK refers to the OECD guidelines in interpreting and applying the arm's length principle.

The South African transfer pricing rules are brought in line with the generally accepted arm's length principle effective from 1 October 2011. The rules will allow SARS to adjust prices and terms of connected party transaction to reflect what would have been the position if those parties were independent of each other (Mazars, 2010/2011).

Self assessment

In terms of UK tax legislation taxpayers are required to self assess their liability to tax, taxpayers must calculate their tax liability on their tax returns on the basis that their provisions with connected persons were priced in accordance with the arm's length principle (UK, INTM432090)

Section 31 of the Act was an adjustment provision, but effective from 1 October 2011 the connected persons must ensure that terms or conditions of all cross-border transactions must be at arm's length (as if between independent parties) (Olivier & Honiball, 2011:665; SARS,1962:31).

Transfer pricing methods

According to Ernst and Young (2011:160) the HMRC generally prefers transaction methods over profit methods.

SARS accepts the methods prescribed by the OECD viz. Comparable Uncontrolled Price, Resale Price Method, Cost Plus Method, Transactional Net Margin Method and Profit Split (SARS, 1999:13).

Documentation requirements

The UK documentary requirements build on the guidance published by the OECD. The UK Guidance divides documentation into primary accounting records, tax adjustment records and evidence. HMRC applies an risk-based approach under which

they would expect the level and depth of analysis to be dictated by the perceived risk of tax loss through manipulating of pricing (Ernst & Young, 2011:161).

Although no specific documentation requirements exist in SA transfer pricing, SARS is of the view that by not preparing documentation, a company is not adequately monitoring the policies in place and cannot support that they result in an arm's length outcome (Ernst & Young, 2011:137). In Practice Note No. 7 (1999:6), SARS refers to the OECD in the absence of specific guidance.

CHAPTER 4: TRANSFER PRICING IN DOUBLE TAXATION AGREEMENTS (“DTA’S”)

4.1 INTRODUCTION

The cost of falling foul of a country's transfer pricing rules can be severe. There will be additional tax to pay, and this is likely to be double taxation. It may be possible to get relief for this double taxation if there is a double taxation treaty between the two relevant countries (or if they are EU members). If profits are increased in one country, there should be a corresponding reduction in profits taxed in the other country.

This is what will happen in most cases, but relief is not guaranteed, as the two tax authorities may not be able to reach an agreement. If there is no double taxation agreement, then relief will not be available. However, even when double taxation relief is available, it will often be the case that profits are increased in a high tax rate country and reduced in a low tax rate country. The overall amount of tax payable increases.

If a multinational company is undertaking the same transactions around the world, it would seem sensible to adopt one common transfer pricing policy. This is however not the case as different countries have different methods of determining what an arm's length transaction is (Harrowven, 2010).

Most countries base their transfer pricing regulations on the arm's length principle as defined by the OECD. Although South Africa is not a member country of the OECD, in Practice Note No. 7 (1999:7), SARS acknowledges the OECD Guidelines as an important, influential document that reflects unanimous agreement among the member countries, reached after an extensive process of consultation with industry and tax practitioners in many countries. The OECD Guidelines are also followed by many countries which are not OECD members and are therefore becoming a globally accepted standard.

SARS, in addition to the above, acknowledges that a tax authority's view on appropriate arm's length prices, if they impact on how an enterprise conducts its cross border activities, can directly affect the competitive position of that enterprise. Following the OECD Guidelines will thus promote tax equality and reduce the possibility of South Africa contributing to the establishment of a harmful preferential tax regime.

4.2 OECD GUIDELINES

Article 9 of the OECD Model Tax Convention, the associated enterprises article, contains the arm's length rule for cross-border transactions between related enterprises resident in the two contracting states.

Article 9 of the OECD Model Tax Convention stipulates that the arm's length principle must be applied to commercial and financial relations between associated companies residing in the contracting states. These principles are embodied in each of South Africa's tax treaties. Tax treaties cannot impose a tax liability as they merely allocate existing tax liabilities between countries (SARS, 1999:7).

Article 9(1) of the OECD Model Tax Convention provides that:

- where an enterprise of a contracting state participates in the management, control or capital of the other contracting State;
- or where the same persons participate in the management, control or capital of the enterprise of a contracting state and an enterprise of the other contracting state;
- then if the profits which have accrued to a particular enterprise did not accrue as if the parties were acting independently; and
- profits may then be re-allocated between the contracting states and be taxed as if the parties were acting independently.

Therefore the true arm's length taxable profits are determined and adjusted so that the correct enterprise is taxed thereon.

Article 9(2) of the OECD Model Tax Convention provides the adjustment mechanism. There was no provision for automatic or compulsory adjustments in South Africa, pre-amendment to Section 31 of the Act. The Commissioner had the authority to make a transfer pricing adjustment.

Article 9(3) of the OECD Model Tax Convention prescribes a corresponding adjustment and further prescribes that in determining such adjustment, due regard must be given to the other provisions of the tax treaty. It further considered it necessary, that the competent authorities of the contracting states had to consult each other.

In South Africa Article 9 of the OECD Model Tax Convention merely allows adjustments in terms of domestic law and the more specific provisions of Section 31 of the Act will prevail over the more general provisions of article 9 of the OECD Model Tax Convention (Olivier & Honiball, 2011:647- 648).

