Alternatives for the treatment of secondary transfer pricing adjustments in South Africa

LH Harmse

13007564

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Supervisor: Prof P. van der Zwan

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NORTH-WEST UNIVERSITY
YUNIBESITI YA BOKONE-BOPHIRIMA
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DECLARATION

I declare that: **"Alternatives for the treatment of secondary transfer pricing adjustments in South Africa"** is my own work; that all sources used or quoted have been indicated and acknowledged by means of complete references, and that this mini-dissertation was not previously submitted by me or any other person for degree purposes at this or any other university.

SIGNATURE	DATE

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ABSTRACT

Deviations from arm's length prices (prices charged between independent persons) charged between connected cross-border companies are corrected by primary transfer pricing adjustments, effected by the tax authorities of a country, resulting in secondary transactions classified as constructive loans, constructive dividends or constructive equity contributions. Tax could be imposed on the secondary transaction, giving rise to a secondary adjustment. For years of assessment commencing on 1 April 2012 secondary transactions, previously regarded as constructive dividends with Secondary Tax on Companies, were amended to be treated as constructive loans with interest adjustments. The primary research problem addressed by this literature study was to establish whether the constructive loan is the appropriate treatment of secondary transfer pricing transactions in the South African context and if not, whether the other alternatives suggested by the Organisation for Economic Co-operation and Development ("OECD") guidelines should be considered.

The OECD suggests that a transaction should be characterised in accordance with its substance. Determination of the subjective economic substance may be established by the motives of multinational groups for setting transfer prices. Multinational groups could have various motives for setting transfer prices that deviate from the arm's length principle, influencing the economic substance of secondary transactions. In order to determine if the treatment of a secondary transaction, as a constructive loan, would be appropriate and reflect the economic substance of adjustments arising as a result of these motives, the characteristics of each alternative were analysed. The characteristics determined for each of the alternatives were then applied to the economic substance arising from a motive, to determine the appropriateness of each of the alternatives as a secondary transaction.

Based on the motives for entering into these transactions, an analysis was performed. The findings led to the conclusion that in the case of the economic substance of transactions, which give rise to transfer pricing adjustments, a constructive dividend appears to be the appropriate treatment for a secondary transaction in most circumstances, as opposed to the constructive loan currently applied by South Africa. Constructive loans or constructive equity contributions may be reflective of the

economic substance in exceptional circumstances. The study makes recommendations that South Africa should consider amending the current treatment of a secondary transaction as a constructive loan, to a constructive dividend. It was also recommended that overlapping criteria in the dividend definition be eliminated and that further research should be undertaken in order to determine how the exceptional circumstances for characterisation as a constructive loan or constructive equity contribution, should be provided for in the Income Tax Act (58 of 1962).

Key words:

- Constructive equity contribution;
- Deemed or constructive dividends;
- Deemed or constructive loans;
- Multinational companies or multinational groups;
- OECD guidelines;
- Primary adjustments;
- Secondary adjustments;
- Secondary transactions; and
- Transfer pricing

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LIST OF ACRONYMS

Act	Income Tax Act 58 of 1962
CFC	Controlled foreign company
CIR	Commissioner for Inland Revenue Services
CSARS	Commissioner for South African Revenue Services
EU	European Union
IFRS	International Financial Reporting Standards
IN	Interpretation note
OECD guidelines	Organisation for Economic Co-operation and Development guidelines
PwC	PricewaterhouseCoopers
SARS	South African Revenue Services
STC	Secondary Tax on Companies
UNCTAD	United Nations Conference on Trade and Development

CHAPTER 1: NATURE AND SCOPE OF THE STUDY

1.1 INTRODUCTION AND BACKGROUND

1.1.1 Transfer pricing

Abnormal pricing in international trade has long been a concern of governments, since it leads to capital flight, eroding the country's tax base (De Boyrie, Pak & Zdanowicz, 2005:249). Transfer pricing, in the context of Multinational Enterprises, is governed by the Organisation for Economic Co-operation and Development ("OECD") guidelines (OECD, 2010a:3). The OECD member countries are: Australia, Austria, Belgium, Canada, Chile, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxemburg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States (OECD, 2010a:1). Practice Note 7, issued by SARS on 4 August 1988, with wording in force until 31 March 2012, stated that although South Africa is not a member country, the OECD guidelines are acknowledged as an important document. Practice Note 7 further states that Section 31 of the Income Tax Act (58 of 1962) ("Act") was introduced into the said Act with effect from 19 July 1995 to counter transfer pricing practices. Moreover, it stated that the OECD guidelines should be followed in the absence of specific guidance from this Practice Note, Section 31 of the Act or the tax treaties entered into by South Africa.

Traditional transfer pricing problems arise when a local company is undercharging its supply of goods and services to connected offshore parties, or is being overcharged for the goods and services it is acquiring from connected offshore parties, thereby shifting taxable profits to other tax jurisdictions (Kotze, 2011:16). If subsidiaries are paying for services for which there is no apparent or material benefit, the South African Revenue Services ("SARS") will investigate and potentially decide to audit (Kaplan, 2009:7). In the Johannesburg Tax Court case of ABC (Proprietary) Limited v Commissioner for South African Revenue Services ("CSARS") (2010), in South Africa, charges by a holding company to its subsidiary for services rendered (marketing) were challenged by SARS, as they were perceived to be excessive in that situation. Changes in legislation have shifted the focus in South Africa from a specific transaction in isolation, to that of

focusing on the overall profit objective, economic substance and commercial objective of an arrangement with a related party (Els, 2012:27). SARS is of the opinion that the legislation, before the amendment of Section 31 of the Act, placed emphasis on price instead of profits and that this was not aligned with the wording in the associated enterprises articles in the tax treaties concluded by South Africa (Brodbeck, 2011:1).

The OECD (2010a:125) explains that if, for example, the price or margin of the controlled transaction is within the arm's length range (range of prices charged between independent persons), no adjustment should be made and if it falls outside the arm's length range asserted by the tax administration, the taxpayer should have the opportunity to present arguments.

1.1.2 Transfer pricing legislation

Section 31 of the Act has been amended in respect of years of assessment commencing on or after 1 April 2012. Section 31(2) that was in force until 31 March 2012 applied to the supply of goods and services that have been affected, whereas the amended section 31(2) in force from 1 April 2012 applies to any transaction, operation, scheme, agreement or understanding that constitutes an affected transaction.

SARS's revised 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 to reduce disputes and protracted litigations between taxpayers and SARS (KPMG, 2011:3).

1.1.3 Primary adjustments

The OECD (2012:28) defines a primary adjustment as an adjustment that a tax administration in a first jurisdiction makes to a company's taxable profits as a result of applying the arm's length principle to transactions involving an associated enterprise in a second tax jurisdiction. Primary adjustments change the allocation of taxable profits for a multinational group for tax purposes (OECD, 2010a:151).

Section 31(2), prior to 1 April 2012, empowered the Commissioner to adjust the income of a taxpayer to reflect an arm's length price for the goods or services received (Wiesener, 2011:17). Brodbeck (2011:2) points out that after amendment of Section 31, the discretion of the Commissioner was replaced by an obligation on the taxpayer to

calculate its taxable income, as if all transactions had been entered into on an arm's length basis. The taxpayer could therefore make voluntary adjustments without attracting penalties (Brodbeck, 2011:2).

1.1.4 Secondary adjustments

A secondary adjustment is an adjustment that arises from imposing tax on a secondary transaction (OECD, 2010a:28). The latter is a constructive transaction that some countries will assert under their domestic legislation after having proposed a primary adjustment in order to make the actual allocation of profits consistent with the primary adjustment (OECD, 2010a:28). Secondary transactions may take the form of constructive dividends, constructive equity contributions or constructive loans (OECD, 2010a:28).

Previously, the primary adjustment had a deemed dividend effect which was subjected to a secondary adjustment of tax on dividends. Section 64C (2)(e) of the Act deemed any amount, adjusted or disallowed in terms of section 31 of the Act, to have been distributed to a recipient by the company and subject to Secondary Tax on Companies ("STC"). Dividends, other than foreign dividends, are generally not subject to tax in the hands of companies, but the company declaring the dividend would have been liable for STC for years, ending 31 March 2012 (PwC, 2011:1). Section 31(3), in force from 1 April 2012, regards these adjustments as a constructive loan (affected transaction). The objective of the amendments is to update the transfer pricing rules in line with the OECD and international tax principles (PwC, 2012a:1; National Treasury, 2011:115).

1.2 SCOPE OF THE RESEARCH

Secondary transactions attempt to account for the difference between the re-determined taxable profits and the originally booked profits (OECD, 2010a:151). The subjecting to tax of a secondary transaction gives rise to a secondary transfer pricing adjustment (OECD, 2010a:151). A country making a primary adjustment may treat the excess profits as having been transferred as a dividend, in which case taxes, such as withholding tax, may apply (OECD, 2010a:151). A tax administration making a primary adjustment may also choose to treat the excess profits as being a constructive loan, giving rise to an obligation to repay the loan (OECD, 2010a:151). The tax administration making the primary adjustment may seek to apply the arm's length principle to this

secondary transaction, to impute an arm's length rate of interest (OECD, 2010a:160). Issues such as the interest rate to be applied, the timing to be attached to the making of interest payments, if any, and whether interest is to be capitalised would generally need to be addressed (OECD, 2010a:160). The constructive loan approach may have an effect not only for the year to which a primary adjustment relates, but also on subsequent years, until such time as the constructive loan is considered, by the tax administration asserting the secondary adjustment, to have been repaid (OECD, 2010a:160).

The OECD (2010a:152) states that many hypothetical transactions might be created, raising questions of whether tax consequences should be triggered in other jurisdictions, besides those involved in the transaction for which the primary adjustment was made. This situation might be avoided if the secondary transaction was a loan, but constructive loans are not used by most countries for this purpose and they carry their own complications because of issues relating to imputed interest (OECD, 2010a:152). According to a summary by PricewaterhouseCoopers ("PwC") (PwC (2012b:31) some countries, such as the United Kingdom have no secondary adjustments, whereas the United States of America apply secondary adjustments, depending on who the transacting party is, and the adjustments may be treated as either a constructive dividend or a constructive capital contribution, or the taxpayer may choose to repatriate.

In the draft response document from the National Treasury and SARS, as presented to the Standing Committee on Finance (2011:37), SARS responded that the adjustments will be treated as interest free loans and that the interest free nature of the loans will give rise to deemed interest under standard transfer pricing principles until the constructive loan is repaid to the South African entity that is deemed to have made a loan. The constructive loan will constitute a secondary transaction and will attract interest at an arm's length rate (Brodbeck, 2011:2). The primary adjustment will not be regarded as a constructive loan if it is repaid within the same financial year as the primary adjustment is made (Brodbeck, 2011:2).

However, the problem that arises from the adjustment being treated as a loan is the inability of the parties to repay the loan, because operating entities have difficulty convincing the respective authorities of the existence of a constructive loan due to transfer pricing adjustments in South Africa, resulting in indefinite interest being

attracted (Brodbeck, 2011:2). Issues that should be taken into account are whether secondary adjustments are necessary and whether SARS should have the discretion to determine the nature of the secondary adjustment (Wiesener, 2011:17).

1.3 MOTIVATION OF TOPIC ACTUALITY

The amended Section 31 of the Act has been in force since 1 April 2012. Until 31 March 2012, transfer pricing primary adjustments were treated as constructive dividends (secondary transaction) giving rise to STC (secondary adjustment). From 1 April 2012, transfer pricing adjustments have given rise to a constructive loan (secondary transaction) under Section 31(3) which is deemed to be an affected transaction. The constructive loan attracts interest (secondary adjustment) at an arm's length rate (Brodbeck, 2011:2). SARS has indicated that the primary adjustment is not regarded as a constructive loan, if repaid within the same financial year, in which the primary adjustment is made (National Treasury, 2011:116). Currently, there is an ongoing debate as to whether the interest rate used should be benchmarked, whether the interest rates used by the banks should be applied or whether SARS will publish the rate to be used. The constructive loans arising may be impossible to repay, attracting indefinite interest (Brodbeck, 2011:2). Operating entities in another jurisdiction would also have trouble convincing the respective authorities of the existence of a constructive loan due to transfer pricing adjustments in South Africa (Brodbeck, 2011:2). Exchange controls may prevent an associated enterprise from transferring interest payments abroad on a loan made by another associated enterprise located in a different country (OECD, 2010a:55).

1.4 PROBLEM STATEMENT

The South African tax authorities have now amended Section 31 of the Act by treating primary adjustments as constructive loans that should attract interest at an arm's length rate. Previously, transfer pricing adjustments were treated as constructive dividends attracting STC. The primary research problem may therefore be formulated as follows: Is a constructive loan the appropriate treatment of secondary transactions in the South African context?

1.5 RESEARCH OBJECTIVES

1.5.1 General objective

The general objective of this study was to determine if the appropriate treatment of secondary transactions in South Africa is that of a constructive loan with deemed interest (secondary adjustment) or whether other alternatives should be considered.

1.5.2 Specific objectives

The following objectives were formulated to address the primary research question and general objective:

1. A critical analysis of the impact of the current treatment of secondary adjustments in terms of Section 31(3) on taxpayers;

2. An investigation of possible motives of multinational companies to manipulate transfer prices;

3. Analysing the characteristics of the alternatives available for secondary transactions and therefore secondary adjustments; and

4. Identifying the secondary transaction and secondary adjustment that would best describe the economic substance of a deviation from the arm's length principle arising from each motive for transfer pricing manipulation.

1.6 RESEARCH METHOD

1.6.1 Research design

The study was concluded by a critical analysis of the criteria developed through a non-empirical literature review of the following:

- Journals and articles to analyse the impact of the current treatment of secondary adjustments in terms of Section 31(3) on taxpayers;
- Journals and articles to determine the motives of multinational groups to manipulate transfer prices; and
- The OECD guidelines, court cases, journals and articles to analyse the alternative methods available to South Africa.

1.7 STRUCTURE AND OVERVIEW

The chapters that are included in the study are listed below, providing a brief overview of the contents of each.

Chapter 1: Nature and scope of the study

Chapter 1 presents the background of transfer pricing and the amendments to Section 31, the problem statement, motivation of the actuality of the topic and the chapter division.

Chapter 2: An investigation of the influence of multinational behaviour on transfer prices

Chapter 2 investigates the motives of multinational groups for setting transfer prices to determine the influence on the economic substance of deviations from the arm's length principle.

Chapter 3: Alternatives for the treatment of transfer pricing adjustments

In Chapter 3, a discussion on the alternative forms for transfer pricing adjustments, in order to establish the characteristics of each alternative available to South Africa, is undertaken.

Chapter 4: Establishing a suitable transfer pricing adjustment alternative for each motive to manipulate transfer prices

In Chapter 4, the economic substance arising due to the motives established in Chapter 2 is addressed comparing the economic substance of the deviation from the arm's length principle, to the characteristics of the alternative forms discussed in Chapter 3.

Chapter 5: Conclusion and recommendations

In Chapter 5, the questions arising from the general and specific objectives are answered and recommendations are made.

1.8 CONCLUSION

Prior to 1 April 2012, secondary transactions arising, due to primary adjustments made by tax administrations, were treated as constructive dividends, with the effect of STC as

the secondary adjustment. After the amendment of Section 31, currently the secondary transaction is treated as a constructive loan, with the effect of deemed interest as the secondary adjustment.

In order to determine whether the current treatment of a secondary transaction as a constructive loan is appropriate in the South African context, the subsequent chapter attempts to establish the motives for transfer pricing manipulation and the possible influence thereof on the economic substance of the deviation from the arm's length principle.

CHAPTER 2: AN INVESTIGATION OF THE INFLUENCE OF MULTINATIONAL BEHAVIOUR ON TRANSFER PRICES

2.1 INTRODUCTION

The OECD (2010a:52) suggests that the character of a transaction between multinational entities in a group may derive from the relationship between the parties rather than being determined by normal commercial conditions. In cases where the economic substance of such a transaction differs from its form, the characterisation of the transaction may be disregarded and re-characterised, in accordance with its substance (OECD, 2010a:51). In the United States case of ACM Partnership v the Commissioner for Inland Revenue ("CIR") (1998) it was determined that [the] "...inquiry into whether the taxpayer's transactions had sufficient economic substance to be respected for tax purposes turns on both the objective economic substance of the transactions and the subjective business motivation behind them." The phrase "objective economic substance" refers to "whether the transaction has any practical economic effects other than the creation of income tax losses" (ACM Partnership v the Commissioner, 1998), while the "subjective economic substance" refers to the taxpayer's expectations and motives (business purpose) (Bankman, 2000:27).

In Chapter 1, it was indicated that a primary transfer pricing adjustment is an adjustment to a company's taxable profits as a result of applying the arm's length principle to transfer prices set by a multinational group (OECD, 2010a:151; OECD, 2012:28). Currently, Section 31(3) of the Act, in force from 1 April 2012, treats the difference arising from a transaction between cross-border connected parties (members of a multinational group), giving rise to a tax benefit, as a constructive loan, which may result in further transfer pricing adjustments. The other alternative forms of secondary adjustments proposed by the OECD (2010a:28) are constructive dividends and constructive equity contributions.

It is submitted, by the researcher, that the current treatment of all differences as a constructive loan may not be appropriate in all circumstances, as the underlying transaction, giving rise to the deviation from an arm's length price, may differ significantly in its economic substance from a loan. The objective economic substance should be read together with the subjective economic substance, referring to the

motives of the multinational group, for purposes of classification. The aim of this chapter is to determine the different motives of multinational groups when setting transfer prices, in order to establish the economic substance of the transaction which gives rise to the secondary transaction. In the subsequent sections of this chapter, transfer prices and profit shifting by multinational entities are discussed for background purposes as well as for purposes of emphasising the influence of multinational entities on the economy of a country. The discussion is followed by the formulation of a definition of a multinational entity and an illustration of the possible relationships among the entities in the group. Once these fundamentals are established, a review of the different motives of multinational entities for setting transfer prices follows.

2.2 TRANSFER PRICES AND PROFIT SHIFTING

According to the World Investment Report 2013, multinational-coordinated global value chains account for approximately 80% of global trade and contribute nearly 18% to developing countries' gross domestic product on average (UNCTAD, 2013:1). The share of domestic value added to the exports produced by foreign affiliates rather than domestic firms is very high – the United Nations Conference on Trade and Development ("UNCTAD") estimates that this share revolves at around 40% on average in developing countries (UNCTAD, 2013:151). Firms within their own network absorb an estimated 65% of foreign affiliate exports (UNCTAD, 2013:137). The profit component of the estimated 40% added value may be affected by transfer price manipulation, potentially leaking added value and the associated fiscal revenues, and reducing value capture from global value chains (UNCTAD, 2013:156). It is evident from the report that transfer pricing manipulation by multinational groups will exert an immense effect on the economy of a country.

