2017 Southern African Accounting Association
Biennial International Conference Proceedings
Champagne Sports Resort
Drakensberg
SOUTH AFRICA
(ISBN 978-0-620-74762-2)
http://www.saaa.org.za/

TAX008 **The challenges faced by developing countries regarding transfer pricing**

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ABSTRACT:

This research report aims to highlight the challenges which developing countries face regarding transfer pricing as well as the steps that these developing countries can take in order to address these challenges.

The growth of multinational enterprises has led to much-needed economic growth in developing countries, resulting in job creation, reduction of poverty and a decline in government expenditure and therefore a decline in government debt resulting in much more wealthier countries. The growth of multinational enterprises has also resulted in the growth of intercompany transactions as well as cross border transactions. The growth of cross border transactions has led to an erosion of the tax base from the countries which need the taxes revenues the most, such as developing countries. The erosion of the tax base in developing countries has led to increasing regulations regarding transfer pricing. The regulation of transfer prices may lead to a loss of foreign direct investment which developing countries need, therefore resulting in a trade-off for these developing countries.

The research method adopted for this research report is of a qualitative, interpretive nature and is based on a detailed interpretation and analysis of various sources including an extensive literature review.

This research report finds that even though developing countries face numerous challenges with regards to transfer pricing, these countries have progressed in terms of their transfer pricing legislation and regulations as these regulations are in line with OECD recommendations.

Key words: Transfer pricing, developing countries, multinational enterprises (MNEs), foreign direct investment (FDI), BRICS

INTRODUCTION

Globalisation has contributed significantly to the increase in foreign direct investment into developing countries (Worasinchai and Bechina 2010:171). Multinational enterprises (MNEs) have contributed to economic growth and welfare in developing countries through job creation and increased buying power by local citizens, leading to increased tax revenue, increased exports, improved infrastructure and significant technological advancements (Worasinchai and Bechina 2010:172).

Transfer pricing is part of MNE operations and it cannot be said that all transfer pricing activities are tax avoidance activities. In this research report 'transfer price' is used to mean:

> a price adopted for bookkeeping purposes which is used to value transactions between affiliated enterprises integrated under the same management at artificially high or low levels in order to effect an unspecified income payment or capital transfer (OECD 2007:801).

A closer evaluation of transfer pricing still needs to be made, regardless of the fact that transfer pricing is incidental to MNEs operations, because of the abuse of transfer pricing over the past number of years. MNEs can distort transfer prices in order to ensure that profits are reflected in specific jurisdictions resulting in the erosion of the tax base of the countries from which the profit has been shifted. Transfer mispricing reduces a country's tax revenue resulting in a decline of much-needed economic growth for developing countries (Jantjies 2015:20).

Ideally, developing countries would like to protect their tax bases while still ensuring that foreign direct investments into these countries are not adversely affected (Silberztein 2010). The increased popularity of the use of complex structures by MNEs to avoid tax in certain jurisdictions by using transfer pricing has led to losses in tax revenues of those under-resourced countries and that has resulted in economic challenges for resource-constrained developing countries.

Research Problem

The aim of this research report is to address the following research problem:

What steps can developing countries take in order to address the challenges of transfer pricing without impeding foreign direct investments and how is South Africa addressing transfer pricing?

In addressing the above-mentioned problem the report will address the following sub-problems:

- What are the difficulties faced by developing countries when designing tax policies that take into account global trade and the growth of MNEs?
- What structures are used by MNEs to shift profits into low or no tax jurisdictions?
- How can developing countries address their unique transfer pricing difficulties?
- What steps have developing countries taken in addressing base erosion and profit shifting and are these in line with the recommendations made by the Organisation for Economic Co-operation and Development (OECD) and/or the United Nations (UN)?
- Is South Africa's transfer pricing regime adequate?

Importance

Transfer pricing by MNEs in developing countries presents itself with challenges for the country. The developing country needs to strike a balance between maintaining its competitive advantage as well as ensuring wealth remains within the country to generate the tax revenue needed for further economic growth. (Jantjies 2015: 18)

Developing countries face administrative challenges when mitigating tax avoidance schemes that MNEs may be entering into. Another administrative burden is the difficulty faced by some governments in obtaining relevant information from MNEs due to the inability to determine what information is relevant. (Lohse, Riedel and Spengel 2012:6)

The Organisation for Economic Co-operation and Development (OECD) provides guidelines on how countries should deal with transfer pricing and the type of tax laws that should be in place to regulate transfer pricing (Baxter 2015). The OECD guidelines only apply to OECD member countries, which are mostly developed countries. However, other developing countries have adopted the application of these guidelines such as the BRICS countries (Silberztein 2010). The United Nations has developed a manual for transfer pricing for developing countries (Baxter 2015).

South Africa has developed extensive legislation to address transfer mispricing and tax abuse behaviour. However, limited resources of the South African Revenue Service's transfer pricing department may limit the effectiveness of the legislation (Hattingh 2015:9).

Research Methodology

The research method adopted is of a qualitative, interpretive nature, based on an extensive literature review and an analysis will be undertaken in order to determine the challenges that developing countries face as well as the advancements they have made with regards to transfer pricing legislation and regulation in comparison to OECD and UN recommendations on transfer pricing.