Although the provisions of Section 31 of the Act will override article 9 of the OECD, the importance of rather reaching a mutual agreement of many issues of a general nature regarding the interpretation or application of a treaty, is supported by the OECD.

The following agreements to resolve the possible double taxation burden will be discussed:

An advance pricing agreement (APA) is an agreement between one or more domestic tax authorities and a multinational group engaged in cross-border activities. An APA is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time.

Mutual Agreement Procedure (MAP) is a means through which competent authorities consult to resolve disputes regarding the application of double tax conventions. This

procedure, which is described and authorized by Article 25 of the OECD Model Tax Convention, can be used to eliminate double taxation that could arise from a transfer pricing adjustment, but can also be relevant for other aspects of a tax treaty's operation (OECD, Glossary 3).

Requests/claims for a Mutual Agreement Procedure (MAP) (including a claim for a corresponding/correlative adjustment) or an Advance Pricing Agreement (APA) should be lodged with the Office of the Revenue Commissioners. The MAP request should quote the legal basis for the MAP i.e. the relevant Article in the double taxation treaties/agreements or EU Arbitration Convention:

- explain why a MAP is considered necessary;
- explain the issues involved (attaching relevant background documentation); and
- set out what the requester considers to be the correct outcome (attaching any documents, case law, etc, backing up the requester's view).

Relief from double taxation in the case of a transfer pricing adjustment (i.e. a claim for a corresponding or correlative adjustment) must be claimed, relief cannot be taken automatically.

To enable Revenue to examine the merits of a claim for relief, the letter claiming relief should:

- quote the legal basis for the claim i.e. the relevant article(s) in the double taxation treaties/agreements (including a statement as to why the agreement quoted is the relevant agreement) or the EU Arbitration Convention;
- set out how the relevant enterprises are associated;
- explain what the transfer pricing policy was prior to the audit in the other country (attaching a copy of any documentation evidencing that policy e.g. transfer pricing study, economist report, any other expert advice);
- set out those elements of the transfer pricing policy that the other country did not agree with and why;

- set out how the agreement with the other country was arrived at to include details of;
- how the enterprise sought to rebut the assessment;
- the process by which agreement was reached and how such an agreement is justifiable at arm's length;
- the quantum of the adjustment agreed and the financial years covered;
- an account (if relevant) of the considerations leading to acceptance of a negotiated settlement as opposed to litigation (including, where available, a copy of the legal advice the enterprise received);
- contain a copy of the settlement agreement reached with the other country;
- state whether any previous or subsequent years are to be audited where there is a prospect of similar issues arising; and
- state whether there are audits being undertaken by other countries that might affect the profits of the associated enterprise.

In making a claim it is important to be aware that no relief will be available, inter alia, for:

- interest and penalties imposed by the other country;
- secondary/repatriation of profits adjustments implemented under the laws of the other country; and
- non-deductible payments of a capital nature.

If the merits of the claim are accepted, the associated enterprise will be asked to submit revised tax computations for the accounting periods affected in order to compute the quantum of the relief and normally a revised assessment will then be issued.

With a view to improving the functioning of the EU Arbitration Convention and to bring about a more uniform application of transfer pricing rules within the EU, the EU Joint Transfer Pricing Forum (JTPF) has developed three documents which set out best practice. All three documents have been adopted by the EU Commission and Ecofin.

The documents are not legally binding, rather they are political commitments. The documents are:

1. The Code of Conduct for the effective implementation of the Arbitration Convention: The Code was revised in 2009 – the hyperlink is to the revised Code. The purpose of the Code is to ensure the effective and uniform application of the EU Arbitration Convention by all Member States.
2. The Code of Conduct on EU Transfer Pricing Documentation: This Code is intended to ease the compliance burden of enterprises that are required to comply with transfer pricing documentation obligations of Member States.
3. Guidelines for Advance Pricing Agreements within the EU: International Tax: Mutual Agreement Procedures Issued by: International Tax Branch, Corporate Business and International Division (OECD, 2011b: 1-3)

4.3 SUMMARY

The associated enterprises article (Article 9 of the OECD Model Tax Convention) contains the arm's length rule for cross-border transactions between related enterprises resident in the two contracting states.

Internationally, there is a debate about whether article 9 of the OECD Model Tax Convention is an adjustment provision or merely allows adjustment in terms of domestic law. In South African domestic law, SARS may make any transfer pricing adjustment in terms of the pre-amended Section 31 of the Act. Practice Note No. 7 does not state in which circumstances, and in what manner SARS will make adjustment in the event that article 9(2) of the OECD applies (where there is a tax treaty but Article 9(2) is not prescriptive) or if there is no tax treaty.

South Africa has stated its non-OECD member country position and reserves the right to replace the word “shall” by “may” in the first sentence of paragraph 2 of Article 9.

The above is in line with the wording of the pre-amended Section 31 of the Act (Olivier & Honiball, 2011:647-648).

CHAPTER 5: OTHER AMENDMENTS TO SECTION 31 OF THE ACT

5.1 INTRODUCTION

Before the amendment of Section 31 of the Act, transfer pricing and thin capitalisation provisions were dealt with separately under Sections 31(2) and 31(3) of the Act. The thin capitalisation rules have now merged directly with the transfer pricing rules. The significant amended wording of the transfer pricing legislation will now also apply to thin capitalisation.