The price set for the transfer of goods, intangibles, or services between wholly owned or partly owned affiliates (parent, branch, subsidiary) of a multinational group is referred to as a transfer price (Eden, 1998:4). An important feature of transfer prices is that they are largely immune to the influence of market forces, due to the relationship between the persons involved (Denčić-Mihajlov & Trajčevski, 2011:382). Transfer prices are significant for both taxpayers and tax administrators as these prices determine the income and expenses and therefore taxable profits, of associated enterprises in different tax jurisdictions (OECD, 2010a:19). As a multinational group is an integrated

enterprise, its affiliates often engage in substantial amounts of intra-firm transactions (Eden, 1998:4), including activities conducted across national boundaries (Kopits, 1976:626). Large amounts of international, intra-firm sales and large differences in tax rates between regions may present multinational entities with the opportunity to manipulate the prices of goods transferred, to minimise their global taxes (Jacob, 1996:301). While there are many causes for the erosion of domestic tax bases, one of the most significant sources of base erosion is profit shifting, which can be done by, amongst other techniques, the manipulation of transfer prices (OECD, 2013:5). One method for shifting profits between countries is to under-price goods sold to affiliates in low-tax countries and over-price goods sold by affiliates in low-tax countries, following the opposite pattern for transactions with affiliates in high-tax countries (Clausing, edited by Hines, 2000:175-176). Base erosion constitutes a serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike (OECD, 2013:5). This erosion may result in a variety of fiscal effects; for example, the loss of tax revenues and the growth of the tax base are dampened, the progressivity implied by the statutory rate structure is not achieved, the costs of tax administration are increased and horizontal and vertical equity may suffer (Alm, Bahl & Murray, 1991:849). Enterprises which operate cross-border and benefit from access to sophisticated tax expertise, may profit from base erosion and profit shifting opportunities and therefore gain unintended competitive advantages compared with enterprises that operate mostly at the domestic level (OECD, 2013:8).

Transfer pricing rules exist to address the potential mismatch between profit allocation, and the distribution of risks, assets and functions across the group (OECD, 2012:14). In order to provide for multinational groups to transact at arm's length and to ensure adjustment in case of deviation from the arm's length principle, Article 9(2) of the Model Tax Convention (OECD, 2010b:28) applies. A State is entitled to make an appropriate adjustment to the amount of the tax charged on the profits of an enterprise, if the profits taxed in a Contracting State should have been included in the profits taxed in the State, if the conditions made between the two enterprises had been those which would have been made between independent enterprises (OECD, 2010b:28). In South Africa, this provision has been built into section 31 of the Act.

The arm’s length principle is set out in Article 9(1) of the Model Tax Convention (OECD, 2010b:27) as follows: [where] “...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, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.” In order to establish an arm’s length transfer price, the OECD guidelines explain that a comparability analysis should be performed. In order to compare a transfer price to prices charged between independent entities, the conditions for these prices must also be compared (OECD, 2010a:41). The factors that should be considered to achieve comparability include the characteristics of the property or services transferred, the functions performed by the parties, the contractual terms, the economic circumstances of the parties and the business strategies of the parties (OECD, 2010a:44).

The above discussion indicates that multinational groups have various opportunities to move profits by manipulating transfer prices, which will impact negatively on the economy of a country and that there are guidelines available to address this risk; by, for example, making an adjustment in the form of a constructive loan. In the next section, the discussion on multinational entity behaviour is expanded by exploring the meaning of the concept of a multinational group.

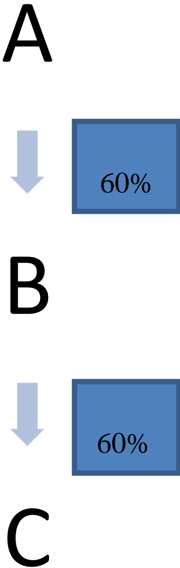
2.3 MULTINATIONAL GROUPS

Practice Note 7, applicable to years of assessment commencing before 1 April 2012, defines a multinational group as the term used to refer to any group of connected persons with members or business activities in more than one country. The WebFinance Dictionary (2014d) supports this definition by describing a multinational corporation as an entity operating in several countries, but which is managed from one home country. Examples of the possible structures of a multinational group are a decentralised corporation with a strong home country presence; a multinational group with centralised production or an international company that builds on the parent corporation's technology or research and development (WebFinance Dictionary, 2014d).

Kopits (1976:626) describes a multinational entity as a group that operates through a parent corporation in the home country and through affiliates, in the form of branches (legally, as part of the home-incorporated parent) or subsidiaries (as separate host-incorporated entities) in host countries. Ghoshal and Barlett (1990:603), holding a similar view, describe a multinational corporation as a group of geographically dispersed and goal-disparate organisations that includes its headquarters and the different national subsidiaries. Dunning and Sarianna (2008:6) widened this description by making reference to the fact that a multinational group can be either privately or publically owned or managed. Ordinarily, the multinational entity operates as a corporation; in rare instances, it may take the form of a non-corporate entity, that is, a partnership or sole proprietorship (Kopits, 1976:626). For purposes of this study and the definition of a multinational group, the structure of a group will be limited to that of a parent company with affiliates in the form of branch operations (legally, as part of the home-incorporated parent) or subsidiary companies (as separate host-incorporated entities).

Kopits (1976:627) continues the description of a multinational group by adding that it entails ownership with control over foreign affiliates (Kopits, 1976:627), an interlocking network of activities, working more or less in tandem depending on the control exercised by the parent company (Eden, 1998:6). This means that the behaviour of each entity, at home or abroad, is subject to the multinational group's unified control, compatible with a certain degree of decentralised decision making, sometimes deliberately allowed by the parent company (Kopits, 1976:627). In today’s multinational groups the individual group companies undertake their activities within a framework of group policies and strategies that are set by the group as a whole (OECD, 2013:25). The separate legal entities forming the group operate as a single integrated enterprise following an overall business strategy (OECD, 2013:25). Subsidiaries might enjoy freedom from the control of their parents, but at the same time, are required to meet short-term financial targets (Sakurai, 2002:176). It is submitted, by the researcher, that the following may be added to the definition of a multinational group: the activities undertaken by these entities would be within a framework of group policies and strategies, subject to the control exercised by the parent company.

The previous paragraph emphasises the element of control necessary to implement the group's strategies. Interpretation Note ("IN") 67, issued by SARS on 1 November 2012, considers the elements of "control" and "managed" in order to determine whether entities are connected persons, which is also one of the determining factors for the application of Section 31 of the Act. In South Africa, companies are considered connected persons if, in terms of paragraph *(d)* of the connected person definition in Section 1 of the Act, more than 50% of the equity shares in each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof. Companies would also be considered connected persons if no shareholder holds the majority voting rights in that company and any other company holds at least 20% of the equity shares of or voting rights in the company (paragraph *(v)* of the connected person definition in Section 1 of Act). IN 67 explains that the "more than 50%" requirement should be interpreted as follows: if A owns 60% of B and B owns 60% of C, A's 60% interest in B and B's 60% interest in C will determine whether A and B, B and C, or A and C are part of the same group of companies.



Taking into account A and B's 60% shareholdings, A, B and C are part of the same group of companies for purposes of the definition of a connected person in section 1(1). A's effective interest in C of 36% (60% x 60%) is not relevant for this purpose. The

shares held will be equity shares if the right to participate in either a distribution of profits (dividends) or capital (return of contributed tax capital) is not restricted (IN 67).

Paragraph *(d)(vA)* of the connected person definition in Section 1 of the Act, also refers to "...any other company if such other company is managed or controlled by aa) any person who or which is a connected person in relation to such company; or bb) any person who or which is a connected person in relation to a person contemplated in item (aa)." IN 67 explains control as *de facto* control generally, but not necessarily, held and exercised by the board of directors. Management is defined as the organisation and coordination of the activities of a business in order to achieve defined objectives (WebFinance Dictionary, 2013d). Control could therefore stem from either direct or indirect shareholding. Paragraph *(d)(vA)* of the definition of a connected person in Section 1 of the Act may best be explained by the following example (IN 67):

- X is a connected person in relation to Company A
- Y manages or controls Company B
- Y is a connected person in relation to X
- Company B is therefore a connected person in relation to Company A

Based on the discussions above, the definition of a multinational group would be: A parent company with affiliates in the form of branch operations (legally, as part of the home-incorporated parent) or subsidiary companies (as separate host-incorporated entities) where the activities undertaken by these entities would be within a framework of group policies and strategies subject to the control exercised by the parent company. Even though the group is subject to the control of the parent company and all the companies in the multinational group work towards the same goal, Section 31 of the Act is triggered by any cross-border transaction between connected companies (discussed above) that leads to a tax benefit enjoyed in South Africa. The possible relationships that could exist in a multinational group should therefore be evaluated to determine when Section 31 could apply. It is submitted, by the researcher, that from the definition of a multinational group it could be assumed that the companies functioning in a multinational group would be connected parties: either by holding more than 50% or at least 20% (as per paragraph *(d)* of the connected person definition in Section 1 of the Act discussed above) or by indirect shareholding in companies in the group. The

submitted definition of a multinational group mentions 2 main parties: a parent, extended into its branch, and a subsidiary. This is again reflected in the opinion of other authors, Lin and Chang (2010:2), stating that transactions of goods or services between parent companies and subsidiaries are common and frequent. The following are examples of relationships, considered for purposes of the study (the list is not exhaustive), that might exist between a parent and its subsidiaries:

- A parent company (or its branch) holding 100% of the equity shares of or voting rights in a subsidiary;
- A parent company (or its branch) holding more than 50% but less than 100% of the equity shares of or voting rights in a subsidiary (for example a subsidiary with minority shareholders);
- Two subsidiaries managed and controlled by the same parent company; and
- A subsidiary (controlled by a subsidiary of the parent) (indirect shareholding) and a parent company.

A joint venture and a venturer (investor company) and companies holding more than 20% but less than 50% in another company; leading to, for example, associate enterprises, could also be relationships that exist among members of the group, but for purposes of the submitted definition of a parent company and its subsidiaries, these relationships will not be considered in this study.

The other elements that might trigger Section 31 of the Act, come into play if a company enjoys a tax benefit in South Africa due to a transfer price not constituting an arm's length price and if a cross-border transaction is affected between a resident and a non-resident/ a resident with a permanent establishment outside South Africa; or between a non-resident and a non-resident with a permanent establishment in South Africa/ a controlled foreign company ("CFC") of a South African resident. A tax benefit could, for example, be enjoyed by a company which moved profits that should have been taxed in South Africa to a company taxable at a lower rate in another country. For purposes of the study, an adjustment would therefore only be considered if the deviation from the arm's length principle leads to an entity enjoying a tax benefit in South Africa.

The definition of a multinational group submitted, by the researcher, is that it comprises a parent company with subsidiaries. Should the requirements in terms of the Act be met, any subsidiary could be regarded as a permanent establishment or CFC of another company. These relationships mentioned in Section 31 of the Act, would therefore not be separately considered. For purposes of the application of Section 31 of the Act, they should however be considered when a parent or subsidiary company would be considered a resident for South African tax purposes. Paragraph *(b)* of the resident definition in Section 1 of the Act determines that a company would be considered a resident if it is incorporated, established or formed in the Republic or has its place of effective management in the Republic, but does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation. Section 31 would only become applicable if one of the companies is a resident and the other a non-resident.

From the above discussion, it has been established that multinational groups consist of connected companies functioning cross-border and that the transfer prices set by these groups could affect the economy of a country. The subsequent discussion considers the different motives that multinational entities might have when setting transfer prices.

2.4 MULTINATIONAL GROUP BEHAVIOUR

The literature suggests that multinationals have both internal and external motivations for setting a transfer price (Eden, edited by Reuter, 2012:210). This view is shared by Bernard, Jensen and Schott (2006:2), who state that multinational firms have both managerial (internal motivations) and financial motives (external motivations) for setting different prices for related-party transactions.

2.4.1 Internal motives

Eden (1998:13) explains that transfers may take place in a multinational group where there is no internal motivation for setting a price; for example, where the affiliates offer short-term assistance when a problem arises. There are however, also internal transfers for which prices will be set. A discussion of these internal motives follows.

2.4.1.1 Performance evaluation of profit centres and motivating managers

A multinational group may be either horizontally integrated (different affiliates produce the same product in different markets) or vertically integrated (upstream affiliates produce intermediate products that are further processed by downstream affiliates prior to sale) or a combination of the two (Eden, 1998:4). Caplan (2006:2) explains that the sale will be included in the revenue of the selling or upstream division and the former will be an expense for the buying or downstream division. Multinational groups have to take into account the marginal costs and revenues of each affiliate when establishing transfer prices, creating an awareness among affiliates regarding the effect on the revenues of the other affiliates while still retaining their independent decision making prerogative (Hirshleifer, 1957:100).

Transfer prices are instruments for integrating and differentiating the actions of parts of the organisation and for evaluating their individual performance (Cools, Emmanuel & Jorissen, 2008:3). They are also a control mechanism for accomplishing a multinational group’s strategy (Cravens, 1997:131) as well as a behavioural tool that motivates managers to make the right decisions (Anthony, Dearden & Govindarajan, 1992). Multinational groups have to consider how prices should be set in order to induce each division to act to maximise the profit of the firm as a whole (Hirshleifer, 1956:172). The prices, which are set on internal transfers, affect the level of activity within divisions, the rate of return on investment by which each division is judged and the total profit that is achieved by the firm as a whole (Hirshleifer, 1956:172).

It should not be assumed that transfer prices are not at arm’s length, as connected persons within a multinational group can often bargain with each other as though they were independent persons (OECD, 2010a:32). Managers may, for example, be interested in establishing a good profit record and would therefore not want to set prices that would reduce the profits of their own companies (OECD, 2010a:32). Subsidiary managers need to be motivated to maximise (or increase) their divisional profits and transfer their products or services at appropriate transfer prices in and out of their areas of responsibility within the multinational group (Cools *et al.*, 2008:69). Transfer prices, in this case, may be used to motivate subsidiary managers to achieve their divisional goals (by maximising their divisional profits) while at the same time achieving their multinational group’s goals (Cools *et al.*, 2008:69). Many foreign companies operate as

profit centres and, as a result, the rewards to management depend on their profit centre's profits (Eden, 2001:593). Transfer prices are frequently adjusted so that the manager, who is compelled to purchase goods internally, even though external sources may be less expensive, will not suffer in terms of his or her own goals relating to compensation or evaluation (Cravens, 1997:134).

The Oxford University Press Dictionary (2013d) defines a profit centre as "...a part of an organization with assignable revenues and costs and hence ascertainable profitability." The opposite of a profit centre in a multinational group is a cost centre. A cost centre is defined by the WebFinance Dictionary (2013a) as "...a distinctly identifiable department, division, or unit of an organization whose managers are responsible for all its associated costs and for ensuring adherence to its budgets."

It is submitted, by the researcher, that even though all divisions work together to achieve the overall goal of their company as well as the multinational group, and are required to be aware of the influence on other affiliates of transfer prices set, the managers of each profit centre might still be concerned with their personal goals and the goals of their profit centre, since profit centres and managers are subjected to regular evaluation. This could have the effect that the profit distribution to profit centres might be higher than to the cost centres in the multinational group, without any rationale for the apportioning. These transfers could be anticipated between any of the relationships illustrated in paragraph 2.3, since the motive is to enhance the profit of the group as a whole. The misallocation of profits between profit- and cost centres would not necessarily influence the profit of the group as a whole (multinational groups are still expected to keep tax regimes in mind), but will have an impact on the profit of a company constituting a profit centre or a cost centre. It is therefore possible that this motive could lead to a transfer price that deviates from the arm's length principle and therefore to a possible adjustment in terms of Section 31 of the Act.

2.4.1.2 International or operational objectives

Subsidiaries are established for a variety of motives; for example, resource seeking, market seeking, or even efficiency seeking and through diverse modes, such as greenfield, acquisition, or joint venture (Birkinshaw & Hood, 1998:773). When entering a market, the strategy may be to become the lowest-cost producer in the industry (Porter,

1985:12). This is possible if other companies in the group set a low transfer price for an importing affiliate (Schjelderup & Sørgard, 1997:278).

The appropriate transfer price may allow a subsidiary to enter a new market at a competitive price, or allow a market leader to institute price reductions in response to slack demand or a general decline in economic conditions in a particular geographic area (Cravens, 1997:134). Schjelderup and Sørgard (1997:287) also concluded that the optimal transfer price generally depends on the nature of competition. Kind, Midelfart and Schjelderup (2005:510) explain that if affiliates of a multinational group face competition, the multinational group stands to gain by setting the transfer price of internationally traded goods at a central level and delegating decisions about quantities (or prices) to its local affiliates. Such a strategy is beneficial to the group as a whole if it triggers favourable responses from local competitors (Kind *et al*., 2005:510).

It should be borne in mind that the transfer prices set in a multinational group to enable a company to seek resources, to enter into a new market, or assist a market leader with its efficiency will not necessarily lead to transfer prices deviating from the arm's length principle. In paragraph 2.2, it was mentioned that various factors pertaining to contractual terms, economic circumstances and business strategies should be considered in order to verify whether the companies are trading at arm's length. The strategy of having companies assist a market leader with its efficiency would have to be compared to the strategies of companies in similar economic circumstances (OECD, 2010a:46). Entering into a new market or assisting a company with its efficiency, would also be considered business strategies. According to the OECD (2010a:50), tax administrators would have to determine if independent companies would have been willing to follow the same strategy and whether the companies were at all times following the strategy, in which case the pricing may be at arm's length. If not, a transfer pricing adjustment could result from pricing based on this motive.

2.4.2 External motivations

According to Bernard *et al.* (2006:2), financial motives of multinational groups encompass the minimisation of corporate tax and tariff payments as well as the circumvention of foreign exchange controls or other restrictions on cross-border capital movements.

2.4.2.1 Differences in corporate income tax rates between countries and tariff-induced motivations for transfer price manipulation

a. Differences in corporate income tax rates between countries:

Large tax rate differences between countries create strong incentives for multinational groups to reallocate their divisional accounting profits (Li & Balachandran, 1996:191). While income shifting may be accomplished through the reallocation of actual activities by moving the relevant assets (or risks assumed (OECD, 2010a:26)) and performing certain functions in low tax jurisdictions, it can also be achieved by shifting reported income, as occurs when firms manipulate their transfer prices on international transactions (Swenson, 2001:7).

Income shifting is explained as occurring where a multinational group over-prices tax-deductible inbound transfers into high-tax countries and under-prices them into low-tax countries, thereby shifting corporate profits from high-tax to low-tax jurisdictions (Eden, edited by Reuter, 2012:212). From a South African perspective, this would mean that a company could move income that would have been taxed in South Africa to another company taxed in a country with a lower tax rate. In the case of any resident of South Africa, the total amount in cash or otherwise, received by or accrued to or in favour of such resident, excluding receipts of a capital nature, will be included in the gross income of the resident (as per the gross income definition in Section 1 of the Act). This means that a resident will be taxed on its worldwide income, whereas a non-resident will only be taxed on its South African sourced income. The resident/ non-resident relationship would therefore present a multinational company with the opportunity to manipulate its transfer prices and move taxable income to a lower tax jurisdiction. The Act also makes provision for preventing a South African tax resident from moving profits into a lower tax jurisdiction in terms of section 9D of the Act pertaining to CFC's. In Section 9D of the Act a CFC [means] "...any foreign company where more than 50% of the total participation rights in that foreign company are directly or indirectly held, or more than 50% of the voting rights in that foreign company are directly or indirectly exercisable, by one or more persons that are residents other than persons that are headquarter companies." Section 9D ensures that profits belonging to the South African tax resident are imputed to their taxable income. In order for this provision to apply, however, it should first be established whether the foreign company may be regarded

as a CFC and then, whether profits of the CFC might pertain to a foreign business establishment (satisfying the provisions in Section 9D of the Act). Under certain circumstances, the CFC rules would therefore prevent an adjustment under Section 31 of the Act.

b. Trade taxes - Tariff-induced motivations for transfer price manipulation:

In some countries there is a clear incentive to under-report or misclassify products in order to circumvent export duties (Goetzl, 2005:9). Transfer price manipulation poses clear problems for international price indices because it reflects efforts to reduce income taxes, as well as the burdens of customs duties or exchange controls, and may thus be far removed from any reflection of marginal costs and changes in supply and demand (Eden & Rodriquez, 2004:61). If custom duties are levied on a percentage basis, the multinational can reduce the duties paid by under-pricing imports (Eden, edited by Reuter, 2012:213). There is also a natural tendency for multinational groups to ensure that the affiliate responsible for production is situated in the country having the larger market, in order to avoid the tariff duties on a large volume of imports (Horst, 1971:1064). According to the OECD (2010a:55), governmental interventions (including import- or export duties), should be treated as conditions of the market in the particular country when evaluating the arm’s length principle by comparing the controlled transaction to similar transactions between independent companies. It is therefore submitted, by the researcher, that it cannot automatically be assumed that this motive constitutes a deviation from the arm’s length principle; however, it may, in certain instances, result in a non-arm’s length price.

2.4.2.2 Hedging motives

a. Foreign exchange restrictions and the risk of devaluation of local currency:

An analysis by Chan and Chow (1997:101) of tax audits in China provided empirical evidence that the tax rate differential does not appear to be the major consideration for transfer pricing manipulations by companies. They found that other factors, such as foreign exchange control and the risk of devaluation of the local currency may play an even more prominent part in multinationals' transfer pricing decisions (Chan & Chow, 1997:101). If the host country’s currency is not convertible or there are foreign exchange restrictions on the amount of currency that can be bought or sold, the

multinational can, in effect, move its profits out despite restrictions by over-pricing inbound transfers and under-pricing outbound transfers (Eden, edited by Reuter, 2012:214).

If transfer prices are manipulated due to foreign exchange control restrictions, it is questionable whether this transaction ought to be subject to Section 31 of the Act, even if there is a saving in taxes. The purpose of the manipulation would appear to be that of enabling a company to, for example, pay for goods or services rather than having the intention of enjoying a tax benefit. Similar to tariff-induced motivations for transfer price manipulation, foreign exchange control restrictions are considered a governmental intervention and should be treated as conditions of the market in the particular country when evaluating the arm's length principle by comparing the controlled transaction to similar transactions between independent companies (OECD, 2010a:55). A factor that should however be considered, is whether the situation of foreign exchange control restrictions existed before or after the company started trading. If it existed before the company started trading, consideration should be given to whether independent parties would have been willing to trade under these restrictive circumstances (OECD, 2010a:56).

A company that sets a transfer price with the intention of avoiding losses due to the devaluation of the country's currency would have to be compared to companies functioning under similar economic circumstances, before concluding that the price deviates from the arm's length principle.

b. Political risk and capital flight:

A common explanation for capital flight from developing countries is that wealth holders move their wealth out of a country because of political and economic uncertainty (Mohamed & Finnoff, 2004:3) to avoid the possibility that the government may in one way or another erode the future value of their asset holdings (Lensink, Hermes & Murinde, 2000:74). If a multinational therefore fears expropriation of its assets in a host country, or more generally, if political risk is great, over-pricing of inbound transfers and under-pricing of outbound transfers can be used to shift income out of the high-risk location (Eden, edited by Reuter, 2012:215). The WebFinance Dictionary (2013b) defines economic risk as "…the risk that arises from investments in foreign countries.

Factors such as economic development and currency exchange rates influence the amount of risk associated with the investment. Countries with stable economic growth have less risk as compared to those countries whose economic growth fluctuates rapidly through time."

A transfer price set under these circumstances would have to be compared with transfer prices set by multinational groups under similar political and economic risk circumstances. Consideration would have to be given to whether the risk was present before or after the company started trading. In this regard, it is similar to foreign exchange control restrictions; consideration needs to be given to whether independent companies would have been willing to trade under these circumstances. Transactions circumventing foreign exchange control restrictions or political and economic risk could occur between any of the relationships mentioned in paragraph 2.3. They would trigger Section 31 of the Act if the South African tax resident company incurred a tax benefit.

2.4.3 Conclusion – multinational behaviour

Transfer prices are affected by both internal and external motives of multinational groups. The researcher therefore submits that in cases where according to tax authorities, it is established that a transfer price deviates from the arm's length principle tax avoidance may not always be the only reason or motivation for having set such a price. From the above discussion, the following considerations, which may cause pricing to deviate from the arm's length principle for multinational groups in setting transfer prices, have been identified:

- Internal motives:
  - Performance evaluation of profit centres and motivation of managers; or
  - International and operational objectives.
- External motivations:
  - Differences in corporate income tax rates and the avoidance of duties; or
  - Hedging (foreign exchange risk and political risk).

In Chapter 4, these motives are applied to consider the effect on the economic substance of the transaction and, therefore, also the most appropriate secondary adjustments to the transaction, should it deviate from an arm's length price. It is

submitted, by the researcher, that for purposes of this study, an adjustment would only be considered if an entity enjoys a tax benefit in South Africa.

2.5 CONCLUSION

In this chapter, the OECD guidelines were discussed to suggest the re-characterisation of a transaction, according to its economic substance, and it was confirmed that the motives of multinational entities for setting prices should influence the economic substance of an adjustment. The economic substance approach is in line with the discussion in Chapter 1 where Els (2012:27) stated that the focus of South Africa has now shifted to the overall profit objective, economic substance and commercial objective of an arrangement with a related party. The effect of the motives (analysed in paragraph 2.4) and the relationships (analysed in paragraph 2.3) on the economic substance of the adjustment will be considered in more detail in Chapter 4 to determine the appropriateness of a constructive loan as a secondary transfer pricing adjustment.

It should be borne in mind that transfer prices driven by these motives (intentions) would not necessarily constitute deviation from the arm's length principle. The factors set by the OECD guidelines should always be considered when determining an arm's length price. These factors, as discussed in this chapter, include the characteristics of the property or services transferred, the functions performed by the parties, the contractual terms, the economic circumstances of the parties and the business strategies of the parties (OECD, 2010a:44). Only once it has been determined that the transfer price deviates from the arm's length principle and that an entity enjoyed a tax benefit in South Africa, would an adjustment be applied in terms Section 31 of the Act. For purposes of further discussion in Chapter 4, it is however, assumed that these motives do lead to transfer prices deviating from the arm's length principle in order to establish the economic substance of the deviation for comparison with the characteristics determined in Chapter 3.

Currently, Section 31 of the Act, in force from 1 April 2012, treats the difference arising from a transaction between connected cross-border parties giving rise to a tax benefit, as a constructive loan. It may be submitted, by the researcher, that not all transfers would be affected with the intention to expect repayment. As discussed in Chapter 1 and in this chapter, the OECD guidelines suggest other alternatives to the constructive

loan, such as constructive dividends and constructive equity contributions. In the next chapter, these alternatives for secondary transactions are discussed in order to establish characteristics for comparison with the economic substance of the deviation (adjustment) arising, due to the motives described in this chapter.

CHAPTER 3: ALTERNATIVES FOR THE TREATMENT OF TRANSFER PRICING ADJUSTMENTS

3.1 INTRODUCTION

Primary transfer pricing adjustments change the allocation of the taxable profits of a multinational group (OECD, 2010a:151) and could give rise to a secondary transaction in order to make the allocation of the profits consistent with the primary adjustment (OECD, 2010a:28). The OECD guidelines suggest that countries regard these secondary transactions as either constructive loans, constructive dividends or constructive equity contributions (OECD, 2010a:28). At present, South Africa follows the approach of treating these secondary transactions as constructive loans under Section 31(3) of the Act. However, in the most recent South African tax budget speech (National Treasury, 2014:172) it was proposed that the loan is an administrative burden for both the taxpayer and SARS and that the constructive dividend treatment should be reinstated. It was also suggested that the treatment of a secondary transaction as a capital contribution should be added to the provision (National Treasury, 2014:172). The change to the provision has not yet been implemented; therefore the focus will remain on the current treatment being implemented by South Africa.

In most Member States of the European Union ("EU"), where transfer pricing adjustments are compulsory, these adjustments are treated as hidden profit distributions and are therefore considered as constructive dividends that are potentially subject to withholding tax (European Commission, 2013:3). The EU Joint Transfer Pricing Forum launched a questionnaire during July 2011 to take stock of legal and administrative aspects related to secondary transfer pricing adjustments (European Commission, 2013:2). The responses of 27 of the EU Member States indicated that they preferred not to treat secondary transactions as constructive loans (European Commission, 2013:3). It appears as if the reason for this may be that Member States want to avoid the complications arising from constructive loans; such as issues related to compounded imputed interest on those loans, therefore preferring to make transfer pricing adjustments in the form of constructive dividends or constructive equity contributions (European Commission, 2013:3).

In Chapter 2, the different relationships and motives that may influence transfer prices (set by multinational groups), which may in some instances result in primary and consequently, secondary transfer pricing adjustments, were established and considered. In this chapter, the alternative models for the treatment of transfer pricing adjustments available to countries making use of secondary transactions, as suggested by the OECD guidelines, are discussed in terms of their nature, tax consequences, benefits and disadvantages. The aim of this chapter is to establish the characteristics and tax consequences of each alternative, for the purposes of critically analysing the appropriateness of the treatment of a secondary transaction as a constructive loan for each of the motives identified in Chapter 2. As the constructive loan is currently the alternative used by South Africa in terms of Section 31(3) of the Act, the discussion commences with this alternative model.

3.2 THE ALTERNATIVE MODELS FOR SECONDARY TRANSACTIONS

3.2.1 Constructive loan

3.2.1.1 The nature of a constructive loan

The amendments of Section 31(1) and 31(3), which came into force from 1 April 2012, resulted in a primary adjustment arising from certain affected transactions, for example, transactions where an amount has been undercharged by a South African tax resident to a connected non-resident, to require the South African taxpayer to recover the amount of the primary adjustment from the foreign counterparty to prevent a secondary adjustment (Brodbeck & Gers, 2012:4). Until such time as the difference between the price charged and the arm’s length price (the amount of the adjustment) is settled through the repatriation of funds (Kruger, 2012:2; National Treasury, 2011:116), the difference will be regarded as a loan advanced by the resident party to the other party (Louw, 2012:1; National Treasury, 2011:116). The loan that remains outstanding will not only increase every year, but will also require an interest charge to be imputed, at an arm’s length rate, until the loan is repaid (Kruger, 2012:2; National Treasury, 2011:116). It is submitted, by the researcher, that the affected transaction, arising from the lack of actual interest being charged on a constructive loan, should give rise to a further adjustment, which in turn may require yet another secondary adjustment.

In order to be able to assess the appropriateness of a constructive loan as a secondary transaction, the characteristics of the loan should be considered. The Oxford University Press Dictionary (2013c) defines a loan as "...a thing that is borrowed, especially a sum of money that is expected to be paid back with interest." This meaning is confirmed in the context of the South African common law in the case of Schlemmer v Viljoen en Andere (1958), where it was held that the nature of a loan is such that one would expect stipulations regarding interest and repayments. Discussions regarding the characteristics of loans are limited in the South African courts.

As the purpose of this discussion is to identify the characteristics of a loan in general, rather than interpret a specific piece of legislation, examination of foreign case law where the concept was considered, may also be useful. The nature of a loan has been considered extensively in cases in the courts of the United States of America. Some of the views expressed in these cases are therefore considered here. In order to be classified as debt (loan) or equity (capital contribution), various factors have been taken into account by courts in the United States. These factors include:

1) Whether the money is used to start the corporation (Montclair Inc. v CIR, 1963);

2) Whether repayment is subordinated to other indebtedness (Montclair Inc. v CIR, 1963; Fin Hay Realty Co. v United States, 1968; Shedd v CIR, 2000; Berkowitz v United States, 1969 and Roth Steel Tube Co. v CIR, 1986);

3) Whether there is a fixed maturity date provided and a schedule of payments (Montclair Inc. v CIR, 1963; Fin Hay Realty Co. v United States, 1968; Shedd v CIR, 2000; Berkowitz v United States, 1969 and Roth Steel Tube Co. v CIR, 1986);

4) Whether the corporation was inadequately capitalised, for example, "thin" payments – the debt to capital ratio (Montclair Inc. v CIR, 1963; Fin Hay Realty Co. v United States, 1968; Shedd v CIR, 2000; Berkowitz v United States, 1969 and Roth Steel Tube Co. v CIR, 1986);

5) Whether interest was to be paid or a fixed rate of interest provided (Montclair Inc. v CIR, 1963; Fin Hay Realty Co. v United States, 1968 and Roth Steel Tube Co. v CIR, 1986);

6) Whether interest was payable out of earnings (dividend money) only and the source of payments (Montclair Inc. v CIR, 1963; Fin Hay Realty Co. v United States, 1968; Shedd v CIR, 2000; Berkowitz v United States, 1969 and Roth Steel Tube Co. v CIR, 1986);

7) Whether those making the advances acquired voting power in the corporation and participation in management because of the advances (Montclair Inc. v CIR, 1963; Fin Hay Realty Co. v United States, 1968; Shedd v CIR, 2000 and Berkowitz v United States, 1969);

8) Whether advances were made in the same ratio as risk capital (Montclair Inc. v CIR, 1963);

9) What the intent of the parties was (Montclair Inc. v CIR, 1963; Fin Hay Realty Co. v United States, 1968 and Berkowitz v United States, 1969);

10) The ability of the corporation to obtain outside financing from other sources (Montclair Inc. v CIR, 1963; Fin Hay Realty Co. v United States, 1968; Shedd v CIR, 2000; Berkowitz v United States, 1969 and Roth Steel Tube Co. v CIR, 1986);

11) The names given to the certificates evidencing the indebtedness and the formal *indicia* of the arrangement (Fin Hay Realty Co. v United States, 1968; Shedd v CIR, 2000; Berkowitz v United States, 1969 and Roth Steel Tube Co. v CIR, 1968);

12) The right to enforce the payment of principal and debt or contingency on the obligation to repay (Fin Hay Realty Co. v United States, 1968; Shedd v CIR, 2000 and Berkowitz v United States, 1969);

13) The use to which the advance was put and the extent to which the advance was used to acquire capital assets (Shedd v CIR, 2000 and Roth Steel Tube Co. v CIR, 1986);

14) The failure of the debtor to pay and the risk involved in making the advances (Fin Hay Realty Co. v United States, 1968 and Shedd v CIR, 2000);

15) A provision for redemption by the corporation or holder (Fin Hay Realty Co. v United States, 1968); the timing of the advance with reference to the corporation (Fin Hay Realty Co. v United States, 1968); the identity of interest between the creditor and the stockholder (Berkowitz v United States, 1969 and Roth Steel Tube Co. v CIR, 1986);

16) The security, if any, provided for the advances (Roth Steel Tube Co. v CIR, 1986); and

17) The presence or absence of a sinking fund to provide repayment (Roth Steel Tube Co. v CIR, 1986).

The discussion that follows is limited to identifying the factors concerning the classification of an arrangement as a loan, as discoursed by the various courts. It was possible to group many of the factors above together for purposes of the discussion.

In the United States' case of Hewlett-Packard Co. v CIR (2012) and the South African case of Tucker v Ginsberg (1962) it was argued that formal documentation and labels awarded to an arrangement are not decisive. Therefore, in order to characterise a transaction as a loan, other characteristics should be considered. In Montclair Inc. v CIR (1963) it was stated that the cumulative weight of the factors and the surrounding circumstances have to be considered in order to establish if the intention was to create an unconditional obligation to repay the advances. Correspondingly, it was established in court cases such as Curry v United States (1968), Farley Realty Co. v CIR (1960) and Title Guarantee and Trust Co. v United States (1943) that a loan is an unconditional, fixed or definite obligation to repay a sum on a set date, along with a fixed percentage of interest, regardless of the debtor's income or lack thereof. Characteristics that may be derived from these views, indicating a loan, are:

- The intention to create an unconditional obligation to repay the advances (Roth Steel Tube Co. v CIR, 1986);
- A fixed maturity date (Ragland Inv. Co. v CIR, 1969; National Farmers Union Serv. Corp. v United States, 1968; Hewlett-Packard Co. v CIR, 2012; Nestle Holdings Inc. v CIR, 1995 and PepsiCo v CIR, 2012);

- A fixed or stated interest rate (PepsiCo v CIR, 2012; Pritired I LLC v United States, 2011 and Nestle Holdings Inc. v CIR, 1995); and
- A right to enforce a specified repayment schedule of interest and capital (Shedd v CIR, 2000; National Farmers Union Serv. Corp. v United States, 1968; Nestle Holdings Inc. v CIR, 1995; Hewlett-Packard Co. v CIR, 2012; O.P.P. Holding Corporation v CIR, 1935; Curry v United States, 1968 and PepsiCo v CIR, 2012), irrespective of the company's success or failure (PepsiCo v CIR, 2012).

Lenders seek to realise a reliable return and avoid subjecting funds to the risk of the borrower's business (Title Guarantee and Trust Co. v United States, 1943 and Laidlaw Transp. Inc. v CIR, 1998). The repayment should therefore not be dependent on the availability of accumulated earnings (PepsiCo v CIR, 2012 and Ragland Inc. Co. v CIR, 1969) or the risk of the business (Nestle Holdings Inc. v CIR, 1995 and O.P.P. Holding Corporation v CIR, 1935). It may thus be submitted that lenders would seek security for advances (Roth Steel Tube Co. v CIR, 1986) and would prefer that their claims not be subordinated to the claims of other creditors or shareholders (Nestle Holdings v CIR, 1995).

Since lenders prefer security for their loans and would therefore want to be guaranteed repayment of their loan, possible indicators of debt could be if the borrower has a high level of cash and investments available for repayment (Nestle Holdings v CIR, 1995), or an established sinking fund (cash that is set aside for the future repayment of the debt) (Roth Steel Tube v CIR, 1986). This may be considered as an indication of a loan, because an indicator of equity (as discussed in paragraph 3.2.3) is that no repayment is expected and therefore the availability of cash or cash investments or a reserve for repayment is not required. If a company was consequently able to borrow funds from outside sources under similar circumstances, this could indicate debt (Hewlett-Packard Co. v CIR, 2012 and Shedd v CIR, 2000). It is therefore submitted, by the researcher, that a lender would review the cash flow of an entity to ensure a low risk for the repayment of the funds made available, whereas shareholders do not expect the repayment of their capital and would only be interested in the growth of the business in order to receive a return on their investment at a later date.

The use to which the advances are put is another factor considered in court cases such as Shedd v CIR (2000), Roth Steel Tube Co. v CIR (1986) and PepsiCo v CIR (2012). This factor alone, however, would not constitute a decisive reason. According to these cases, an indication of indebtedness would be the use of the advances for the daily operating needs of a corporation instead of the purchase of capital assets; for example, working capital, or for meeting expenses needed to commence operations. The latter would be indicative of an investment and therefore equity by nature (paragraph 3.2.3 refers).

The characteristics established by reference to court cases and other sources are confirmed, and to some extent supplemented, by a review of the International Financial Reporting Standards ("IFRS"). IAS 32(11) defines a financial liability (a loan) as a contractual obligation to deliver cash or another financial asset to another entity or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity with the liability (IFRS, 2012:954). An example of this would be a debenture that requires the issuer to make interest payments and redeem the debenture for cash, which is classified as debt (PwC, 2014:1).

In order to classify an arrangement or transaction as debt (a loan), it is submitted by the researcher, that the following definition, focussing solely on the factors mostly emphasised by the courts, may be derived from the above discussion. There must be an intention to create an unconditional obligation to repay advances, irrespective of the availability of accumulated earnings or the risks of the company. It can therefore be deduced that an important indicator of the intention of an unconditional obligation to repay the advances would be the availability of sufficient funds for repayment, as this would prove that a lender would have been willing, as an independent party, to make a loan to that company. In addition, it is submitted that labelling and interest would not be factors indicative of a constructive loan, since a secondary transaction is a hypothetical transaction and will have no label or interest. The interest is only regarded as a by-product and secondary adjustment once the transaction is classified as a constructive loan. Having established the definition of a constructive loan, a review of the tax consequences of a loan follows.