Section 64C(3) of the Act deems an amount to be distributed by a company to a recipient if the said amount has been adjusted or disallowed in terms of Section 31 of the Act. Secondary Tax on Companies (“STC”) is levied on the amount deemed to be distributed. The amended Section 31 of the Act will still have an impact when a deemed dividend will occur and the connected persons will be liable for STC.

STC will be replaced with a Dividends Tax, subject to treaty relief, on the beneficial owner of a dividend) with effect from 1 April 2012. The application of the transfer pricing provisions by the South African Revenue authorities giving rise to the automatic levying of STC in section 64C(3) of the Act will going forward not adjusted automatically, give rise to an application of the impending Dividends Tax but may do so depending on the facts and circumstances applicable (BDO, 2011).

5.2 THIN CAPITALISATION

Thin capitalisation rules apply if a foreign resident has granted financial assistance to a resident connected person. Measures to counter transfer pricing schemes are in essence contained in Section 31(1) and (2) of the Act. Although these provisions may also, in certain circumstances, be applied to combat thin capitalisation, the provisions of subsection (3) of the Act are more specifically aimed at countering thin capitalisation schemes.

In terms of Practice Note No. 2 (1996:1) thin capitalisation provisions are applied to limit the deductibility of interest where there is a disproportionate ratio between the loan capital and equity employed in, for example, a company.

Once the excessive portion of financial assistance has been determined in accordance with the guidelines as set out in paragraph 4 of this Practice Note, the provisions of Section 31(2) of the Act must be applied to determine whether the interest calculated on that portion of the financial assistance falling within the 3:1 guideline provided in the aforementioned paragraph, is based on an arm's length price (interest rate). In this regard consideration should be given to the guidelines provided in paragraph 2.2 of Practice Note No. 2.

In a literal interpretation of Section 31 of the Act the concept of financial assistance would include not only interest bearing financial assistance, but also interest-free financial assistance. As the purpose of subsection (3) is in essence to enable the Commissioner for Inland Revenue to determine an acceptable debt/equity ratio in order to disallow a deduction in respect of interest relating to the excessive portion of loan capital, the application of subsection (3) will be limited to interest-bearing financial assistance. This will, however, not have the effect that financial assistance which is not interest bearing, will be regarded as permanent owners' capital.

The thin capitalisation rules apply if a foreign resident has granted financial assistance to a resident connected person (or a resident person in whom the foreign resident is entitled to participate in 25 per cent or more of the dividends, profits, capital or voting rights). The thin capitalisation rules include back-to-back arrangements with independent third parties or co-investors.

The rules do not apply to financial assistance by a foreign resident to another foreign resident, even if the latter has a South African permanent establishment. Some taxpayers have sought to exploit this loophole by having a foreign company utilise a wholly owned foreign subsidiary with most or all its operations conducted in South Africa through a permanent establishment. The foreign company would then capitalise the foreign subsidiary with excessive debt, thereby using the interest

deductions associated with the excessive debt to offset income attributable to the South African permanent establishment (SARS, 2010a:75-76).

The Explanatory Memorandum on The Taxation Laws Amendment Bill indicates a change from 1 October 2011 where the transfer pricing rules will henceforth be used to deny deductions for interest that would not have existed had the South African entity not been thinly capitalised with excessive debt (SARS, 2010a:75).

The previous thin capitalization rules involve the application of a 3:1 debt:equity ratio. These rules do not apply to permanent establishments or branches in South Africa.

This study will illustrate the above by way of an example:

A profitable South African company, TPS (Pty) Ltd, was capitalised in Rand by its shareholder who is a non-resident. The company's financial year ends on 31 August. The RSA prime rate was 18.5% throughout the 1995/6 year of assessment. The following further information is relevant for the application of Section 31:

Fixed capital

Shareholder R1 000 000

Loans R4 000 000

- Shareholder granted loan # 1 on 1/9/95 @ 24% pa - R2000 000
- Shareholder granted loan # 2 on 26/1/96 @ 0% pa - R2000 000

Interest

- Loan # 1: R2 000 000 at 24% R480 000
- Section 31(3) is not applicable as the interest-bearing financial assistance granted falls within the 3:1 guideline.

Calculation of excessive interest in terms of Section 31(2)

- Interest falling within the 3:1 guideline = R480 000
- Weighted average of financial assistance:
 - R2 000 000 for 147 days 294 000 000
 - R4 000 000 for 219 days 876 000 000
 - 1 170 000 000 for 366 days = R3 196 721

Effective interest rate of acceptable financial assistance = R480 000 + `U 196 721 = 15%

Excessive interest relating to the 1995/6 year of assessment is Rnil as the 20.5% (18.5% + 2% (see 2.2 below)) limit has not been exceeded.

The amended thin capitalization rules will follow the new transfer pricing principles. This means that there will be no 3:1 debt:equity ratio. Instead the thin capitalization rules will apply if any term or condition of the debt funding differs from the terms and conditions that would have existed between independent persons dealing at arm's length. The new thin capitalization rules will also apply to permanent establishments in South Africa.

The amended transfer pricing and thin capitalization rules will therefore require a different analysis and approach to that applied for such arrangements (Dachs, 2010:2). Olivier and Honiball (2011) raised the concern that wide wording of the amended Section 31 of the Act could potentially be abused by SARS should they be unable to collect taxes by using other anti-avoidance measures.