3.2.1.2 Tax consequences of a constructive loan

The tax consequences of a loan (an instrument), more specifically, the interest charged or paid in respect of a loan, are determined by Section 24J of the Act. The consequences for the borrower are determined by Section 24J(2), which states that [where] "...any person is the issuer in relation to an instrument during any year of assessment, such person shall for the purposes of this Act be deemed to have incurred an amount of interest during such year of assessment, which is equal to-- a) the sum of all accrual amounts in relation to all accrual periods falling, whether in whole or in part, within such year of assessment in respect of such instrument; or b) an amount determined in accordance with an alternative method in relation to such year of assessment in respect of such instrument, which must be deducted from the income of that person derived from carrying on any trade, if that amount is incurred in the production of the income."

On the other hand, the consequences for the lender are determined by Section 24J(3) which states that [where] "...any person is the holder in relation to an income instrument during any year of assessment, there shall for the purposes of this Act be deemed to have accrued to that person and must be included in the gross income of that person during that year of assessment (whether or not that amount constitutes a receipt or accrual of a capital nature), an amount of interest which is equal to-- a) the sum of all accrual amounts in relation to all accrual periods falling, whether in part or in whole, within such year of assessment in respect of such income instrument; or b) an amount determined in accordance with an alternative method in relation to such year of assessment in respect of such income instrument."

According to Section 24J(1), the amount accrued is calculated by applying the formula: an arm's length yield (rate) to maturity multiplied by the outstanding balance on the loan. In the South African case of Genn and Co. v CIR (1955), it was stated that interest is consideration received for the use of money. It is submitted, by the researcher, that this definition could be interpreted as not solely applicable to the use of money, but for purposes of this study, also to the use of anything of value. It can therefore be deduced that a constructive loan is the deemed use of anything of value and that notional interest would accrue on a constructive loan (value) in terms of Section 31 of the Act to achieve the same outcome as that under Section 24J, if the loan was interest-bearing. For

illustrative purposes, an interest rate of 6% was applied. The tax consequences of an adjustment, treated as a constructive loan, may thus be explained as follows (example adapted from a presentation by PwC (2012b:32)):

A South African company is performing distribution services for its connected company in the United States. The South African company renders the services at a price established as the cost to render the service, plus a mark-up of 5%. During an audit by SARS it is determined that the arm's length remuneration for the services performed by the South African company should be determined as the cost to render the service plus a mark-up of 10%. This results in a transfer pricing adjustment of R50,000 which is made on 30 June 2013. The financial year end of the South African company is 31 December 2013.

If the company in the United States makes a repayment of R50,000 to the South African company before this year end, no constructive loan or notional interest will arise as the adjustment is only at the year end, and repatriation would have taken place before final assessment (31 December 2013). Should the company in the United States however not make a repayment of the R50,000 to the South African company by that date, the calculation will look as follows:

Table 3.1: The tax consequences of an adjustment treated as a constructive loan

Year	Transfer pricing adjustment	Tax on adjustment (28%)	Deemed loan	Notional interest accrued (6%)	Tax on the notional interest accrued (28%)	Total tax payable
1	R50,000	R14,000	R50,000	R1,500	R420	R14,420
2			R51,500	R3,090	R865	R865
3			R54,590	R3,275	R917	R917
4			R57,865	R3,472	R972	R972
5			R61,337	R3,680	R1,030	R1,030
Total						R18,204

The secondary adjustment will be based on the interest that should have been charged in respect of the primary adjustment, which is treated as a loan. Table 3.1 illustrates that an interest transfer pricing adjustment will be made on the loan until such time when repayment of the loan is made.

This section of the chapter concludes with a brief discussion devoted to the benefits and disadvantages of the treatment of a secondary transaction as a constructive loan.

3.2.1.3 Benefits and disadvantages, from a South African perspective, if the secondary transaction takes the form of a constructive loan

A transfer pricing adjustment in terms of Section 31 of the Act will only be required if a transfer price affected in a cross-border arrangement between connected persons deviates from the arm’s length principle and leads to a tax benefit enjoyed in South Africa. In the case of a constructive loan, a lack of interest charged is likely to result in a tax benefit as the interest would have been taxable had it been charged. A lack of interest paid, and therefore an understatement of a deduction, is unlikely to result in a tax benefit. The discussion will therefore be limited to a constructive loan deemed to be advanced by a South African resident to a connected non-resident person. If repayment does not occur, the benefit for SARS would be that the South African resident would be deemed to have received taxable interest income. This would however not benefit the South African taxpayer, as a secondary interest adjustment could be indefinitely required until the repayment of the constructive loan on a compounded basis, resulting in a recurring and increasing exposure to taxable income without a corresponding cash flow. This tax effect is explained in paragraph 3.2.1.2 above. According to PwC (2012b:35) a benefit for the taxpayer is less tax payable where repatriation occurs earlier rather than later, as interest with tax consequences will not be indefinitely imputed. It is submitted, by the researcher, that repatriation will also benefit SARS, as its administration process, of having to track the interest to be imputed, will be simplified.

A disadvantage is that one cannot be certain how foreign tax authorities might treat a constructive loan, especially if there is a disagreement on what constitutes an arm's-length amount for the transaction in question (Brodbeck & Gers, 2012:4). Scenarios might arise where exchange control regulations or other rules of foreign jurisdictions do not permit the repayment of a constructive loan or, that even if such repayment would

be permitted, the foreign party's minority shareholders or joint venture partners may not agree to the repayment of a constructive loan (Brodbeck & Gers, 2012:4).

3.2.1.4 Conclusion: constructive loan

The treatment of a primary transfer pricing adjustment as a constructive loan which requires a secondary adjustment in respect of interest that should have been charged is currently in effect in South Africa (Section 31(3) of the Act). No evidence of any other countries following this approach could be found (European Commission, 2013:3). This treatment could lead to complications in terms of repayment and indefinite imputed interest. This alternative should however still be considered for purposes of Chapter 4, to determine whether any of the differences, arising from the internal and external motives of a multinational group, leading to primary adjustments, could in substance be classified as a constructive loan.

The following matrix, derived from the submitted definition in paragraph 3.2.1.1, may be formulated for the characteristics of a constructive loan:

Table 3.2: A matrix for the characteristics of a constructive loan

Unconditional obligation to make repayments to the lender
Repayments of advances are expected irrespective of the availability of accumulated earnings or the risks of the company
Availability of sufficient funds or a reserve (for example a sinking fund)

The discussion in the section above highlighted certain potential advantages and disadvantages to making use of constructive loans to effect secondary adjustments. An alternative to a constructive loan, which may address some of the concerns, is a constructive dividend. The constructive dividend approach, as suggested by the OECD guidelines for secondary transactions, will be considered in the following section of this chapter.

3.2.2 Constructive dividend

3.2.2.1 The nature of a constructive dividend

Section 1 of the Act defines a dividend as "…any amount transferred or applied by a company that is a resident for the benefit or on behalf of any person in respect of any share in that company, whether that amount is transferred or applied -

a) by way of a distribution made by; or

b) as consideration for the acquisition of any share in, that company, but does not include any amount so transferred or applied to the extent that the amount so transferred or applied -

  i. results in a reduction of contributed tax capital of the company;
  ii. constitutes shares in the company; or
  iii. constitutes an acquisition by the company of its own securities by way of a general repurchase of securities as contemplated in subparagraph (b) of paragraph 5.67(B) of section 5 of the JSE Limited Listings Requirements, where that acquisition complies with any applicable requirements prescribed by paragraphs 5.68 and 5.72 to 5.84 of section 5 of the JSE Limited Listings Requirements."

This definition is also used by IAS 18(5) stating that dividends are distributions of profits to holders of equity investments (IFRS, 2012:771). Helminen (1999:1) adds to this definition by interpreting a dividend distribution as a transaction where corporate profits are distributed to the owners without the corporation expecting to receive anything in return.

The definitions above can be divided into the following important elements:

1) An amount transferred or applied;
2) By a company that is a resident (residency has already been discussed in Chapter 2);
3) For the benefit or on behalf of, any person in respect of any share in that company;
4) By way of distribution or consideration out of profits.

The first element, as interpreted by Cliffe Dekker Hofmeyr (2012:3-4), includes the sale of property at less than market value, as it represents a benefit transferred by the

company to or on behalf of a shareholder. In the South African case of Brummeria Renaissance (Pty) Ltd and Others v CSARS (2007) it was held that the right of a non-capital nature, to use funds or property, constitutes an amount received or accrued. The transfer however excludes the return of capital (SARS, 2012:1). Section 1 of the Act defines the return of capital as "…any amount transferred by a company that is a resident for the benefit or on behalf of any person in respect of any share in that company to the extent that that transfer results in a reduction of contributed tax capital of the company, whether that amount is transferred -

a) by way of a distribution made by; or
b) as consideration for the acquisition of any share in, that company, but does not include any amount so transferred to the extent that the amount so transferred constitutes -
    i. shares in the company; or
    ii. an acquisition by the company of its own securities by way of a general repurchase of securities as contemplated in subparagraph (b) of paragraph 5.67(B) of section 5 of the JSE Limited Listings Requirements, where that acquisition complies with any applicable requirements prescribed by paragraphs 5.68 and 5.72 to 5.84 of section 5 of the JSE Limited Listings Requirements."

It is submitted, by the researcher, that the return of capital is a return of a shareholder's investment in equity, resulting in a reduction in the company's equity (contributed tax capital) and could therefore not constitute a dividend, as a dividend is not a return of investment but a return on an investment. It is further submitted that "an amount" constitutes any monetary benefit (value) transferred by a company.

The third element is outlined in the United States' case, Shedd v CIR (2000), where it was concluded that the shareholder does not have to receive the benefit personally, but that the benefit could be received by another company since there is a common shareholder and if it is under the control of such shareholder. It is submitted that a monetary benefit transferred by a South African tax resident company to a connected person, not the shareholder, could therefore still constitute a dividend as it might be under the control of a common shareholder.

The final element is illustrated by the South African case in Cohen No v Segal (1970) where it was decided that dividends may only be declared out of profits and not out of capital. This is also confirmed in United States' cases such as Ragland v CIR (1969) and Shedd v CIR (2000) which explained dividends as payments that should only be made out of corporate earnings and profits. This is in contrast with the constructive loan, as discussed in paragraph 3.2.1.1, where it is required that the repayment of a loan should not be dependent on the availability of accumulated earnings. This characteristic is not a requirement for purposes of the section 1 dividend definition and would not be considered an implicit characteristic.

It can therefore be submitted, by the researcher, that a dividend is any benefit with a monetary value transferred by a resident company, in respect of a share in that company for the benefit of or on behalf of a shareholder, without any counter performance required.

In Shedd v Commissioner (2000) it was argued that every economic benefit transferred to a shareholder, for which the shareholder does not give equivalent value in exchange, could be regarded as a disguised dividend. Such a disguised or unlabelled distribution effectively constitutes a constructive dividend. The AllBusiness.com Inc. Dictionary (2013b) defines a constructive dividend as a "...tax concept in which a stockholder is considered to have constructively received a dividend although it was not actually paid by the company. For example, a shareholder who used company property for personal purposes rent-free might be considered to have received a constructive dividend equal to the fair market rental value of that property."

Jenks (1970-1971:83) described a constructive dividend as the diversion of corporate funds to, or for the benefit of, controlling stockholders of a closely-held corporation that may be treated as a dividend, despite the absence of a formal distribution. If a stockholder has paid less for property or services, the stockholder has extracted something of value directly from the corporation without paying a proper price for it (Jenks, 1970-1971:84). If, from a transfer pricing perspective, the transaction were at arm's length, the income would have been available for the company to declare a dividend (Wiesener, 2011:1). The excess value, for which he (the shareholder), has not paid a consideration, is regarded as a distribution to him out of the corporate earnings and profits (Jenks, 1970-1971:84).

It can therefore be submitted, by the researcher, that the definition of a dividend would include both the payment of an actual dividend and of a constructive dividend, with the only difference being that a constructive dividend is not an actual distribution but a deemed one. In Shedd v CIR (2000), the following statement was made with regard to constructive dividends: “Two tests are normally employed to decide whether a transfer between related corporations constitutes a constructive dividend. One is an objective distribution test and the other a subjective test of primary purpose, both of which must be satisfied. First, there must be a distribution from the transferring corporation's earnings and profits; i.e., the transferee corporation must receive something at the expense of the transferor. This test requires property to leave the control of the transferor corporation in a way that allows a common shareholder to directly or indirectly control the property through some other instrumentality. Where property is transferred between related corporations, a common shareholder does not personally receive the property. Therefore, a distribution is thought to occur when a transferee corporation attains an increase in assets or control at the expense of a transferor corporation. The amount of such distribution is measured by the loss to the transferring corporation. However, where a corporation's distribution serves no legitimate corporate purpose, it must be treated as a constructive dividend to the benefited shareholder.” It is therefore submitted, by the researcher, that a characteristic of a constructive dividend, in contrast to a dividend, should be a decrease in assets or a loss incurred by the transferor.

It is submitted, by the researcher, that a constructive dividend is any benefit with a monetary value transferred by a resident company, leading to a decrease in assets or a loss suffered by the resident company, in respect of a share in that company for the benefit of, or on behalf of, a shareholder, without any counter performance required. In the subsequent section, the tax consequences of a dividend and constructive dividend are discussed in order to form a distinctive opinion of this OECD alternative model.

3.2.2.2 Tax consequences of a constructive dividend

The tax implications of a secondary adjustment arising from a constructive dividend will be liability for dividends tax. As of 1 April 2012, dividends tax is imposed at a rate of 15% of the amount of any dividend paid by any company other than a headquarters company (Section 64E of the Act). Dividends tax is a tax imposed on shareholders on the payment of dividends by companies and, under normal circumstances, is withheld

from their dividend payment (SARS, 2012:1). The withholding tax is a tax on the shareholder, unless it is a dividend *in specie* resulting in a tax liability on the company itself (SARS, 2012:1).

The transfer (distribution) of an amount in cash is referred to as a dividend otherwise than *in specie*, whereas the transfer of an asset (corporeal or incorporeal) other than cash is regarded as a dividend *in specie* (Cliffe Dekker Hofmeyr, 2012:3). The Practical Law Dictionary (2013) also defines a dividend *in specie* as "...a dividend which is satisfied in assets other than cash."

Section 64F does not contain an exemption from dividends tax in the case of a dividend declared to a non-resident company. If a dividend *in specie* is declared, the dividend could be exempt from dividends tax, in terms of section 64FA of the Act, if the company receiving the dividend forms part of the same group of companies. In terms of Section 41(1) of the Act, however, a foreign company is specifically excluded from the definition of a group of companies. The dividend or constructive dividend declared, whether in cash or *in specie*, would therefore not be exempt from dividends tax since the transfer would be between a South African tax resident and a non-resident. The tax consequences of an adjustment treated as a constructive dividend, may thus be explained as follows (example adapted from a presentation by PwC (2012b:32)):

A South African company is performing distribution services for its connected company in the United States. The South African company renders the services at a price established as the cost to render the service, plus a mark-up of 5%. During an audit by SARS it is determined that the arm's length remuneration for the services performed by the South African company should be determined as the cost to render the service plus a mark-up of 10%. This results in a transfer pricing adjustment of R50,000 which is made on 30 June 2013. The financial year end of the South African company is 31 December 2013. The tax consequences for the South African company will be as follows:

In order to determine whether the South African company or the United States company would be liable for the payment of the dividends tax, it would first have to be determined whether the constructive dividend will take the form of a dividend *in specie*, or a dividend other than a dividend *in specie*. As explained, a dividend *in specie* constitutes

a transfer of an asset other than cash. The distribution company undercharged for its services; therefore the dividend would be considered a dividend *in* specie if the transaction contained the characteristics of a dividend, for example if the company in the United States is a shareholder in the South African company.

Table 3.3: The tax consequences of an adjustment treated as a constructive dividend

Dividend other than a dividend *in specie*				
Transfer pricing adjustment	Tax on adjustment (28%)	Dividends tax on adjustment (15%)	Total tax payable by the South African company	Total tax payable by the United States company
R50,000	R14,000	R7,500	R14,000	R7,500
Dividend *in specie*				
R50,000	R14,000	R7,500	R21,500	R0

The above discussion has involved the nature and tax consequences of a constructive dividend. The section that follows will provide a brief overview of the benefits and disadvantages of the treatment of a secondary transaction as a constructive dividend.

3.2.2.3 Benefits and disadvantages, from a South African perspective, if the secondary transaction takes the form of a constructive dividend

Similarly to the discussion in paragraph 3.2.1.3 regarding a constructive loan, a transfer pricing adjustment, in terms of Section 31 of the Act, will only be required if a transfer price effected in a cross-border arrangement between connected persons deviates from the arm's length principle and leads to a tax benefit enjoyed in South Africa. If a South African person overcharges for services or goods supplied to a connected non-resident person, or the non-resident company undercharges for services or goods supplied to a connected South African resident person (depending on the shareholding), the excess income of the South African company would be taxed at 28%, leading to no tax benefit being received and therefore no adjustment requested by SARS. The discussion will therefore be limited to a South African resident undercharging for services or goods

supplied to a connected, non-resident person or a non-resident connected person overcharging the South African person for services or goods supplied.

The example in paragraph 3.2.2.2 demonstrates that the payment of dividends tax is a once-off payment that will not continue indefinitely, in comparison with the interest on the constructive loan if not repatriated immediately (refer to the example in paragraph 3.2.1.2). The benefit is that this will simplify the administration process for SARS and not lead to possible endless taxes for the taxpayer.

One of the disadvantages mentioned by the OECD (2010a:152) is that the dividends tax payable by a non-resident company may not be deductible or qualify for a rebate because the company's domestic legislation does not deem a dividend as a receipt. This however, is not a concern from a South African tax perspective and will therefore not be discussed further here.

According to the National Treasury (2011:115), the reason why South Africa moved from the constructive dividend model to the constructive loan model is due to the deemed dividend rules under current law replicating the concept of secondary adjustments. The discussion in paragraph 3.2.2.1 illustrated that "an amount" constitutes any monetary value transferred and would therefore be considered a dividend, even if there is no actual distribution.

Even though many Member States of the EU (as discussed in paragraph 3.1) consider this a simpler model than the constructive loan, this model might lead to duplication in the Act and therefore double taxation, unless the Act stipulates that either Section 1 or Section 31 would enjoy preference. It is submitted that if the dividends tax rules in the Act already capture and tax a deemed dividend, secondary adjustment rules in the Act might be unnecessary. It is however, further submitted that not all adjustments resulting from the motives established in Chapter 2 would necessarily have the characteristics of a constructive dividend, for example if it is not paid for the benefit of a shareholder (a payment made by a parent company to a subsidiary), and those differences might be left unadjusted were it not for Section 31 secondary transaction rules.

3.2.2.4 Conclusion: constructive dividend

For the years of assessment ending on or before 31 March 2012, a secondary transfer pricing adjustment in South Africa was treated as a constructive dividend. South Africa however altered its model to a constructive loan in order to avoid duplication. The purpose of this study is to determine the true nature of a transaction arising from the motives listed in Chapter 2, by comparing it to the characteristics of the different models suggested by the OECD guidelines. This model is therefore still considered for purposes of Chapter 4. Compared to the constructive loan model, the advantage of this model is that the secondary transfer pricing adjustment, dividends tax, is a once-off payment and will not lead to possible indefinite interest imputed because repatriation did not occur.