An example of potential application to an indirect transaction could include a loan advanced by a foreign investor to a South African subsidiary company, Company B, held by another South African company, Company A. However, it is unclear whether the equity capital of Company A can be added to that of Company B in order to calculate the 3:1 ratio (Olivier & Honiball, 2011:664).

Thin capitalization is not directly referred to in any of South African's tax treaties. Internationally it is generally accepted that a thin capitalization rate (the proportion of debt capital in relation to equity capital) can be tested by reference to either the arm's length principal, or a fixed debt to equity ratio (Olivier & Honiball, 2011:657).

The current SARS Practice Note No. 2 will be withdrawn and SARS has announced that a revised transfer pricing practice note will be issued which will include

guidelines on how SARS will treat thinly capitalized entities (Olivier & Honiball, 2011:664).

5.3 SECONDARY TAX ON COMPANIES

STC is currently levied at a rate of 10% and is relevant to transfer pricing and thin capitalisation (refer to 5.2 for a discussion of thin capitalisation).

Section 64C(2) of the Act provides that any amount which is deemed to have been distributed in terms of Section 64C(3) of the Act by a company to a recipient will be deemed to be a dividend declared by the company. In terms of Section 64C(2)(e) of the Act an amount is deemed to have been distributed by a company to a recipient if such amount represents an amount which has been adjusted or disallowed in accordance with the provisions of Section 31 of the Act.

This deeming provision apply both to the transfer pricing adjustments and thin capitalisation disallowances of the pre-amended Section 31 of the Act and is in effect an indirect penalty which is applied in addition to any tax which may be due to the adjustment or disallowance (Olivier & Honiball, 2011:659).

Under current law, deemed dividend rules exist as a measure targeted at minimizing the avoidance of the Secondary Tax on Companies through the transfer of certain benefits to a company's shareholders without a formal declaration of a dividend. These deemed dividend rules contain a provision relating to transfer pricing. More specifically, a deemed dividend arises from any additional income (or reduced loss) of a South African company stemming from a transfer pricing adjustment. The purpose of this deemed dividend provision is to account for the removal of value from a South African company due to the underlying transfer pricing violation.

The deemed dividend rules under current law essentially seek to replicate the concept of secondary adjustments that exist in many transfer pricing regimes. Under current law, the transfer pricing rules provides SARS with a discretionary power to adjust the consideration to reflect an arm's length transaction if required. While this power

provides SARS with the power to mark-up or mark-down the price or value associated with all the parties involved in a transfer pricing avoidance transaction, this power does not include the power to make secondary adjustments. In the Draft Taxation Laws Amendment Bill of 2010 it is proposed that the law be extended to cater for secondary adjustments arising from transfer pricing transactions. The OECD defines a correlative adjustment as - an adjustment that creates an increase or decrease on the tax imposed on one member of a group of companies, correlating to the primary adjustment made in respect of another member of the same group.

A new provision will specifically be added to provide SARS with the discretionary power to evaluate consequential secondary adjustments on a facts and circumstances basis (including the power to create a deemed dividend) (SARS, 2011:103-104).

In the 2007 National Budget Speech it was announced that a new dividend withholding tax will be introduced in South Africa. STC will be replaced with dividends tax with effect from 1 April 2012. Under the new dividends tax the company pays tax on its profits but will then withhold a further amount of tax when a dividend is distributed to its shareholders. The dividend is then usually subject to tax in the shareholders' hands (Olivier & Honiball, 2011:76).

SARS will no longer automatic levying of STC/dividend tax in section 64C(3) of the Act but will first consider the facts and circumstances applicable (BDO:2011).

5.4 TRANSFER PRICING LITIGATION

In the case of transfer pricing litigation, it is noteworthy that to date, not a single matter in regards to transfer pricing in the context of Section 31 of the Act has come before the courts in South Africa. It is submitted that (if and) when such a case comes before a court that the courts will not be called upon to decide on the technical application of Section 31 of the Act but rather will be called upon to settle differences of opinion regarding the valuation involving the quantum of a potential adjustment suggested by SARS (Stiglingh *et al.*, 2011:1102).

The growing importance of transfer pricing can be seen by the actions of tax authorities around the world. Vietnam introduced transfer pricing regulations in 2006, and the tax authorities have now carried out several transfer pricing audits involving automotive companies. China also issued new transfer pricing regulations last year, and the tax authorities are now aiming to establish a transfer pricing team with several hundred specialists. The Indian tax authorities have substantially increased the size of their transfer pricing team over the last two years. The UK tax authorities established a transfer pricing group in 2008 with about 70 specialists, and there are currently about 1,000 ongoing transfer pricing enquiries.

The figures involved can be substantial. In 2006, UK-based group GlaxoSmithKline made an out-of-court transfer pricing settlement to the US tax authorities of \$3.1bn. This dispute centred on the price paid by the group's US subsidiary company to the UK parent company for Zantac, a drug used to treat ulcers. In China, recent transfer pricing cases have resulted in more than RMB (RenMinBi China exchange rate)100m (£10m) of additional taxes being paid (Harrowven, 2010).

Recent cases involving transfer pricing disputes include

- *GlaxoSmithKline Holdings Americas Inc. v IRS*;
- *GlaxoSmithKline v The Queen*; and
- *Roche Products Pty Limited v Commissioner of Taxation*.