The following matrix, derived from the definition submitted, by the researcher, in paragraph 3.2.1.1, may be formulated for the characteristics of a constructive dividend:

Table 3.4: A matrix for the characteristics of a constructive dividend

Any benefit with a monetary value transferred
By a resident company
A decrease in assets or a loss suffered by the resident company
In respect of a share in that company
For the benefit or on behalf of a shareholder
No counter performance is required

Once it has been established that these characteristics are present, the transaction could be classified as a constructive dividend. The last section of this chapter considers the third approach to secondary transfer pricing transactions suggested by the OECD guidelines; namely, a constructive equity contribution.

3.2.3 Constructive equity contribution

3.2.3.1 The nature of a constructive equity contribution

Similar to constructive loans, the purpose of this discussion is to identify the characteristics of an equity contribution in general, rather than interpret a specific piece of legislation; therefore both South African and foreign case law where the concept was considered may be useful. In paragraph 3.2.1.1, the characteristics considered by the courts in the United States were listed. As with the discussion regarding the constructive loans, the discussion that follows will similarly be limited to factors concerning just the classification of a transaction as equity as discoursed by the various courts as well as supplementary sources. Many of the listed factors are grouped together in the following paragraphs, depending on the overall trend of discussion by the courts.

In the South African court case of Sage Holdings Ltd v The Unisec Group Ltd and Others (1982), an equity contribution was defined as "…funds invested in the company." The definition is confirmed by the AllBusiness.com Inc. Dictionary (2013a), explaining contributed capital as "...payments made in cash or property to a corporation by its stockholders either to buy capital stock, to pay an assessment on the capital stock, or as a gift (also called paid-in capital)." In contrast to the characteristic of a constructive loan, advances would therefore be used to invest in capital assets instead of corporate operating expenses.

In the United States case of PepsiCo v CIR (2012), it was concluded that the advanced funds (equity contribution) are tied to the well-being of the business. The funds are therefore at the risk of the business (Shedd v CIR, 2000). This was also the view in the South African case of Schlemmer v Viljoen en Andere (1958) where it was confirmed that these invested funds are exposed to the risk of the business, which is not returned in the normal course of the business. The WebFinance Dictionary (2013c), explains, under the term equity investment, that "…investors recover it only when they sell their shareholdings to other investors, or when the assets of the firm are liquidated and proceeds distributed among them after satisfying the firm's obligations." The investor is therefore exposed to a more prominent risk, compared to the lender, since:

- There are no fixed obligation or enforcement provisions to repay interest or principle (PepsiCo v CIR, 2012 and Roth Steel Tube v CIR, 1986);

- No maturity date (Pritired v United States, 2011 and PM Fin. Corp. v CIR, 1962);
- Their claims are subordinated to the claims of other creditors or investors (PepsiCo v CIR, 2012; Tyler v Tomlinson, 1969; Roth Steel Tube v CIR, 1986; Hewlett-Packard v CIR, 2012; Shedd v CIR, 2000; Fin Hay Realty v United States, 1968 and National Farmers Union v United States, 1968); and
- In contrast to a loan, there would also be an absence of security for advances (Tyler v Tomlinson, 1969 and Roth Steel Tube v CIR, 1986).

These are the characteristics that distinguish equity from a loan, because a lender prefers limited risk and expects a fixed schedule of repayments of the loan, irrespective of the risk of non-availability of funds. It is submitted that a shareholder would therefore expect a higher return, to accommodate the exposure to the higher risk. One of the characteristics that might also compensate for the risk is participation in management (Hewlett-Packard v CIR, 2012; Shedd v CIR, 2000; National Farmers Union v United States, 1968 and PepsiCo v CIR, 2012).

Keyes (2013:1) proposed that an investor profits through the growth of the business and will not necessarily withdraw funds in advance. The United States' courts explain that returns on shareholder's investments, for example dividends, are received out of corporate earnings (O.P.P. Holding Corporation v CIR, 1935 and Fin Hay Realty v United States, 1968) at the discretion of the parties involved (Shedd v CIR, 2000 and National Farmers Union v United States, 1968). As no fixed schedule of repayments is expected, there will also not be a provision for a sinking fund (Tyler v Tomlinson, 1969 and AutoStyle Plastics Inc. v United States, 1999).

A lender expects fixed repayments and would therefore not extend a loan to a corporation that is thinly capitalised (a company that has more debt than equity) or has insufficient funds to pay off the debt. In contrast to these characteristics, being thinly capitalised (PepsiCo v CIR, 2012 and Astleford v CIR, 1974) or being unable to obtain loans from independent sources at arm's length due to insufficient assets or funds to pay off the debt (Nestle Holdings v CIR, 1995; Curry v United States, 1968 and Berkowitz v United States, 1969), would be characteristics of equity, as the investors do not expect fixed repayment for the funds advanced.

The characteristics established by reference to court cases and other sources are confirmed, and to some extent supplemented, by a review of IFRS. IAS 32 paragraph 11 prescribes that a financial instrument may only be classified as an equity instrument if the instrument includes no contractual obligation to deliver cash or other financial assets to another entity or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer (IFRS, 2012:956). Examples would be a contract that indicates a residual interest in the entity's assets after deducting all of its liabilities, or the issuing of ordinary shares where the payments are at the discretion of the issuer (PwC; 2012c:1). This is another characteristic which is in contrast to that of a loan; as equity incurs no contractual obligation for repayment with interest.

In comparison to an equity contribution, a constructive equity contribution may occur when a shareholder transfers property (shares, cash or other property) to a corporation without receiving something of equal value in exchange, while the other shareholders do not take part in this transaction (Harvey, 2010:500).

It is therefore submitted that a constructive equity contribution is the transfer of property or funds by a shareholder to a company, in order to increase the former's participation in management and to eventually share in the profits of the company, without any contractual obligation on the company to make repayments to the shareholder.

The following statement by O'Brien and Oates adds to the discussion and classification of a constructive dividend or a constructive equity contribution. O'Brien and Oates (2009:21) explain how a constructive equity contribution would have worked, at that point in time, as a suggested adjustment considered for Code Sec. 482 in the United States. In an intercompany transaction between a parent and a subsidiary, the adjustment will depend on which entity holds the excess cash. If the parent holds the excess cash (due to transfer pricing manipulation by overcharging for a transaction), the conforming adjustment will be a constructive dividend (O'Brien & Oates, 2009:21). If the subsidiary, on the other hand, holds the excess cash, the conforming adjustment is a constructive capital contribution (O'Brien & Oates, 2009:21). A review of the tax consequences of an equity contribution will follow.

3.2.3.2 Tax consequences of a constructive equity contribution

As an equity contribution is generally a transaction of a capital nature, there are no immediate tax consequences except when it is distributed back to the owners by way of a return of capital, in which case a base cost adjustment of the investment may be required. The return of capital is not one of the alternatives suggested by the OECD guidelines, but is discussed in Chapter 4.

The tax consequences of an adjustment treated as a constructive equity contribution, may be explained as follows (example adapted from a presentation by PwC (2012b:32)):

A South African company is performing distribution services for its connected company in the United States. The South African company renders the services at a price established as the cost to render the service, plus a mark-up of 5%. During an audit by SARS it is determined that the arm's length remuneration for the services performed by the South African company should be determined as the cost to render the service plus a mark-up of 10%. This results in a transfer pricing adjustment of R50,000 which is made on 30 June 2013. The financial year end of the South African company is 31 December 2013. The tax consequences for the South African company will be as follows:

Table 3.5: The tax consequences of an adjustment treated as a constructive equity contribution

Transfer Pricing Adjustment	Tax on Adjustment (28%)	Total tax payable
R50,000	R14,000	R14,000

This example illustrates that the treatment of a primary transfer pricing adjustment as a constructive equity contribution should result in no further secondary adjustment as there are no tax consequences, except for the normal tax on the adjustment. The section concludes by providing a brief overview of the benefits and disadvantages of using the model of a constructive equity contribution.

3.2.3.3 Benefits and disadvantages, from a South African perspective, if the secondary transaction takes the form of a constructive equity contribution

As for the discussion in paragraph 3.2.1.3, regarding a constructive loan and the discussion in paragraph 3.2.2.3, regarding a constructive dividend, a transfer pricing adjustment in terms of Section 31 will only be required if a transfer price affected in a cross-border arrangement between connected persons deviates from the arm's length principle and leads to a tax benefit enjoyed in South Africa. The discussion will therefore be limited to a South African person undercharging for services, or being overcharged for services by a non-resident, and therefore deemed as having invested in the connected non-resident company by way of a constructive equity contribution representing the transfer pricing adjustment (as with a constructive dividend, it will depend on the direction of the shareholding).

The example in paragraph 3.2.3.2 demonstrates that this alternative has no further tax effects, except for the normal tax payable on the adjustment, and therefore no secondary adjustment. The benefit is that this will simplify the administration process for SARS and lead to a saving in taxes by the taxpayer. Since it also does not demand the repatriation of funds, no restrictions need to be considered. The risk for SARS, however, would be the misclassification of a transaction as equity, whether by accident or on purpose, thereby creating a loss in taxes that would have been applicable to the constructive loan or constructive dividend models. Future studies should investigate why no evidence of this model could be found to be applied by any OECD country. This is however not be discussed further here for the purposes of this study.

3.2.3.4 Conclusion: constructive equity contribution

The treatment of a secondary transaction as a constructive equity contribution will have no secondary adjustment, simplifying the administration process for SARS, and has no additional tax effects for taxpayers. It is submitted that not all transactions arising from the motives listed in Chapter 2 could be classified as constructive equity contributions, as it will depend on the intent of the parties involved and the specific characteristics of the transaction. The following matrix, derived from the definition submitted, by the researcher, in paragraph 3.2.1.1, may be formulated for the characteristics of a constructive equity contribution:

Table 3.6: A matrix for the characteristics of a constructive equity contribution

Transfer of property or funds
By a shareholder to a company
In order to partake in management or eventually share in the profits of the company
Without any contractual obligation on the company to make repayments to the shareholder

It is argued that the emphasis of this example by O'Brien and Oates (2009:21) falls on the shareholding; it confirms that the direction of the shareholding will determine whether the transaction should be classified as a constructive equity contribution or a constructive dividend (this statement and the example that follows just considers the constructive equity and constructive dividend model, but does not imply that the constructive loan model would not still have to be considered for purposes of Chapter 4). In order to illustrate the effect of the shareholding, in terms of the South African context, information regarding the shareholding should be added to the illustration in paragraph 3.2.2. If the company in the United States is regarded as the parent holding 100% of the shares in the South African company, the R50,000 proposed adjustment could be regarded as a constructive dividend because the benefit is seen to be received by the company in the United States, being the shareholder.

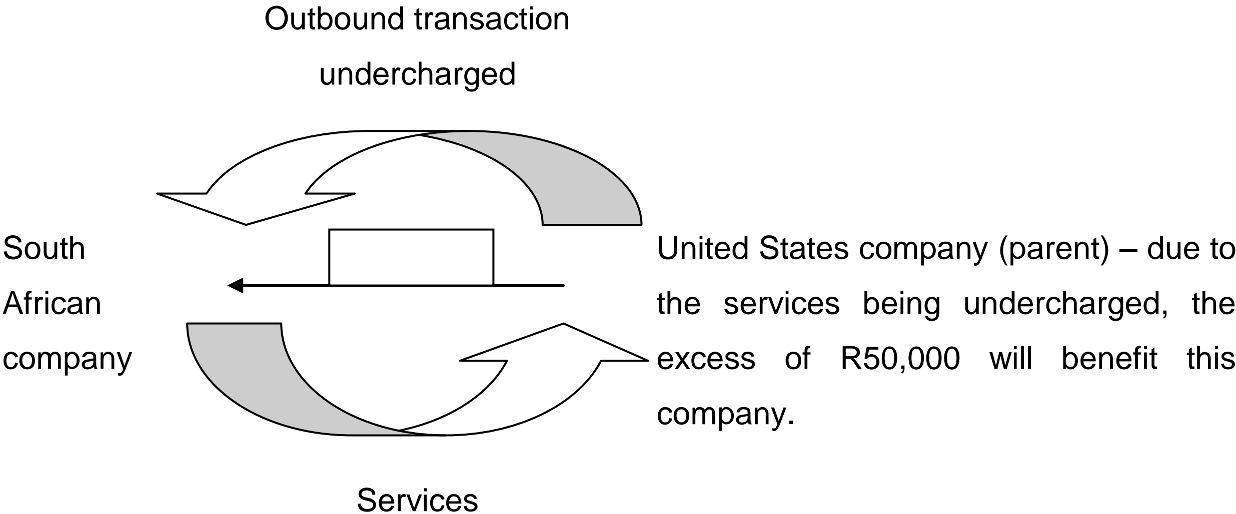


Figure 3.1: Illustration of possible classification as a constructive dividend

In comparison to this, if the company in South Africa is regarded as the parent holding 100% of the shares in the United States company, the R50,000 proposed adjustment could be regarded as a constructive equity contribution, since the benefit is regarded as being received by the company in the United States and therefore would have the appearance of a contribution in equity by the shareholder.

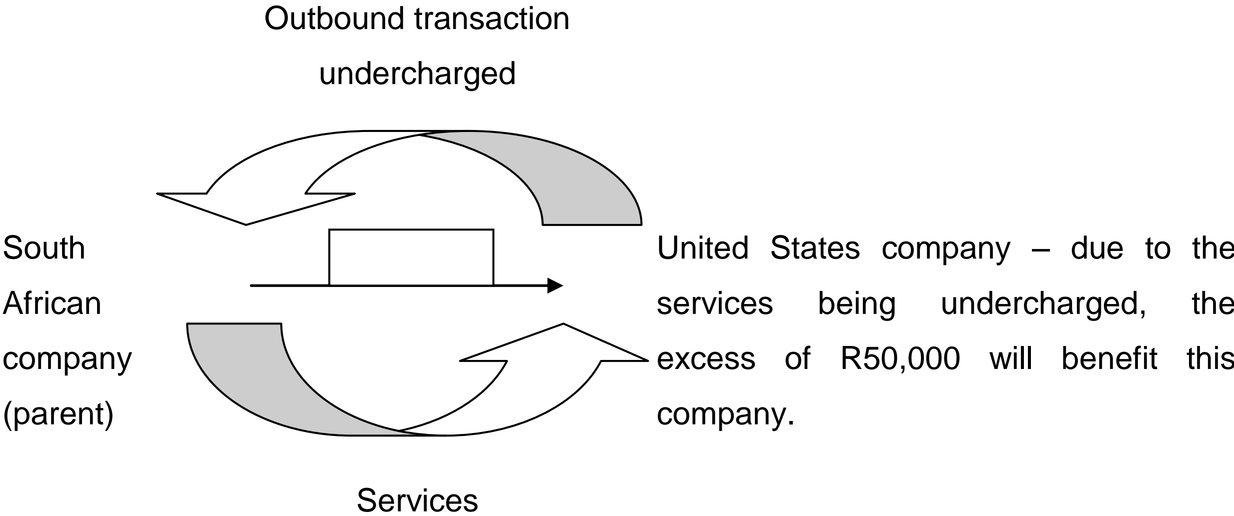


Figure 3.2: Illustration of possible classification as a constructive equity contribution

Shareholding is only one of the characteristics required and it still needs to be established whether all the characteristics listed in the matrix are present before the transaction is classified as a constructive equity contribution. Because the alternatives have been discussed at length, and distinct characteristics have been identified, the following paragraph concludes this chapter.

3.3 CONCLUSION: THE ALTERNATIVE FORMS OF SECONDARY TRANSACTIONS

The aim of this chapter was to establish the characteristics of each alternative for purposes of critically analysing the appropriateness of the treatment of a secondary transaction as a constructive loan for each of the motives identified in Chapter 2. The following matrix contains a summary of the characteristics applicable to each of the alternatives discussed in this chapter:

Table 3.7: A matrix for the characteristics of a constructive loan, -dividend or -equity contribution

	Constructive loan	Constructive Dividend	Constructive Equity Contribution
Obligation			
Unconditional obligation to make repayments to the lender – not dependent on the availability of accumulated earnings or the risks of the company	X		
No obligation to make repayments to the shareholder Reason: Dividends are only payable from available accumulated earnings (sharing in the profits) and affected to enable involvement in management		X	X
No counter performance is required by the shareholder receiving the benefit (excluding the original buying of shares)		X	
Payment			
Transfer of property/ funds/ benefit with a monetary value	X	X	X
By a resident company (tax benefit enjoyed by an entity in South Africa)	X	X	X
A decrease in assets/ loss (tax) by the resident company – indicates that a transfer has occurred	X	X	X
Direction of the transaction			
For the benefit or on behalf of a shareholder		X	
By a shareholder to the company in order to partake in management or eventually share in the profits of the company			X

The following characteristics are similar for all three of the alternatives: there is a transfer of a benefit with a monetary value evident from a decrease in assets or of the company enjoying a tax benefit in South Africa. The characteristics that are unique to each of the alternatives are:

- Constructive loan: The unconditional obligation to make repayments;
- Constructive dividend: A benefit transferred for or on behalf of a shareholder with no counter performance required by the shareholder receiving the benefit; and
- Constructive equity contribution: a benefit transferred by a shareholder with the intention to either partake in management or eventually share in the profits of the company.

As indicated in Chapter 2, primary transfer pricing adjustments may arise from transactions that are driven by various motives identified in that chapter. In Chapter 4, the appropriateness of treating a transfer pricing adjustment as a constructive dividend or a constructive equity contribution approach as an alternative to the constructive loan model, will be critically analysed for each motive, giving rise to a primary adjustment based on the characteristics and inherent benefits and weaknesses of that treatment identified in this chapter.

CHAPTER 4: ESTABLISHING A SUITABLE TRANSFER PRICING ADJUSTMENT ALTERNATIVE FOR EACH MOTIVE TO MANIPULATE TRANSFER PRICES

4.1 INTRODUCTION

It is not the transfer of goods or services between connected entities across borders at an agreed price that is the problem, but the potential transfer pricing manipulation by multinational groups that governments fear (Eden, 2001:594). What one party perceives as a legitimate form of price setting, another may regard as evasive and illegitimate (Eden, 2001:594). In the 2013 Global Transfer Pricing Survey by Ernst and Young ("EY") (2013:15), 66% of the participating multinational companies indicated that tax risk management is their highest priority when setting transfer prices; 1% indicated performance measurement as their highest priority while 14% indicated management or operational objectives. In Chapter 2, it was established that the characterisation of a transaction should be determined by both its objective and subjective economic substance and that the subjective economic substance will depend on the motive of the multinational group when setting the transfer price (OECD, 2010a:51; ACM Partnership v CIR, 1998). It is submitted that this principle should be similarly applied to determine the economic substance of the secondary transaction arising due to a primary adjustment. In Chapter 2, it was recognised that various factors (as prescribed by the OECD guidelines) have to be taken into consideration before it can be said that there is a deviation from the arm's length principle. For purposes of Chapter 4, however, it is assumed that these factors have already been considered and that the result has been a deviation from the arm's length principle, leading to an adjustment in terms of Section 31 of the Act. It is further accepted that no adjustment would be considered if there was not a transfer of a benefit with a monetary value (evident in a decrease in assets) or a tax benefit, enjoyed in South Africa.