The cases listed above have been decided either partially or totally in favour of the relevant revenue authorities.

In either of the above case law, the amounts involved are substantial and from a practical perspective, the adjustments result in double taxation and the taxpayer acting through the relevant taxing jurisdictions (such as the US and UK in the case of the *GlaxoSmithKline America's* case) would need to apply the mutual agreement procedures ('MAP') catered for in the relevant double tax agreements. It should be noted that the MAP procedures are very time consuming in that it may take several years for a matter to be resolved to the satisfaction of both taxing jurisdictions (Stiglingh *et al.*, 2011).

The relevant contracts in the case *DSG Retail Limited and Others V HMRC (2009)* were between the UK stores company, DSG Retail Limited (DSG), (or for part of the period in question a sales agent company, Mastercare Coverplan Service Agreements Limited (MCSAL)), and a third party and between this third party and the Group's insurance company (DISL) resident in the Isle of Man. It was therefore necessary to consider whether a provision had 'been made or imposed as between' DSG and DISL.

The Special Commissioners found that the various entities knew that the different agreements would all take effect together, that they were planned and seen as interlocking and interdependent. The contract with the 'fronter' would not have been entered into unless the fronter would reinsure with DISL. This brought the agreements within the meaning of a "series of transactions" as set out in Paragraph 3 of Schedule 28AA in the ICTA.

However the series itself was not the provision but the means by which it was made or imposed. The relevant provision was found to be something over and above the documented transactions, but given effect by means of the series of contracts. It was "the arrangement that DISL would insure the extended warranty business written in DSG's stores on particular terms".

The provision was made or imposed as between DSG and DISL, even though it may have been imposed by "someone other than DSG". The profits of an unconnected DSG were unlikely to have been different in relation to this provision whether it was made by DSG itself or "on the prompting of another person".

Paragraph 1(2)(a) of the ICTA requires this provision to be compared with "the provision which would have been made between independent enterprises". The Special Commissioners made it clear that this required consideration of what provision independents sharing the characteristics of the actual parties would have made. An interpretation that the "independent enterprises" might not share those characteristics would be inconsistent with OECD principles (UK, INTM432055).

5.5 SUMMARY

The Explanatory Memorandum on The Taxation Laws Amendment Bill indicate a change from 1 October 2011 where the transfer pricing rules will henceforth be used to deny deductions for interest that would not have existed had the South African entity not been thinly capitalised with excessive debt (SARS, 2010a:75).

Where the substantially amended Section 31 of the Act places the burden on the connected persons to conclude transactions at arm's length any deviation from the arm's length principle is automatically a deemed dividend and subject to STC (Olivier & Honiball, 2011:665).

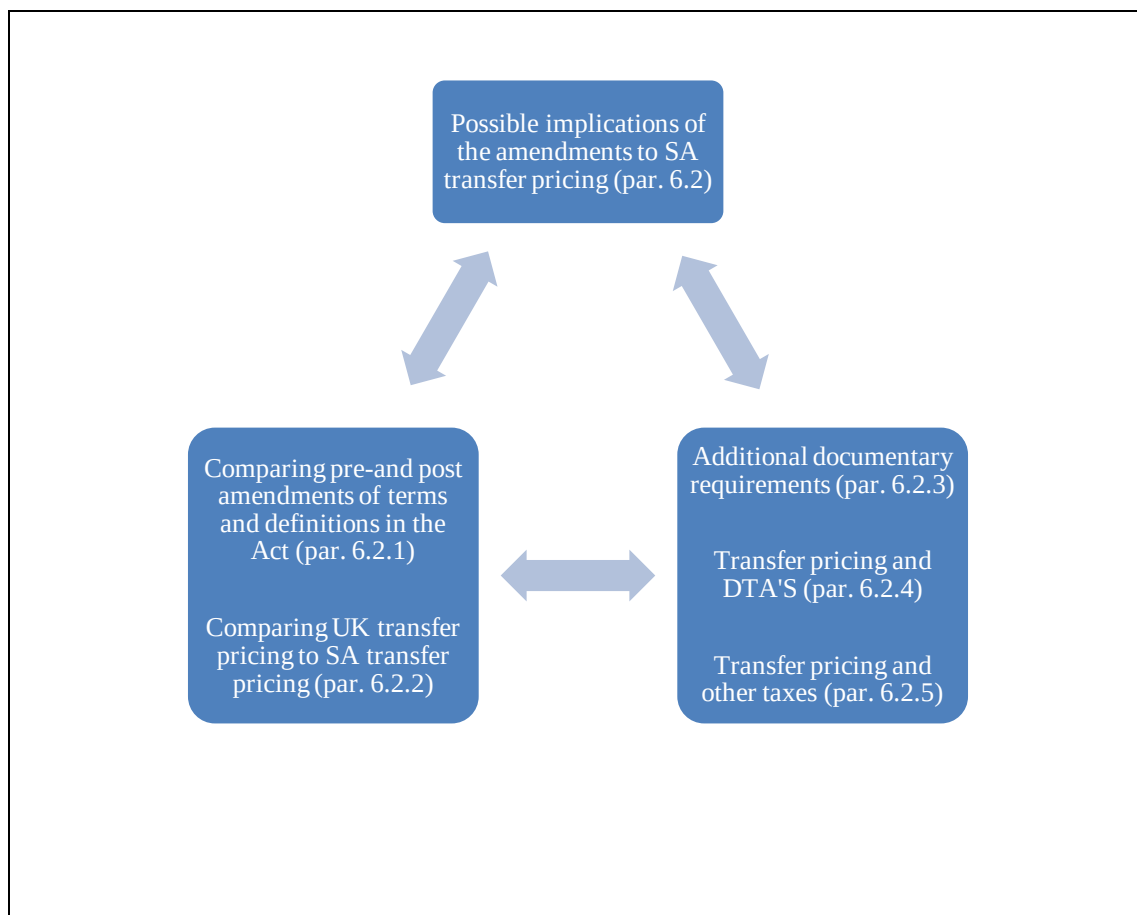
The so-called indirect principle in the DSG case was inserted into the amended South African transfer pricing legislation. It is hoped that SARS will offer some guidance on how indirect transactions will be subjected to these new transfer pricing provisions (Olivier & Honiball, 2011:664).