In South Africa, Section 31 of the Act governs transfer pricing and deems a secondary transaction a constructive loan under Section 31(3) of the Act. This is a hypothetical transaction created due to a primary transfer pricing adjustment (OECD, 2010a:152). As indicated in paragraph 3.2.1.3, there are a number of criticisms of a constructive loan as a secondary transaction. These include the critique that the treatment of a secondary

transaction as a constructive loan carries administrative complications relating to imputed interest, as was highlighted by the OECD (2010a:152) and, recently, by National Treasury (2014:172). National Treasury (2014:172) also proposed the possible reinstatement of the constructive dividend treatment for South Africa as well as adding the capital contribution model to the provision. Consequently, it should be determined if a constructive loan is the appropriate treatment of secondary transfer pricing adjustments in the South African context. This was posed as the primary research problem in Chapter 1, and if not, whether the other alternatives, as considered in Chapter 3 (constructive dividends and constructive equity contributions), could be reflective of the economic substance of a transfer pricing adjustment.

An alternative not proposed by the OECD guidelines is the treatment of an adjustment as a donation. Some of the funds transferred between multinational companies might create the impression of the receipt of something without giving anything in return. Section 55(1) of the Act defines a donation as “any gratuitous disposal of property including any gratuitous waiver or renunciation of a right”. Section 58 of the Act also adds transfers of property at less than market value. The donation under Section 58 would therefore be the market value of the property less the consideration paid. The common-law test of a motivation of “pure liberality” or “disinterested benevolence” is quoted in two South African court cases; Avis v Verseput (1943) and later by Estate Welch v CSARS (2004), to determine whether a disposition is a donation. The Oxford University Press Dictionary (2013b; 2013a) defines liberality as “…the quality of giving or spending freely” and benevolence as “…the quality of being well meaning; kindness.” The judge in the United States’ court case of Graig v Mercy Hospital (1950) described the term “donation or gratuity” as the “…absence of consideration, transfer of money or other things of value from one owner to another without any consideration.” This is confirmed in the case of Estate Welch v CSARS (2004) where the judge described the word “gratuitous” as a disposition made without obligation, for no return and without any quid pro quo being expected or given. It is submitted that connected persons in a multinational group would not be transferring something to another gratuitously. The term *quid pro quo* means something in return for something else, and it may therefore be argued that even if a connected person transfers something to enhance its self-interest in the other company, something was nevertheless given for something else.

The treatment of an adjustment as a donation was therefore not added to the alternatives suggested by the OECD guidelines or considered in Chapter 3 of this study.

The alternatives that are considered are constructive loans, constructive dividends and constructive equity contributions. Before commencing the discussion, in the next paragraph the methodology followed in analysing the information gathered in the previous paragraphs, in order to provide recommendations for the classification of a secondary transaction and secondary adjustment, is provided.

4.1.1 Methodology

In order to evaluate if a constructive loan, as is currently the case in Section 31(3), is the appropriate treatment of secondary transfer pricing adjustments in the South African context, or whether other alternatives should be considered, the discussion is structured as follows:

- In paragraph 4.2, the constructive loan is evaluated as a secondary transaction by comparing the characteristics of a constructive loan, as established in Chapter 3, with the possible economic substance arising from each of the motives established in Chapter 2. The direction of the transaction is also taken into consideration, since it could influence the nature of the transaction and assist with determining the economic substance arising from the motive;
- In paragraph 4.3, the discussion continues, examining the motives for which the characteristics of the constructive loan were not reflective of the economic substance. The suitability of the constructive dividend and constructive equity contribution are evaluated by comparing the characteristics of the constructive dividend and the constructive equity contribution as established in Chapter 3, to the possible economic substance arising from each of the motives established in Chapter 2. The direction of the transaction accompanied by the shareholding will be considered to assist in establishing the economic substance arising from a motive; and
- In paragraph 4.4, a recommendation is made regarding the secondary transaction and accompanying secondary adjustment that would best describe the deviation arising, due to each of the motives of a multinational group for transfer pricing manipulation.

4.2 EVALUATION OF THE CONSTRUCTIVE LOAN AS A SECONDARY TRANSACTION

The characteristics of a loan were summarised in Table 3.2 (paragraph 3.2.1.4). For ease of reference, the Table is repeated in this chapter to enable comparison.

Table 4.1: A matrix for the characteristics of a constructive loan

Unconditional obligation to make repayments to the lender
Repayments of advances are expected irrespective of the availability of accumulated earnings or the risks of the company
Availability of sufficient funds or a reserve (for example a sinking fund)

In the subsequent paragraphs the possible economic substance of a transaction arising from specific motives, as discussed in Chapter 2, is compared to the characteristics in Table 4.1 to determine if a constructive loan would be reflective of the economic substance of a transaction arising from a specific motive.

4.2.1 Internal motives

4.2.1.1 Performance evaluation of profit centres and motivating managers

In paragraph 2.4.1.1, the discussion centred on the need for divisions in a multinational group to be aware of the effect of their transfer prices on other divisions (Hirshleifer, 1957:100) in order to maximise the profit of the group as a whole (Hirshleifer, 1956:172). The discussion in paragraph 2.4.1.1 further indicated that the performance of the divisional managers and the divisions is, however, individually evaluated (Cools et al., 2008:3), based on the profit made by their profit centre (Eden, 2001:593), and could lead to adjustments to ensure that their goals do not suffer (Cravens, 1997:134).

In addition to the discussion in paragraph 2.4.1.1, Steens (2011:75) concurs with the argument by emphasising that transfer prices may affect the decisions made by management because transfer prices influence the allocation of profit, capital components and cash flow across the centres for which they are responsible. As mentioned in paragraph 2.4.1.1, profit centres have assignable revenues and costs (Oxford University Press *Dictionary*, 2013d), leading to their performance being

evaluated in terms of profitability. In comparison with this, cost centres have assignable costs (WebFinance Dictionary, 2013a) leading to the evaluation of their performance based on adherence to the budgeted costs. This indicates the risk of deviation from the arm's length principle, due to the possible misallocation of profits between profit centres and cost centres. A company could consist of multiple profit and cost centres, but for purposes of the discussion, it is accepted that a company represents either a profit centre or a cost centre, which could lead to a company enjoying a tax benefit in South Africa if profits are misallocated to a profit centre for purposes of performance evaluation.

In order to classify the adjustment arising from this motive as a constructive loan (Table 4.1), there would have to be an unconditional obligation on the profit centre to make repayments to the said cost centre, irrespective of the availability of accumulated earnings or the risks of the company. The Financial Accounting Standards Board (2008:1) defines an unconditional obligation as an obligation that "…requires performance to occur now or over a period of time, whereas a conditional obligation requires performance to occur if an uncertain future event occurs." IAS 37.10 describes an obligating event as an event that creates a legal obligation which results in an entity having no realistic alternative but to settle the obligation (IFRS, 2013:1151). As discussed in paragraph 2.4.1.1, adjustments would be made with the intention of motivating the divisional managers to accomplish the goals of the multinational group and their individual goals (Anthony *et al.,* 1992). The WebFinance Dictionary (2014c) defines motivation as the interaction of both conscious and unconscious factors, such as the incentive or reward value of a goal. It is submitted that the burden of repayment would not serve as a reward for a goal, as it would again lead to a decrease in profits, defying the purpose of the original adjustment. Similarly, if an amount were to be received by a division, but with an obligation to return it at a point in time, this amount would not increase the profit of the division, as the corresponding obligation would leave it neutral. It was also indicated, by Hiermann and Reichelstein (2012:4), that some multinational groups adopt a system of two sets of books, where the transfer prices used for internal performance and profit measurement are different from the ones used for tax reporting purposes. This is also an indication that the cost centre would expect no obligatory repayment.

The characteristics of the submitted definition of a constructive loan in paragraph 3.2.1, are not reflective of the economic substance of a deviation from the arm's length price arising from this motive. The economic substance should therefore be compared with the characteristics of the constructive dividend or constructive equity contribution.

4.2.1.2 International or operational objectives

a. Market entry

As discussed in paragraph 2.4.1.2, subsidiaries could be established by a multinational group in order to enter into a new market (Birkinshaw & Hood, 1998:773). It was also indicated in the discussion, in the same paragraph 2.4.1.2, that one strategy of the multinational group could be to charge lower transfer prices to the subsidiary, depending on the competition in the market (Schjelderup & Sørgard, 1997:278), in order to enable the subsidiary to become a low-cost producer in the market (Porter, 1985:12), thereby gaining market entry.

In order to be classified as a constructive loan, the characteristics in Table 4.1 should be present; namely, an unconditional obligation on the subsidiary to make repayments irrespective of the availability of accumulated earnings or the risks of the company. According to Twarowska and Kąkol (2013:1007), market entry gained through a wholly owned subsidiary is the method incurring the highest risk, but also offers the highest market control and expected return on investment. Petrović and Stanković (2009:19) add to this by explaining that the establishment of a subsidiary could generate synergistic gains and that shareholders in a company may benefit if a company's cash flow is internationally diversified due to it holding assets in different countries. The WebFinance Dictionary (2014f), defines synergism as the "…interaction between two or more agents, entities, factors, or substances that produces an effect greater than the sum of their individual effects." As discussed in paragraph 3.2.1.1, lenders avoid subjecting funds to the risk of the borrower's business (Title Guarantee and Trust Co. v United States, 1943 and Laidlaw Transp. Inc. v CIR, 1998). If a parent company therefore intends that the provision of resources at a reduced price should be an investment, the deviation from this motive could not be classified as a constructive loan, since the company would be interested in the growth of the company, share in the profits in future and would not expect obligatory repayments. The deviation arising under these circumstances could therefore not be classified as a constructive loan.

On the other hand, subsidiaries could also be established to allow outsourcing of business functions that can be undertaken at lower cost abroad; for example, call-centre operations to be provided at lower costs by the company due to the employment of low-cost highly skilled workers (Harrison, 2011:4). It could be argued that in certain instances the company transferring goods or services at reduced prices could expect repayment in some obligatory form (the delivery of low-cost services creating a legal obligation) and that this could be a loan extended to the subsidiary to be repaid. It is, however, still debatable whether the company would expect repayment irrespective of the risk incurred by the subsidiary. It is suggested that the risk to which the subsidiary would be subjected should be taken into consideration before classification as a constructive loan, as the group strategy is to maximise profits for the shareholders (Cristea & Nguyen, 2013:26) and therefore to benefit all the companies in a group.

Since subsidiaries could be subsidised by resources gained from other subsidiaries (Twarowska & Kąkol, 2013:1006), one would have to consider whether a company constituting a profit centre providing low-cost products or services to the subsidiary would not in fact expect repayment in some form, because the profit centre's performance evaluation would depend on its profitability (as discussed in paragraph 4.2.1.1). In similar vein to the discussion in the previous paragraph, the company would have to expect repayment in a form that would not subject the subsidiary to unnecessary business risk, leading to the latter's financial failure. This would not be in line with the global strategy of maximising the profits of the group to the advantage of all the companies in the group, by gaining market entry.

From the discussion it may be deduced that in some exceptional cases the deviation from the arm's length price arising from this motive could be treated as a constructive loan. This would, however, only be the case if it falls within the strategy of the multinational group and would also allow for the maximisation of profits for the shareholders (Cristea & Nguyen, 2013:26). The expectations of the individual company would therefore always have to be considered in terms of the effect on the multinational group. Due to the constructive loan being appropriate only in specific and possibly limited circumstances, the economic substance arising from this motive is compared to the characteristics of the other alternatives to determine if a better fit exists.

b. Assisting a company with its efficiency

The remaining discussion in paragraph 2.4.1.2 dealt with a company facing a diminished demand, a general decline in economic conditions or competition. The discussion in paragraph 2.4.1.2 explained that the company could institute price reductions due to other companies in the group charging a lower transfer price to the company (Schjelderup & Sørgard, 1997:278) or by the multinational group setting the transfer price at a central level and delegating decisions about prices to local companies (Kind *et al.,* 2005:510). As in the discussion in paragraph 4.2.1.2.a, this would enable the company to become a low-cost producer in the market (Porter, 1985:12), providing indirect financial assistance to the company and as a result, benefitting the group as a whole (Kind *et al.,* 2005:510).

In order to classify the deviation from the arm's length price arising from this motive as a constructive loan, the decisive factor would be an unconditional obligation on the company to make repayments, irrespective of the availability of accumulated earnings or the risks of the company (Table 4.1). The Cambridge University Press Dictionary (2014) defines financial assistance as official support given to an organisation, for example, in the form of reduced taxes. In similar vein to the discussion in paragraph 4.2.1.2.a, the company providing the assistance could either do so with the intention of receiving a high return on investment (Twarowska & Kąkol, 2013:1007) and therefore demand no obligatory repayment; expect the assisted company to provide low-cost services in future (Harrison, 2011:4) and thereby indirectly receive repayments; or, insist on repayment due to the company providing the assistance constituting a profit centre.

As with the conclusion reached in paragraph 4.2.1.2.a, the treatment of the deviation as a constructive loan would only be reflective of the economic substance of the deviation from an arm's length price, arising from this motive, under exceptional circumstances, and would always have to be considered in terms of the strategy of the multinational group to maximise its profits for its shareholders (Cristea & Nguyen, 2013:26). The individual expectation of the company could therefore never be in violation of the group strategy. The economic substance arising due to this motive should therefore, still be considered by comparing it to the characteristics of the other alternatives.

4.2.2 External motives

4.2.2.1 Difference in corporate income tax rates and the avoidance of duties

According to Li and Balachandran (1996:191), as discussed in paragraph 2.4.2.1.a, significant differences in the tax rates between countries create strong incentives for multinational groups to move accounting profits in order to save on taxes. In paragraph 2.4.2.1.b, it was moreover discussed that multinational groups may also misclassify products to circumvent export duties (Goetzl, 2005:9). Lin and Chang (2010:2) explain that by minimising international taxes, the profits of the group can be maximised. As multinational groups are responsible to maximise profits for their shareholders, differences in policies and tax rates between countries are exploited (Cristea & Nguyen, 2013:26).

In order to classify the adjustment as a constructive loan (Table 4.1), there would have to be an unconditional obligation on the company to make repayments, irrespective of the availability of accumulated earnings or the risks of the company. Eden (2001:597) argues that the overall control by the parent company implies that key decisions are generally made outside of national jurisdictions, with the principal goal being to maximise their global after-tax profits. This indicates that the savings in taxes and duties are mainly intended first to maximise profits, then to enhance the competitiveness of the multinational group thereby, and later for the shareholders to share in the profits. According to Kocieniewski (2011:7), the saving in taxes enabled companies to continue paying dividends to shareholders during the economic downturn. Tax War (2014:8), shares this view by explaining that the saving in taxes leads to shareholders, which are part of the multinational group, benefiting from it in the form of dividends. It is submitted that this does not indicate an unconditional obligation to repay the shifted profits within a specified period, but rather that the companies will share in future profits.

Akin to the discussion in paragraph 4.2.1.2, it could be argued that profits moved by a profit centre to another company, with the intention of enjoying a tax benefit, could be subject to an obligation to make repayments to the profit centre. Repayment would not necessarily be expected in the form of a direct transfer of profits, but could be in the form of low-cost services (Harrison, 2011:4). However, should the profit centre keep two sets of books, as indicated by Hiermann and Reichelstein (2012:4), it would again indicate that the cost centre would expect no obligatory repayment.

From the discussion in this paragraph it can be deduced that the constructive loan could only apply in exceptional circumstances, but would always have to be considered in terms of the strategy of the multinational group (Cristea & Nguyen, 2013:26). The deviation from the arm's length price arising from this motive could, therefore, in substance not be classified as a constructive loan in all instances, and a comparison with the characteristics of the other alternatives needs to be made.

4.2.2.2 Foreign exchange restrictions and the risk of devaluation of currency

In paragraph 2.4.2.2, Chan and Chow's finding (1997:101) was discussed: that the circumvention of foreign exchange control restrictions and prevention of losses due to the devaluation of the currency of a country plays an important role in the setting of transfer prices by multinational groups. It was also explained in this paragraph 2.4.2.2, that these companies can move their profits out, despite such restrictions (Eden, edited by Reuter, 2012:214). Country risk is often used as a synonym for political risk (Petrović & Stanković, 2009:11), but is not actually the same. According to Longueville (cited by Petrović & Stanković, 2009:12), country risk occurs in the following two forms: Risk of sovereignty (that represents the risk of possible expropriation and profit restriction) and transfer/convertibility risk (when the central bank cannot mobilise enough foreign reserves in order to convert financial funds in local currency to foreign currency). Political risk refers to the risk of unexpected specific foreign government policies in the country which can result in an investment either being discontinued, or in it being decreased (Petrović & Stanković, 2009:12). It may therefore be deduced that both foreign exchange restrictions (risk of sovereignty) and the risk of devaluation of a country's currency (transfer or convertibility risk) would be risks specific to a country.

The OECD (2010a:32) classifies foreign exchange restrictions as a governmental pressure and adds that transfer prices may be manipulated due to cash flow requirements of multinational groups. The WebFinance Dictionary (2014a), defines exchange controls as restrictions on the conversion of a country's currency for another in order to improve the balance of payments (to achieve economic growth). The descriptions by both the OECD (2010a:32) and the WebFinance Dictionary (2014a) indicate that had there been no governmental restrictions, payment for goods or services in the normal course of business would have been effected. It is therefore submitted, by the researcher, that an adjustment for a motive to circumvent foreign

exchange controls should be in the form of the expense under which it would have been classified if no foreign exchange control restrictions existed.

According to the OECD (2010a:40), devaluation of currency may lead either to profits for the company functioning with the stronger currency, or in the long run, to fewer profits, due to exports becoming less competitive. The WebFinance Dictionary (2014e) defines devaluation as [planned] "...or market forced reduction in the value of a currency's exchange value. Devaluation may improve a country's balance of payments situation by boosting exports and reducing imports, but it worsens inflation for imported goods or those having significant import content." In order to classify the adjustment as a constructive loan (Table 4.1), there would have to be an unconditional obligation on the company to make repayments irrespective of the availability of accumulated earnings or the risks of the company. The devaluation of currency is therefore a market force and not a governmental pressure (as is the case with the foreign exchange restrictions). Under these circumstances, profits would be moved to prevent losses that could be incurred due to devaluation of the country's currency. The purpose would be to adhere to the principal goal of the group, to maximise profits for the benefit of shareholders (Lin & Chang, 2010:2; Cristea & Nguyen, 2013:26; Eden, 2001:597) in the form of future dividends (Kocieniewski, 2011:7; Tax War, 2014:8). Under these circumstances, it is evident that no obligatory repayment would be expected, as the intention would be to extract the value from the high risk environment on an indefinite basis; therefore the economic substance would not warrant the classification of the secondary transaction as a constructive loan.

From this discussion it can be deduced that the deviation from the arm's length price arising due to foreign exchange controls should be classified as an original expense and that the deviation from the arm's length price arising due to the devaluation of a currency could therefore, in substance, not be classified as a constructive loan. A comparison with the characteristics of the other alternatives should therefore be made for the "devaluation of currency" motive.

4.2.2.3 Political risk and capital flight

In paragraph 2.4.2.2, it was pointed out that according to Lensink et al. (2000:74), Mohamed and Finnoff (2004:3) and Eden (2012:215), multinational groups may transfer wealth out of a country to avoid the erosion of its future value in times of political

uncertainty. The WebFinance Dictionary (2014e) defines political risk as the [probability] "...of loss due to political instability in the buyer's country that may result in cancellation of a license or otherwise affect the buyer's ability to make payments." According to Lin and Chang (2010:4), a turbulent financial environment can only be survived if the economic profits of the multinational group are stabilised.