CHAPTER 6: SUMMARY, CONCLUSION AND RECOMMENDATIONS

6.1 INTRODUCTION

The aim of this study is to determine the possible tax implications of the amended transfer pricing legislation of the Act. In determining the tax implications, this study compared the wording of the Act before and after the amendments to the legislation. In addition, South African transfer pricing legislation was compared to the UK transfer pricing legislation in order to establish the possible practical implications of the amended Section 31 of the Act. Moreover, documentary requirements to prove an arm's length transaction were also considered. Figure 1 provides a summary of the study.

Figure 1 Summary of the study



6.2 IMPLICATIONS OF THE AMENDED SECTION 31 OF THE ACT

6.2.1 Comparing the pre- and post amendment of terms and definitions in the Act

Section 31 of the Act, containing the transfer pricing legislation, was introduced into the Act with effect from 19 July 1995. Since SARS issued Practice Note No. 7 on 6 August 1999, SARS made no changes to the legislation and the tax treatment of international transactions between connected persons.

In terms of Section 31 of the Act, before the recent amendments, SARS was empowered to adjust the consideration for the supply of goods or services between a resident of South Africa and a non-resident connected persons, if the price of the supply was not an arm's length price.

With the amended Section 31 of the Act, effective from 1 October 2011, new terms and wording were inserted into the Act to regulate transfer pricing. In comparing the wording of the pre- and post-amendments to the Act the following change in wording and the possible implication of the amendments were identified and discussed in this study (refer to Chapter 2):

- ***“Transaction, operation, scheme, agreement or understanding replaces “goods and services”***

A much wider meaning to the terms is given compared to the terms “goods” and “services”. The possible implications of transfer pricing provisions invoked to attack indirect transactions as found in the recent UK court case, namely *DSG Retail Limited v HMRC (2009) STC (SCD) 297* is a concern (Honiball, 2010:14-15). One major concern is that the wider meaning will make it easy for SARS to disregard or re-characterise a transaction, operation, scheme, agreement or understanding entered into by taxpayers. Uncertainty exists whether SARS will extend the application of transfer pricing principles to transactions which are so indirect that genuine commercial undertakings are thereby frustrated, as this will create considerable uncertainty for

global multinational companies with genuine commercial undertakings (Olivier & Honiball, 2011:625).

- ***The definition of “Tax benefit”***

No definition is included in Section 31 of the Act to provide a meaning of the word “tax benefit”. The definition of a “tax benefit” in Section 80L of the Act, includes “any avoidance, postponement or reduction of any liability of tax”. Section 80 of the Act empowers the Commissioner to reduce, eliminate or neutralise any tax benefit derived from impermissible avoidance arrangements, thus imposing general limits upon the tax effectiveness of arrangements designed to avoid tax. Similarly to the provisions in Section 80 of the Act, where it is the connected person’s sole or main purpose to obtain a tax benefit and it has created rights or obligations that would not normally be created between persons dealing at arm’s length, Section 31 of the Act will apply. In absence of a specific definition of a “tax benefit” in Section 31 of the Act the definition of Section 80L of the Act is assumed to apply on transfer pricing provisions.

- ***Onus of proof***

Before the amendments of Section 31 of the Act, the discretion to adjust the consideration in respect of a transfer pricing transaction rested on the Commissioner. The amended Section 31 of the Act requires the connected party to transact on an arm’s length basis, without SARS intervention. Taxpayers can no longer wait for SARS to consider if a transaction is at arm’s length. Taxpayers not assessing the arm’s length nature of their connected party transactions on an annual basis are at risk.

- ***The term “prices” replaces “profits”***

The reason provided by SARS to change the word “price” to “profits”, was to align the wording of the transfer pricing provisions with the tax treaty wording, which previously may have created difficulties in the mutual agreement procedures available under tax treaties.

- ***The adjustment of prices – arm’s length principle***

It terms of the amended Section 31 of the Act where terms or conditions made or imposed in transactions, operations, schemes, arrangements or understandings differ from the terms and conditions that would have otherwise existed between independent persons acting at arm’s length, and the difference confers a South African tax benefit on one of the parties, the parties that have benefited must calculate the taxable income as if the terms and conditions had been at arm’s length. A problem that multinational companies have is to determine the price that would have arisen if transactions between its members were subject to market forces. According to Practice Note No. 7 issued by SARS the solution is that a comparable transaction between independent parties (an uncontrolled transaction) should be used as a benchmark against which to appraise the multinational company’s prices (the controlled transaction).

In order to establish transfer prices, it is recommended in Practice Note No. 7 that a connected person follows the following broad guidelines, which will still apply on transactions after the amended Section 31 of the Act has been promulgated:

- establish economic justification before the transaction is entered into;
- be satisfied that the consideration is an arm’s length consideration;
- prepare and retain up to date documentation to support the above matters;
- and the assessment of market conditions at the time when the pricing decisions were made; and
- justify the choice of method and establish and consistently follow a systematic process for setting arm’s length international transfer prices (SARS, 1999:34).

6.2.2 Comparing UK transfer pricing to SA transfer pricing

Section 31 of the Act broadly followed the same wording of Section 770 of the UK Income and Corporation Taxes Act, 1988 as it read at the time of the introduction of Section 31 of the Act in 1995. Section 31 of the Act before the amendments, gave SARS discretion as to when it could adjust prices which were not regarded as being at arm’s length (Olivier & Honiball, 2011:623).

Based on the comparison between UK transfer pricing legislation and SA transfer pricing legislation the following possible implications of amendments to the Section 31 of the Act is summarized:

- ***Goods or services versus transactions***

With the amended Section 31 of the Act, effective from 1 October 2011, transfer pricing no longer applies to the supply of goods and services but instead on cross-border transactions, operations, schemes, agreements or understandings that have been effected between, or undertaken for the benefit of, connected persons.

In terms of UK legislation reference is made to the term “transaction or a series of transactions”. The definition is wide and includes arrangements, understandings and mutual practices whether or not they are, or are intended to be legally enforceable.

The UK legislation further defines a series of transactions which can include transactions entered into in pursuance of, or in relation to, the same arrangement. Regular purchases made by a distributor under a distribution agreement would constitute a series of transactions (UK, INTM432050).

From the above can be deducted that SARS changed the wording “goods” and “service” to “transactions, operations, schemes, agreements or understandings” that have been effected between, or undertaken for the benefit of connected persons, to widen the scope and application of the Section.

- ***Arm’s length principle and self assessment***

In terms of the amended SA transfer pricing legislation the terms or conditions of all cross-border transactions, agreements or understandings between connected persons must be as if it is entered into between independent persons dealing at arm’s length.

Section 31 of the Act, before the amendments, placed the discretion to adjust the consideration in respect of a transaction with SARS. The amended Section 31 of the Act however puts the obligation on the connected person taxpayer to transact based on arm’s length terms. The taxpayer is now required to test the arm’s length nature of the

transaction and to the extent the transaction may not be arm's length, to make an appropriate adjustment. SARS is moving to a self assessment tax system by requiring the connected person to enter into transactions at arm's length.

A self assessment tax system for transfer pricing was introduced in UK transfer pricing legislation since 1 July 1999. The UK legislation puts the onus on taxpayers to include in their self assessment any upwards adjustments to their commercial profits that arise from the application of the arm's length principle.

According to UK transfer pricing legislation the amount of the adjustment is the amount that it required to bring the profits up to what they would have been if the arm's length provision had applied. Adjustments under UK transfer pricing legislation may only increase taxable profits or reduce a tax loss.

The purpose of the UK legislation is to counter tax losses generated by non-arm's length pricing and implements the arm's length principle as articulated in the Associated Enterprises Article of the OECD Model Tax Convention on Income and Capital. It operates by substituting, for the purposes of calculating taxable profits, arm's length terms in place of the actual terms of transactions between connected parties.

A connected person taxpayer is now obliged to transact based on the arm's length basis changing the adjustment provision to a taxing provision. When a transaction does not have arm's length terms, it also becomes an adjustment provision because SARS would be obliged to re-assess the transaction on an arm's length basis (Olivier & Honiball, 2011:665).

- ***Transfer pricing methods***

In Practice Note No. 7 SARS acknowledged the problem by multinational companies to determine what price would have arisen if transactions between its members were subject to market forces. SARS recommends comparing transactions between independent parties (an uncontrolled transaction) as a benchmark against which to

appraise the multinational companies' prices (the controlled transaction)(SARS, 1999:8).

The HMRC follows the OECD Guidelines with regards to pricing methods. HMRC generally prefers transactions over profit methods. SARS accepts the methods prescribed by the OECD viz. Comparable Uncontrolled Method, Resale Price Method, Cost Plus, Transactional Net Margin Method and Profit Split method (Practice Note No. 7, 1999:13). It is uncertain whether any changes to prescribed methods of transfer pricing may be prescribed by SARS when SARS issues a new guide on transfer pricing.

6.2.3 Additional documentary requirements

In terms of Section 31(2) of the Act SARS may adjust the taxpayers' gross income to compensation for what SARS believes to be an arms length charge between group companies. SARS has acknowledged that the exercise of their discretion cannot be based on estimates and must be supported by evidence.

If taxpayers have not maintained appropriate records, the process of verifying compliance with the arm's length principle becomes far more difficult. In terms of the provisions of Section 31 of the Act before the amendments, the burden of proof initially rested on SARS. With the new legislation (effective 1 October 2011), this burden initially rests with the taxpayer. The best way to discharge the burden of proof is by developing a transfer pricing policy, determining the arm's length amount and voluntarily producing documentation to evidence the analysis undertaken. Having said this, the tax authority would expect taxpayers to have created, referred to and retained transfer pricing documentation in accordance with prudent business management principles (i.e., the principles that would govern the process of evaluating a business decision at a similar level of complexity and importance).