In order to classify the adjustment as a constructive loan (Table 4.1), there would have to be an unconditional obligation on the company to make repayments, irrespective of the availability of accumulated earnings or the risks of the company. In paragraph 4.2.2.2, it was mentioned that the investment could either be discontinued or that a decrease in the investment could occur (Petrović & Stanković, 2009:12). If the investment is discontinued, it indicates that there is no obligation on the company retrieving the investment to make any repayment.

It could however be argued that if the investment is decreased, the amount could be expected as a repayment and future equity injection once the political risk has declined. As with the discussions in paragraph 4.2.2.1 and 4.2.2.2, the intention of the multinational group would be to maximise the profits of the group by preventing possible losses, due to the erosion of the future value of its investments. Perhaps the decisive factor in this case would be whether the move is permanent (as an investment) or temporary (repayable as a loan). The Oxford University Press Dictionary (2014b) defines permanent as [intended] "...to last or remain unchanged indefinitely" and temporary as [lasting] "...for only a limited period of time." In instances where amounts are transferred out of a country due to political risk, with the possibility of transferring these back in future, it is submitted that the re-transfer would be contingent upon the conditions in the country improving. It is therefore unlikely that an unconditional obligation to re-transfer the value into the country would exist at the time of extracting value in terms of this motive. It is submitted, by the researcher, that the political risk could continue indefinitely and that no period, when the repayment would be expected, can be specified. This concurs with the discussion of one of the characteristics of a loan in paragraph 3.2.1.1 where court cases such as Curry v United States (1968), Farley Realty Co. v CIR (1960) and Title Guarantee and Trust Co. v United States (1943) held that a loan should have a set date for repayment. The treatment of the economic

substance arising from this motive would therefore not warrant classification as a constructive loan.

In accordance with the explanation by Petrović and Stanković (2009:12), the company could either be moving the entire investment or only decreasing it. The latter could be accomplished by withdrawing accumulated wealth. It is submitted, by the researcher, that this would not be a direct transfer of profits by a profit centre and that it could not be argued that repayment would be expected. The classification of the economic substance as a constructive loan would not be warranted for this motive; the characteristics of the other alternatives should therefore be considered.

4.2.3 Conclusion for the evaluation of a constructive loan as a secondary transaction

It is evident from the above discussions that classification of a deviation from an arm's length price, arising due to a specific motive as a constructive loan, would only be possible under exceptional circumstances. According to the submitted definition of a constructive loan (Table 4.1) there would have to be an unconditional obligation on the company to make repayments, irrespective of the availability of accumulated earnings or the risks of the company. It has been established that the principal strategy of a multinational group is to maximise profits for the benefit of shareholders, rather than maximising profits of individual entities to the detriment of the group as a whole. The shareholders will, however, only share in these benefits in the future and therefore no legal obligation for repayment within a specified period is created. The exceptional circumstances that might lead to the creation of an obligation for repayment exist if profits are moved or given up by a company constituting a profit centre, which might expect repayment due to its performance evaluation, depending on its profits and if low-cost services are expected, which does represent some form of repayment. In the case of the "political risk motive" it may furthermore also be difficult to establish whether the company making the transfer is doing so on a temporary or a permanent basis, creating uncertainty and contingency in the obligation to make repayment. As discussed above, these exceptions are also unlikely to exist in deviations from arm's length arising from the "foreign exchange restriction motive" or the "political risk motive" if considered in terms of the principal strategy of the multinational group.

It has been confirmed that the constructive loan model leads to administrative complications (OECD, 2010a:152; National Treasury, 2014:172). From the above discussion, it is evident that this treatment only reflects the substance of a transaction if an implied obligation to make repayment exists. It is submitted that the administrative difficulty in applying the constructive loan model may stem from the difficulty in establishing such implied repayment arrangements. It is further submitted that the fact that this model could only apply under exceptional circumstances, and that it results in administrative complications, serves as a logical explanation as to why no evidence could be found of other countries using the constructive loan as an alternative for transfer pricing adjustments, as well as the reason why South Africa is considering amendment (European Commission, 2013:3; National Treasury, 2014:172).

Since findings suggest that the constructive loan is only applicable in exceptional circumstances, the discussion that follows is devoted to the other alternatives, constructive dividends and constructive equity contributions, in order to evaluate whether the characteristics of either of these alternatives could be reflective of the economic substances arising due to the motives.

4.3 EVALUATION OF CONSTRUCTIVE DIVIDENDS AND CONSTRUCTIVE EQUITY CONTRIBUTIONS AS SECONDARY ADJUSTMENTS

The characteristics of these alternatives were discussed in detail, in Chapter 3. The former were summarised in Table 3.7 in paragraph 3.3. For ease of reference, the Table is repeated as Table 4.2, without the constructive loan characteristics or the payment characteristics (for purposes of this Table, it is assumed that there was a transfer of a benefit by a resident company that resulted in a decrease in assets and a tax benefit, otherwise no transfer pricing adjustment would have been required).

Table 4.2: A matrix for the characteristics of a constructive dividend or equity contribution

	Constructive Dividend	Constructive Equity Contribution
Obligation		
No obligation to make repayments to the shareholder Reason: Dividends are only payable from available accumulated earnings (sharing in the profits) and done to enable involvement in management	X	X
No counter performance is required by the shareholder receiving the benefit (excluding the original buying of shares)	X	
Direction of the transaction		
For the benefit or on behalf of a shareholder	X	
By a shareholder to the company in order to partake in management or eventually share in the profits of the company		X

As concluded in paragraph 3.3, the main difference between these alternatives, would be the direction of the transaction. A constructive dividend is a benefit transferred to or on behalf of a shareholder with no counter performance required by the shareholder receiving the benefit. On the other hand, a constructive equity contribution is a benefit that is transferred by a shareholder with the intention of either partaking in management or eventually sharing in the profits of the company. One of the main reasons why it is difficult to classify a deviation as a constructive loan, as concluded in paragraph 4.2.3 above, is that it is difficult to determine whether profits have been moved on a temporary or permanent basis. It is submitted that an equity investment is intended to remain unchanged indefinitely (Oxford University Press Dictionary, 2014b) and it is therefore accepted that companies would not expect the amount returned in the normal course of business (as discussed in paragraph 3.2.3.1; Schlemmer v Viljoen en Andere, 1958).

Since the direction of the transaction is a determining factor, the relationships among these companies, as illustrated in paragraph 2.3, to determine shareholding, will affect

the adjustment and matching alternative. The discussion that follows will consider the economic substance of the specific motives, as discussed in paragraph 4.1.1, by comparison of this substance with the characteristics of these alternatives.

4.3.1 Internal motives

4.3.1.1 Performance evaluation of profit centres and motivating managers

As discussed in paragraphs 2.4.1.1 and 4.2.1.1, adjustments by a multinational group might be effected in order to increase the profit of a profit centre to ensure that the manager's incentives do not suffer (Cravens, 1997:134). In paragraph 4.2.1.1, it was stated that a company could constitute either a profit centre or a cost centre. The tax benefit would be enjoyed in South Africa if the cost centre is allocated less profit than it was entitled to, due to adjustments made to the profits of cross border companies in order to motivate divisional managers (the reward value of the goal (WebFinance Dictionary, 2014c)). It is submitted that a profit centre located in South Africa would be reluctant to waive its profits if its performance is evaluated on this basis.

In order to classify the adjustment as a constructive dividend, there would have to be a transfer of a benefit by a company to or on behalf of a shareholder; whereas for classification as a constructive equity contribution there should be a transfer of a benefit by the shareholder to the company (Table 4.2). By over- or undercharging products or services, there would be a transfer of benefits. In paragraph 3.2.2.1, it was indicated that a constructive dividend would be the transfer of a benefit that has no legitimate corporate purpose, which is directly or indirectly controlled by a common shareholder and received on behalf of the common shareholder (Shedd v CIR, 2000). As discussed in paragraph 2.3, separate legal entities, forming part of the multinational group, operate as a single integrated enterprise following an overall business strategy (OECD, 2013:25). The strategy is to maximise profits for their shareholders (Cristea & Nguyen, 2013:26) under the overall control of the parent company (Eden, 2001:597). It is therefore submitted that any transfer of benefits to an entity controlled by a common shareholder (parent) would be a transfer by reason of the parent's shareholding in the entity. This would support the classification of the economic substance as a constructive dividend, as the benefit transferred to the profit centre would ultimately be transferred, in order to motivate the divisional managers for the benefit of the greater group.

In paragraph 3.2.3.1, it was indicated that an equity contribution was defined in the court case of Sage Holdings Ltd v The Unisec Group Ltd and Others (1982) as "funds invested in the company". The Oxford University Press Dictionary (2014a) defines an investment as an act of devoting time to a specific undertaking with the expectation that it will be profitable in future. The WebFinance Dictionary (2014b) supports this definition by defining an investment as "…money committed or property acquired for future income." It can therefore be deduced that the intention of the cost centre moving profits to a profit centre would not be to commit money or property in order to share in the future profits of the entity that benefits from the transfer, unless the cost centre is the shareholder of the benefitting entity. This would require the cost centre to be a holding entity in a group structure from which goods or services are transferred, to its own subsidiaries, which may be an unlikely scenario.

Based on the discussion above, it is submitted that the most probable match for the economic substance of a transfer price adjustment motivated by performance evaluation will be a constructive dividend.

4.3.1.2 International or operational objectives

a. Market entry

As discussed in paragraphs 2.4.1.2 and 4.2.1.2.a, a multinational group's strategy to enter into a new market could be to establish a subsidiary (Birkinshaw & Hood, 1998:773) and undercharge the latter (Schjelderup & Sørgard, 1997:278), to enable the subsidiary to become a low-cost producer (Porter, 1985:12) or to charge lower prices to customers. The subsidiary would therefore also be making fewer profits than those of its competitors in order to gain market entry and maximise the profits of the group in the future (OECD, 2010a:50). The OECD (2010a:50) describes market entry as the reduction in current profits in anticipation of increased future profits. This description concurs with the definition by the Oxford University Press Dictionary (2014a) that an investment represents an act of devoting time to a specific undertaking with the expectation that it will be profitable in future. It is therefore submitted that the establishment of a subsidiary is an investment acquired for future income.

In paragraph 4.2.1.2a it was noted that market entry can be gained through a wholly-owned subsidiary. This is likely to lead to the highest expected return on investment

(Twarowska & Kąkol, 2013:1007). The deviation from the arm's length price arising from this motive could not be classified as a constructive loan, as the company would be interested in the growth of the investment, share in the profits in future and would not expect obligatory repayments. In order to classify the adjustment as a constructive dividend there would have to be a transfer of a benefit by a company to or on behalf of a shareholder, whereas for classification as a constructive equity contribution there should be a transfer of a benefit by the shareholder to the company (Table 4.2). In accordance with the description by Twarowska and Kąkol (2013:1007), the benefit would therefore be transferred by the parent company, as the shareholder, to the subsidiary. This is substantiated by the fact that the purpose of establishing a subsidiary would be to acquire income in future; therefore, as described in paragraph 3.2.3.1, exposing the funds to the risk of the business and not expecting these to be returned in the normal course of business (PepsiCo v CIR, 2012, Shedd v CIR, 2000 and Schlemmer v Viljoen en Andere, 1958). The purpose of establishing the subsidiary would therefore be for the multinational group to profit through the growth of the business (Keyes, 2013:1). From the perspective of the group as a whole, the assistance would appear to be an equity contribution. If the transfer or assistance is, however, carried out by another subsidiary of the group, it is submitted that such a subsidiary transfers a benefit to the group (its shareholder). From the perspective of this transferring subsidiary, the transfer meets the characteristics of a constructive dividend. Given that operations from which goods or services may be transferred are often found in the subsidiaries, rather than the parent company, in a group, it is submitted that the latter argument is more likely to be the case than the former. This suggests that in most cases, the constructive dividend will be the most appropriate.

As discussed in paragraph 4.2.1.2, establishing a new subsidiary can generate synergistic gains that are beneficial for the shareholders (Petrović & Stanković, 2009:19). A subsidiary is usually profit driven (Tax War, 2014:3), especially if it constitutes a profit centre, and could expect to receive some kind of benefit in return. This would be in line with the discussion in paragraph 4.2.1.2.a, where it was stated that it could be argued that the economic substance arising under these circumstances would constitute a constructive loan. A lack of explicit repayment terms would, however, result in this view being difficult to support.

In conclusion, given that operations from which goods or services can be transferred are often found in the subsidiaries, rather than the parent company, it can be argued that a subsidiary would be providing the funds, therefore transferring a benefit to the group (its shareholder), and that the deviation from an arm's length price arising due to this motive should be classified as a constructive dividend.

b. Assisting a company with its efficiency

As discussed in paragraphs 2.4.1.2 and 4.2.1.2.b, a company facing a slack demand could be assisted by the other companies in the group: they can institute lower prices (Cravens, 1997:134) or set the transfer price at a central level (Kind *et al.,* 2005:510). The strategy of a multinational group is to maximise profits for their shareholders (Cristea & Nguyen, 2013:26). If the companies in the group do not assist a company in increasing its efficiency, the group's profit will suffer because of losses made by the company, which might even lead to a loss in market share and therefore in competitiveness. This emphasises the devotion of time and money to ensure the group's shareholders do not suffer and, consequently, the protection of an investment.

In order to classify the adjustment as a constructive dividend there would have to be a transfer of a benefit by a company to or on behalf of a shareholder, while for classification as a constructive equity contribution there should be a transfer of a benefit by the shareholder to the company (Table 4.2). As with the discussion in paragraph 4.2.1.2.a, the benefit transferred would only constitute a constructive equity investment if the parent company assists its subsidiary, as this would be a transfer of a benefit by a shareholder. If the company receiving the assistance holds shares in the company making the transfer, it could be argued that it would be the transfer of a benefit to a shareholder and would therefore warrant classification as a constructive dividend. As discussed in paragraph 4.3.1.1, if the company receiving the benefit does not constitute a shareholder in the company making the transfer, it could still be regarded as a constructive dividend. The latter is possible if it is argued that the benefit was under the overall control of the parent company (Eden, 2001:597), as the common shareholder, and therefore received on behalf of the parent company.

Similar to the conclusion drawn in paragraph 4.3.1.2.a, it is most likely that the assistance would be provided by other subsidiaries, as operations from which goods or

services can be transferred are often found in the subsidiaries, and that the benefit would be transferred by the subsidiary to the group (its shareholder). The deviation from an arm's length price arising due to this motive should therefore be classified as a constructive dividend. The exceptional circumstances mentioned in paragraph 4.2, where transfers are made by a profit centre or there are expectations of low-cost services in return, should however still be considered for classification as a constructive loan.

4.3.2 External motives

4.3.2.1 Difference in corporate income tax rates and the avoidance of duties

As discussed in paragraphs 2.4.2.1 and 4.2.2.1, multinational groups could exploit differences in policies and tax rates between countries in order to minimise international taxes (Lin & Chang, 2010:2) and maximise profits for their shareholders (Cristea & Nguyen, 2013:26) by moving accounting profits (Li & Balachandran, 1996:191) or by the misclassification of products to circumvent export duties (Goetzl, 2005:9). By moving the profits, the companies are subjecting their profits to the risks of the global business (PepsiCo v CIR, 2012, Shedd v CIR, 2000 and Schlemmer v Viljoen en Andere, 1958). As described in paragraph 3.2.3.1, they would be expecting a high return because of an increase in profits (due to the saving in taxes) and also a possible increase in competitiveness. It is therefore submitted that the group is investing their time and money in order to share in the future profits of the multinational group. This is substantiated by the fact that both Kocieniewski (2011:7) and Tax War (2014:8) have explained that profits are moved to save in taxes and thereafter share in the profits by way of a return in dividends.

In order to classify the adjustment as a constructive dividend, there would have to be a transfer of a benefit by a company to or on behalf of a shareholder, whereas for classification as a constructive equity contribution there should be a transfer of a benefit by the shareholder to the company (Table 4.2). According to Tax War (2014:6) it is possible that a parent company could attempt to shift profits to its subsidiary situated in a tax haven (a country with low tax rates). Under these circumstances, it may be said that a benefit has been transferred by the shareholding company (the parent) to its subsidiary in order to share in the future profits, increased by the saving in taxes. The

economic substance under these circumstances could warrant treatment as a constructive equity contribution.

Nonetheless, should the profits be transferred where neither of the companies hold shares in the other, it could be argued that this was effected under the overall control of the parent company and therefore on behalf of the latter. This characteristic is however not one of the characteristics of a constructive equity contribution, but is one described by the submitted definition of a constructive dividend in Table 4.2 and in Shedd v CIR (2000). If the company receiving the transfer holds shares in the company making the transfer, a benefit would have been received by a shareholder constituting a constructive dividend. It can be argued that the latter would be possible if the benefit received is regarded as a reward for the investment in the group to maximise profits. This is in line with paragraph 4.3.1.2 where it was observed that the benefit would be transferred by the subsidiary to the group as its shareholder. It should nevertheless still be determined whether an obligation exists to provide anything to the transferring entity in return, as this will lead back to the classification as a constructive loan.

In conclusion, the decisive factor for this motive would be whether profits are moved to a company constituting a shareholder, or if the profits are moved by a shareholder. If the company receiving the benefit were a shareholder in the company transferring the benefit, the economic substance of the transaction would constitute a constructive dividend as a transfer is made for the benefit of the shareholder (greater group) and no counter performance is required. It is submitted that the benefit transferred would only warrant classification as a constructive equity contribution if the parent company, as the shareholder, moves the profits to a company in the group. It can be argued that since 66% of companies indicated tax risk management as their highest priority (EY, 2013:15) and since maximising profits for the shareholders through saving in taxes is the principal goal of a multinational group (Lin & Chang, 2010:2; Cristea & Nguyen, 2013:26), a benefit transferred between these companies would warrant classification as a constructive dividend resembling the sharing in future profits because of their commitment to the group; whether as a shareholder or on behalf of the parent company as the shareholder. The latter substantiates why assistance provided to a company, as discussed in paragraph 4.3.1.2.b, is more likely to be considered a constructive dividend, not merely a constructive equity contribution.

4.3.2.2 Foreign exchange restrictions and the risk of devaluation of currency

As discussed in paragraphs 2.4.2.2 and 4.2.2.2, companies in a multinational group can move their profits out and prevent losses despite the devaluation of the currency of a country (Chan & Chow, 1997:101; Eden, edited by Reuter, 2012:214). It was also observed in paragraph 4.2.2.2 that the multinational group would be preventing possible losses in order to maximise profits for the benefit of the shareholders (Lin & Chang, 2010:2; Cristea & Nguyen, 2013:26; Eden, 2001:597) in the form of future dividends (Kocieniewski, 2011:7; Tax War, 2014:8). In paragraph 4.2.2.2, it was determined that the circumvention of foreign exchange restrictions should be treated as though no circumvention has occurred, and be classified according to the original expense.

In order to classify the adjustment, due to the devaluation of currency, as a constructive dividend, there would have to be a transfer of a benefit by a company to or on behalf of a shareholder, while for classification as a constructive equity contribution, there should be a transfer of a benefit by the shareholder to the company (Table 4.2). As with the discussion and conclusion in paragraph 4.3.2.1, classification of the amounts transferred as constructive dividends could be warranted, as the benefit could be received by a shareholding company or on behalf of a shareholding company and could be seen as a reward for the commitment to the goals of the group. Once again, classification of this amount as a constructive equity contribution would be the exception rather than the rule, as it would have to be the transfer of an amount by the parent company (assuming that the parent company is situated in the country with the devaluation risk). If the amount is transferred by any other company holding shares in the company receiving it, it is debatable whether the intent would be to invest in that company rather than just to maximise the profits of the group by preventing a loss due to devaluation.