No specific documentation requirements exist, however, by not preparing documentation, SARS may come to the conclusion that a company is not adequately

monitoring the policies in place and cannot support that they result in an arm's length outcome.

Where a taxpayer has provided full details of the international agreements that it has entered into with connected parties, the absence of formal transfer pricing documentation will not be regarded as non-disclosure. Taxpayers choosing not to prepare documentation must, however, realise that they are at risk and that it may be more difficult to discharge the onus of proving that an arm's length price has been established.

It will therefore be in the best interest of the parties involved to make conscientious efforts to establish transfer prices that comply with the arm's length principle and prepare documentation to evidence that compliance.

Where such steps have been taken, SARS may determine that the taxpayers' transfer pricing practices represent a lower tax risk and therefore reduce the time and resources allocated by SARS in verifying that the taxpayer comply with the arm's length principle.

6.2.4 Transfer pricing and double taxation agreements

SARS recognizes that many tax administrations around the world have encountered cross-border transactions that aim to use agreements entered into between countries for the avoidance of double taxation or relief measures in domestic law to generate tax benefits.

Where a connected person does not comply with the transfer pricing regulations of its country except for additional tax that may be payable, it is likely that the profits will be exposed to double taxation. Double taxation relief is available if there is a double taxation treaty between the two relevant countries (or if they are EU members). If profits are increased in one country, there should be a corresponding reduction in profits taxed in the other country.

Relief is however not guaranteed, as the two tax authorities may not be able to reach an agreement. If there is no double taxation agreement, then relief will not be available.

Companies may agree their basis of transfer pricing in advance by applying for an advance pricing agreements. An agreement should ideally be made with both countries because there is the risk that the other country's tax authority will dispute the arm's length price.

Advanced pricing agreements are not available in South Africa and most likely will not in the foreseeable future be made available to South African taxpayers.

6.2.5 Other amendments to section 31 of the Act

Thin capitalisation

Transfer pricing and thin capitalisation before the amendments of Section 31 of the Act were dealt with separately under Section 31(2) and Section 31(3) of the Act. Section 31(2) of the Act only applied to direct transactions whereas Section 31(3) of the Act applied to both direct and indirect transactions. The amended Section 31 of the Act combines both transfer and thin capitalisation principles into a single subsection. Uncertainty already exists in relation to the application of thin capitalisation rules to local entities with genuine commercial undertakings.

The merging of the transfer pricing provisions and thin capitalisation provisions is in line with the associated enterprise article in the OECD and UN Model Tax Conventions. The transfer pricing rules will in future be used to deny deductions for interest that would not have existed had the South African entity not been thinly capitalised with excessive debt.

At the time of writing the research document, new transfer pricing notes had not yet been issued by SARS. Uncertainty exists in relation to the application of the amended thin capitalisation rules.

Secondary tax on companies

STC will be applicable in respect of transfer pricing where the amount distributed by a company to a recipient has been adjusted or disallowed in terms of Section 31 of the Act. Under the amended Section 31 of the Act, all cross border transactions between connected persons must be assessed as if they are concluded on arm's length terms. If they are not so concluded, the difference is automatically a deemed dividend subject to STC or withholding tax on dividends.

6.3 CONCLUSION

The study revealed that transfer pricing provisions will no longer apply to separate transactions (the supply of goods or services) but to all cross-border transactions, operations, schemes, arrangements or understandings, therefore widening the application of transfer pricing. Connected persons will therefore have to consider the possible transfer pricing implications on all actions.

Connected persons will also be obliged to transact on an arm's length basis. Similar to the UK transfer pricing provisions connected persons will be required to perform self assessment of the arm's length principle upon entering into transactions, operations, schemes, arrangements or understandings. The connected persons are therefore required to compare the terms and conditions of the transactions, operations, schemes, arrangements or understandings to similar transactions between independent parties and if there is a difference the connected person must adjust the profits to reflect the arm's length amount.

The UK revenue authorities issued large amounts of guidance materials on the documents required to be kept to substantiate an arm's length transaction. Although Practice Note No. 7 states that there is no specific statutory requirement to prepare and maintain transfer pricing documentation it will be in the best interest of a connected person to compile a formal transfer pricing policy and keep detailed documentation on how they have determined the arm's length amounts. This will be essential to successfully discharge the burden of proof and avoid adjustments of profits by SARS with a possible penalty being levied.

6.4 RECOMMENDATION FOR FUTURE STUDIES IN RESPECT OF TRANSFER PRICING

The significant changes to the wording of the amended Section 31 of the Act and the lack of guidance currently from SARS in the form of a practice note to replace the now outdated practice note issued in 1999 may have a significant impact on the tax treatment of transfer pricing transactions. This study only briefly discussed the possible implications of the amended transfer pricing legislation on other taxes (thin capitalisation and STC) due to the lack of documentation issued by SARS in respect of the practical implications of the amendments in Section 31 of the Act. Thin capitalisation will no longer be contained in a separate sub-section in Section 31 of the Act and follow the new transfer pricing principles. For this reason future study is recommended on the implications of the amended Section 31 of the Act for thin capitalization and dividend tax.

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