In conclusion, a deviation arising from this motive would probably be classified as a constructive dividend; only under exceptional circumstances would it be regarded as a constructive loan (repayment is expected) or a constructive equity contribution (transfer made by a parent company).

4.3.2.3 Political risk and capital flight

As indicated in paragraphs 2.4.2.2 and 4.2.2.3, multinational groups may transfer wealth out of a country to avoid the erosion of future value in times of political uncertainty (Lensink *et al.,* 2000:74; Mohamed & Finnoff, 2004:3 and Eden, 2012:215). The economic profits of the multinational group should therefore be stabilised (Lin & Chang, 2010:4). In paragraph 4.2.2.2, it was mentioned that either the investment could be discontinued or that a decrease in it could occur (Petrović & Stanković, 2009:12). As was pointed out in paragraph 4.2.2.2, the intention would be to permanently withdraw an investment if the investment is discontinued, but this could be temporary if the investment is only decreased. The latter could be an indication that only accumulated wealth was withdrawn.

In order to classify the adjustment as a constructive dividend there would have to be a transfer of a benefit by a company to or on behalf of a shareholder, whereas for classification as a constructive equity contribution there should be a transfer of a benefit by the shareholder to the company (Table 4.2). It is submitted that only a shareholder, in this case assumed to be the parent company, would be able to withdraw accumulated wealth or discontinue an investment. It is therefore argued that for this motive it is unlikely that there would be a transfer of a benefit by a shareholder to the company and that the deviation arising due to this motive is therefore unlikely to be classified as a constructive equity contribution.

The withdrawal of the accumulated wealth, which would have to be determined by deducting the original investment, could be the transfer of a benefit to a shareholder or on behalf of the shareholder (the parent company). This would warrant classification of a deviation, arising under these circumstances, as a constructive dividend. If the shareholder however withdraws the entire investment (discontinues it) this would constitute a return of equity. This is not currently one of the alternatives suggested by the OECD guidelines, but seems like the best fit for the economic substance of the deviation, from the arm's length principle, that would arise. If the secondary transaction were classified as a return of capital, paragraph 76B of the Eighth Schedule to the Act should be considered to determine whether a secondary adjustment in the form of capital gains tax could arise. It is submitted that because both a constructive dividend and a constructive return of equity would possess similar characteristics and no formal

allocation would be made in a transfer pricing adjustment, it would in reality not be possible to determine the funds from which such a transfer is made. From an administrative point of view, it is therefore suggested that the classification of the deviation from the arm’s length price for this motive would be a constructive dividend.

4.3.3 Conclusion: constructive dividends and constructive equity contributions

From the discussion above it may be deduced that the economic substance arising due to the internal and external motives of a multinational group can be mostly classified as a constructive dividend since the transactions will normally be carried out for the benefit of the greater group to which an entity belongs; only in exceptional circumstances will it be regarded as a constructive equity contribution if a specific entity invests in another group entity in which it holds shares. It has been mentioned numerous times that the companies in a multinational group work in tandem to achieve the principal goal of maximising the profits for the shareholders, under the control of the parent company. As the latter makes all the key decisions, this offers a logical explanation as to why the finding suggest that a deviation arising from a motive could be classified as a constructive equity contribution if the benefit is transferred by the parent company as the representative shareholder of the group. In terms of the group strategy, it can therefore be said that any of the companies participating receives rewards for maximising the profits of the group in the form of constructive dividends. This conclusion is in line with the trend that most countries prefer the constructive dividend as a secondary transaction (European Commission, 2013:3), as well as the reason that South Africa is considering adjustment (National Treasury, 2014:172).

4.4 CONCLUSION

In this chapter the possible economic substance of a deviation arising due to a specific motive has been compared to the characteristics of the alternatives for secondary transactions suggested by the OECD guidelines (specific objective 4). The aim of this chapter was to determine whether deviations from the arm’s length principle could, in all circumstances, be classified as constructive loans, as is currently the case under Section 31(3) (the primary research problem). It was concluded that the constructive loan could be applied as a secondary adjustment, but only in exceptional circumstances. These include the expectation that low-cost services would be provided

to the company making the transfer and if the said company is a profit centre for which performance evaluation depends on its profits. In both these circumstances repayment in some form would be expected. These exceptions could however only be applied if they adhere to the principal strategy of the multinational group.

The general objective of this study was to establish whether the appropriate treatment of secondary adjustments in South Africa is a constructive loan or whether other alternatives should be considered. It was established that the constructive dividend could be applied where the company receiving the benefit is considered a shareholder or as receiving it on behalf of the parent company. The constructive equity contribution alternative would only be applied if the parent company were making the transfer. In summary, the findings of the discussion in this chapter indicated that the following secondary transactions would be most appropriate for adjustments arising due to the various motives:

Table 4.3: An illustration of the secondary transactions and adjustments suggested for the economic substance of a deviation from the arm's length principle arising from the motives by multinational groups when setting transfer prices

Motive	Characteristics of secondary transaction	Secondary adjustment
Performance evaluation of profit centres and motivation of managers	Constructive dividend	Dividends tax
Entering into a new market	Constructive dividend Constructive equity contribution (parent to subsidiary); or Constructive loan – in exceptional circumstances	Dividends tax None Interest
Assisting a company with its efficiency in difficult economic circumstances	Constructive dividend; or Constructive equity contribution (parent to subsidiary); or Constructive loan – in exceptional circumstances	Dividends tax None Interest

Motive	Characteristics of secondary transaction	Secondary adjustment
Differences in corporate income tax rates and the avoidance of duties	Constructive dividend; or Constructive equity contribution (parent to subsidiary); or Constructive loan – in exceptional circumstances	Dividends tax None Interest
Foreign exchange restrictions	No secondary transaction – classified as original expense	None
Prevention of losses due to the devaluation of a country's currency	Constructive dividend; or Constructive equity contribution (parent to subsidiary); or Constructive loan – in exceptional circumstances	Dividends tax None Interest
Political risk	Discontinued investment - Return of capital; or Withdrawal of wealth – constructive dividend	Possible capital gain tax in terms of paragraph 76B of the Eight Schedule to the Act Dividends tax

It can be deduced from Table 4.3 that both the direction of the transaction and the motive would determine the economic substance. The study has demonstrated that none of the alternatives suggested by the OECD guidelines can be completely disregarded, since exceptional circumstances could change the economic substance arising from a motive and therefore also its classification. As transfer pricing mostly involves the transfer of goods and services, and operations from which goods or services can be transferred are often found in the subsidiaries (rather than the parent company), it is submitted, by the researcher, that the constructive dividend would in most cases be the appropriate treatment of deviations from the arm's length principles, as the subsidiary would be transferring a benefit to the group (its shareholder). The constructive dividend is therefore considered suitable in most cases, but further

research is suggested to determine how the exceptions for classification as a constructive loan or constructive equity contribution could be provided for in the Act.

CHAPTER 5: CONCLUSION AND RECOMMENDATION

5.1 INTRODUCTION

For years of assessment commencing on 1 April 2012, Section 31(3) of the Act was amended to regard secondary transactions as constructive loans giving rise to deemed interest (secondary adjustment). If the constructive loan is not repaid, indefinite interest may be attracted. The problem statement in respect of this study was therefore to determine whether a constructive loan is the appropriate treatment of a secondary transfer pricing transaction in the South African context (paragraph 1.4, Chapter 1). The general objective of this study was to determine if the appropriate treatment of secondary transactions in South Africa is that of a constructive loan with deemed interest (secondary adjustment), or whether other alternatives should be considered (paragraph 1.5.1, Chapter 1).

In order to answer the problem statement, the following secondary objectives were set (paragraph 1.5.2, Chapter 1):

1. A critical analysis of the impact of the current treatment of secondary adjustments in terms of Section 31(3) on taxpayers;
2. An investigation of possible motives of multinational companies to manipulate transfer prices;
3. Analysing the characteristics of the alternatives available for secondary transactions and therefore secondary adjustments; and
4. Identifying the secondary transaction and secondary adjustment that would best describe the economic substance of a deviation from the arm's length principle arising from each motive for transfer pricing manipulation.

The conclusions reached in respect of each of the objectives are discussed here, with reference to the previous chapters.

5.2 A CRITICAL ANALYSIS OF THE IMPACT OF THE CURRENT TREATMENT OF SECONDARY ADJUSTMENTS IN TERMS OF SECTION 31(3) ON TAXPAYERS

The first of the secondary objectives; a critical analysis of the impact of the current treatment of secondary adjustments in terms of Section 31(3) on taxpayers, was considered in Chapter 1. Transfer pricing adjustments take place when a local company is undercharging or being overcharged for goods or services provided to or received from a connected party (paragraph 1.1.1, Chapter 1). A primary adjustment is effected by a tax administration to correct the allocation of taxable profits (paragraph 1.1.3, Chapter 1) after which a secondary transaction is created to make the actual allocation of profits consistent with the primary adjustment (paragraph 1.1.4, Chapter 1).

For years of assessment ending prior to 31 March 2012, the treatment of a transfer pricing secondary transaction was as a constructive dividend, with the effect of a secondary adjustment in the form of STC (paragraph 1.1.2, Chapter 1). From 1 April 2012, the treatment was changed to the secondary transaction taking the form of a constructive loan, with the effect of a secondary adjustment in the form of interest (paragraph 1.1.2, Chapter 1). Except for the explanation by SARS that the objective of the amendments is to modernise the transfer pricing rules in line with the OECD and international tax principles, there was no actual clarification provided as to why the secondary transaction should now be treated as a constructive loan instead of a constructive dividend (paragraph 1.1.4, Chapter 1). If the primary adjustment is not immediately repaid, the secondary transaction, treated as a constructive loan, may have an effect on subsequent years by attracting indefinite interest and therefore possible indefinite secondary adjustments (paragraph 1.3, Chapter 1). This explanation led to the general objective (paragraph 1.5.1, Chapter 1) and primary research problem (paragraph 1.4, Chapter 1) of the study: to establish whether the constructive loan is the appropriate treatment of secondary transfer pricing transactions in South Africa. In order to determine this, it was established that the possible economic substance arising from motives for transfer pricing manipulation by multinational groups would have to be compared with the characteristics of the alternative secondary transactions suggested by the OECD guidelines.

5.3 AN INVESTIGATION OF POSSIBLE MOTIVES OF MULTINATIONAL COMPANIES TO MANIPULATE TRANSFER PRICES

The second of the secondary objectives; that of investigation the possible motives of multinational companies to manipulate transfer prices, was discussed in Chapter 2. The OECD suggests that the economic substance of a transaction may derive from the relationships between the connected companies in a multinational group (paragraph 2.1, Chapter 2). A multinational group may be defined as a parent company with affiliates in the form of branch operations or subsidiary companies where the activities undertaken by these entities would take place within a framework of group policies and strategies subject to the control exercised by the parent company (paragraph 2.3, Chapter 2). Companies in the group are all either directly or indirectly connected (paragraph 2.3, Chapter 2). By combining the submitted definition of a multinational group and the connected party definition in the Act, it was established that the following relationships might exist between a parent and its subsidiaries (paragraph 2.3, Chapter 2):

- A parent company (or its branch) holding 100% of the equity shares of, or voting rights in, a subsidiary;
- A parent company (or its branch) holding more than 50% but less than 100% of the equity shares of, or voting rights in, a subsidiary (for example, a subsidiary with minority shareholders);
- Two subsidiaries managed and controlled by the same parent company;
- A subsidiary (controlled by a subsidiary of the parent) (indirect shareholding) and a parent company.

These relationships will influence the economic substance as they will determine the direction of the transaction, for example a transfer made by a parent company to its subsidiary or *vice versa*.

It was further established that the subjective economic substance arising due to the relationships between the connected companies is able to be determined by reference to the motives of multinational groups when setting transfer prices. The following

internal and external motives of such groups were examined (paragraph 2.4, Chapter 2):

- Performance evaluation of profit centres and the motivation of managers: Multinational groups might affect adjustments to the profit of a profit centre, as the performance evaluation of the manager depends on it and the manager has to be motivated to maximise the profits of the group.
- International and operational objectives: This is the objective of a multinational group either to gain market entry or to assist a market leader during financial difficulty.
- Differences in corporate income tax rates and avoidance of duties: The differences between the corporate tax rates of different countries create a significant incentive for multinational groups to move reported profits to a country with a lower tax rate. Companies may also under-invoice imports in order to avoid export duties.
- Hedging (foreign exchange control risk and political risk): If a company has difficulty moving money out of a country due to foreign exchange control restrictions or wants to avoid losses due to the devaluation of the local currency, the manipulation of prices would be a method to circumvent the risks. A multinational group might also manipulate prices to move money out of a country with political and economic risk.

By investigating the relationships and motives, and therefore the subjective economic substance, a comparison with the characteristics of the suggested alternatives could be made to determine classification of the secondary transaction.

5.4 ANALYSING THE CHARACTERISTICS OF THE ALTERNATIVES AVAILABLE FOR SECONDARY TRANSACTIONS AND THEREFORE SECONDARY ADJUSTMENTS

The third of the secondary objectives, analysing the characteristics of the alternatives available for secondary transactions and therefore secondary adjustments, was discussed in Chapter 3. The alternative forms available for secondary transactions are constructive dividends, constructive loans or constructive equity contributions (paragraph 3.1, Chapter 3). Currently, South Africa classifies secondary transactions as constructive loans, but is considering reverting to treating them as constructive

dividends (paragraph 3.1, Chapter 3). Each of the alternatives was discussed in detail, both with reference to theory and by way of example.

In order to classify the economic substance arising due to a specific motive, as a constructive loan, there must be an intention to create an unconditional obligation to repay advances, irrespective of the availability of accumulated earnings or the risks of the company (paragraph 3.2.1.1, Chapter 3). The treatment of the secondary transaction as a constructive loan then gives rise to a secondary adjustment in the form of deemed interest (paragraph 3.2.1.2, Chapter 3). The latter may lead to an administrative burden for SARS and continuous taxes and secondary adjustments for the taxpayer (paragraph 3.2.1.3, Chapter 3).

In order to classify the economic substance, arising due to a specific motive, as a constructive dividend, there must be the transfer of a benefit with a monetary value by a resident company. This in turn must lead to a decrease in assets or a loss suffered by the said company, in respect of a share in that company for the benefit of or on behalf of a shareholder, without any counter performance required (paragraph 3.2.2.1, Chapter 3). The treatment of the secondary transaction as a constructive dividend then gives rise to a secondary adjustment in the form of dividends tax (paragraph 3.2.2.2, Chapter 3). Dividends tax is a once-off payment that does not lead to indefinite taxes and an administrative burden for SARS (paragraph 3.2.2.3, Chapter 3). A dividend may be classified as either a dividend *in specie*, or a dividend other than a dividend *in specie* (paragraph 3.2.2.2, Chapter 3). The latter will determine whether the dividend tax is payable by the resident company or withheld from the amount paid to the company receiving the dividend (paragraph 3.2.2.2, Chapter 3).

The final form available for a secondary transaction is a constructive equity contribution. In order to classify the economic substance, arising due to a specific motive, as a constructive equity contribution, there should be a transfer of property or funds by a shareholder to a company in order to increase their participation in management and to eventually share in the profits of the company, without any contractual obligation on the company to make repayments to the shareholder (paragraph 3.2.3.1, Chapter 3). The treatment of the secondary transaction as a constructive equity contribution does not give rise to any immediate tax consequences and therefore no secondary adjustment arises (paragraphs 3.2.3.2 and 3.2.3.3, Chapter 3).

The characteristics established for each of the secondary transaction alternatives suggested by the OECD could subsequently be applied to the possible economic substance arising due to the motive of a multinational group to manipulate transfer pricing.

5.5 IDENTIFYING THE SECONDARY TRANSACTION AND SECONDARY ADJUSTMENT THAT WOULD BEST DESCRIBE THE ECONOMIC SUBSTANCE OF A DEVIATION FROM THE ARM'S LENGTH PRINCIPLE ARISING FROM EACH MOTIVE FOR TRANSFER PRICING MANIPULATION

In Chapter 4, the fourth of the secondary objectives, namely identifying the secondary transaction and secondary adjustment that would best describe the economic substance of a deviation from the arm's length principle arising from each motive for transfer pricing manipulation, was discussed. Additionally, in Chapter 4, the possible economic substance that could arise due to a specific motive (established in Chapter 2) was compared with the characteristics of the alternatives established in Chapter 3. It was accepted that an adjustment had already been effected in terms of Section 31 of the Act because a tax benefit was enjoyed in South Africa, due to the transfer of a benefit deviating from the arm's length principle, between connected parties (paragraph 4.1, Chapter 4). The methodology described (paragraph 4.1.1, Chapter 4) was to evaluate whether the constructive loan would be applicable to all deviations arising due to the motives and, if not, whether any of the other alternatives could be considered.

It was determined that the constructive loan could apply in the exceptional circumstances where low-income services are expected in return or where a profit centre made the transfer and would expect repayment due to its performance evaluation, depending on its profits (paragraph 4.2.3, Chapter 4). This would, however, have to be considered in terms of the principal strategy of the multinational group, as it could never be to the disadvantage of any of the companies in the group (paragraph 4.2.3, Chapter 4).

After establishing that the constructive loan could only apply in exceptional circumstances, a comparison of the economic substance arising from specific motives was made with the characteristics of the other two alternatives, namely constructive

dividends and constructive equity contributions (paragraph 4.3, Chapter 4). It was determined that the constructive dividend could apply to most of the motives, as it could be said that the companies in the group are rewarded for their contribution to the principal strategy of the group to maximise profits for the shareholders (paragraph 4.3.3, Chapter 4). Findings suggest that the constructive equity contribution alternative be applied if the benefit is transferred by the parent company, as the group is under the general control of the parent company (paragraph 4.3.3, Chapter 4).

5.6 SUGGESTIONS FOR FURTHER RESEARCH

From the study, it was concluded that the constructive loan and constructive equity contribution alternatives could apply, but only in exceptional circumstances (paragraph 4.4, Chapter 4). It is, therefore, suggested that further research should be performed to determine how the Act could provide for these exceptions. It is also further recommended that a determination should be made as to whether it would be sensible for the Act perhaps to make provision for secondary transactions to be considered in terms of the motives of a multinational group.

A limitation of this study was the separate consideration of each motive; therefore the findings of this study might be different if a combination of motives leads to the manipulation of prices. The group structure considered consisted of only companies in the form of a parent company and its subsidiaries. Future studies should investigate the possible outcome if more than one alternative influenced the same transfer price and if juristic persons other than companies were considered as part of the group structure.

5.7 CONCLUSION

The outcome of the study, and therefore the answer to the primary research problem (paragraph 1.4, Chapter 4), was that secondary transactions could only be classified as a constructive loan in exceptional circumstances; where low-income services are expected in return or where a profit centre made the transfer and would expect repayment due to its performance evaluation, depending on its profits (paragraph 4.2.3, Chapter 4). Since it was established that the constructive loan would not always apply, consideration was given to whether the other alternatives could be applied. It was established that the constructive equity contribution would only apply where the transfer is made by the parent company, as the relationships among the companies would

influence the economic substance of the deviation from the arm’s length principle (paragraph 4.3.3, Chapter 4).

The study demonstrated that secondary transactions would, in most circumstances, be classified as a constructive dividend, with dividends tax as the secondary adjustment (paragraph 4.2.3, Chapter 4). The latter is warranted by the fact that it may be said that the companies in the group are rewarded for their contribution to the principal strategy of the group to maximise profits for the shareholders.

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