Scope and Limitations

The research report will focus specifically on transfer pricing in developing countries from an income tax point of view. The developing countries that will be considered are the BRICS countries (with particular focus on South Africa) due to the similar economic challenges they face such as unemployment, lack of skills and other resources as well as the common economic objectives they share (Vijaykumar, Sridharan and Rao 2010:2). Russia, India, China and South Africa have adopted some of the OECD guidelines on transfer pricing and base erosion and profit shifting (OECD 2014).

THE IMPORTANCE FOR DEVELOPING COUNTRIES TO REGULATE TRANSFER PRICING

Transfer pricing is inherently subjective because of the reliance on facts and circumstances, a focus on substance over form and the use of price ranges. The subjective nature of transfer pricing requires transfer pricing to be regulated. Transfer pricing is one of the most complex and technical topics in taxation. Transfer pricing requires both technical skills and sectoral expertise both of which require training and resources in developing countries. A benefit to the implementation of transfer pricing regulations is a strengthening of the way in which revenue administration treats large taxpayers. (Stern 2013:4)

The impact of growth in the number of MNEs on transfer pricing

Intercompany transactions may allow MNEs to shift income from one jurisdiction to another; usually from a high tax jurisdiction to a low tax jurisdiction. The shifting of income by MNEs between jurisdictions may result in lost tax revenues for some governments. Governments are introducing and extending transfer pricing regulations in order to reduce profit shifting through intercompany transactions (Lohse, Riedel and Spengel 2012:1). The growth of related party transactions has led to the development and expansion of transfer pricing regimes in developing countries becoming a priority (Curtis and Todorova 2012:5). Developing economies are increasingly becoming aware of the importance of introducing "robust" legislative and administrative framework to deal with transfer pricing issues (Curtis and Todorova 2012:5).

An unregulated transfer pricing regime could enable companies to transfer funds between jurisdictions and misprice these transfers in order to obtain a tax benefit. (Baxter 2015)

This section will explore the need and benefits for developing countries to regulate transfer pricing.

Transfer pricing was previously seen as an issue for developed countries but it has recently arisen as a concern for an increasing number of developing countries. The 2008 financial crisis forced ministers of finance and revenue authorities to rethink where their sources of tax revenue came from. (Stern 2013:1)

The importance of regulating transfer pricing

According to tax authorities across the world, not having a transfer pricing framework leads to an ad hoc treatment of multinational cross border transactions where tax revenue is foregone. Similarly, for MNEs the uncertainty with regards to the treatment of multinational cross border transactions could be seen as a barrier to investment into a country. For developing countries in particular, transfer pricing in is not only an instrument for the generation of revenue but it is also a pillar for the investment climate. Globalisation and rapid growth of cross border investments have forced developing countries to protect domestic tax revenues and to provide certainty by implementing transfer pricing frameworks even though these developing countries have little resources or capacity to implement the transfer pricing frameworks. (Stern 2013:1, 2)

MNEs manipulate prices of intercompany transactions resulting in profits being shifted to other tax jurisdictions resulting in tax revenue losses for one country. The primary objective for developing countries should be to adopt transfer pricing policies that will better enable them to prevent potential losses in tax revenue as a result of transfer pricing manipulation by MNEs. The prevention of tax losses by developing countries is of significant importance as the OECD estimates that between 30 percent and 60 percent of global trade is within MNE groups. (Stern 2013:3)

Many developing countries do not have large treaty networks because they have not implemented administrative procedures for taxpayers to access treaty protections leaving investors to bear the risk of potential double tax. The risk of double taxation decreases the attractiveness of the developing country as an investment location. A transfer pricing framework is important to ensure current and potential investors have clear and certain rules on compliance requirements, interest penalties and transfer pricing methodologies that are considered acceptable according to international standards. A clear transfer pricing framework is needed to allow businesses to properly assess the accounting and tax risk associated with actual and potential investments. In developing transfer pricing frameworks, developing countries need to ensure that the costs of compliance are kept at an appropriate level. Developing countries should have a clearly defined transfer pricing framework that matches the level of sophistication of their commercial activities to ensure that scarce resources are put to proper use. (Stern 2013:3)

Transfer pricing enforcement benefits from bilateral tax information exchanges but developing countries are still lagging behind most developed countries on the exchange of information. Regulating transfer pricing can assist developing countries in accessing information on taxpayers such as MNEs. (Stern 2013:4)

Transfer pricing compliance requirements represents a large portion of overall tax compliance costs. To minimise unnecessary compliance costs, documentation requirements should be appropriately tailored to suit the capacity and level of the assessed transfer pricing risk and should not differ from common practices. Minimising compliance costs is critical for developing countries as it will minimise deterrents to much needed foreign investment. (Stern 2013:5)

Transfer pricing legislation may assist in dealing with transfer pricing risks, but many developing countries do not have specific transfer pricing rules and those that do may need to strengthen their transfer pricing rules (OECD 2012:70). An adequate legal framework does not necessarily mean the legislation will be applied effectively and correctly (Stern 2013:3). It is critical for developing countries to be able to effectively identify high risk cases of transfer pricing to ensure that their limited resources are used effectively (OECD 2012:71). Many developing countries have inadequate or no transfer pricing enforcements and therefore these countries are probably not collecting their side of tax revenue from related party transactions (Stern 2013:3). Greater transfer pricing enforcements by developing countries is likely to result in a gradual increase in tax revenue collected by these developing countries (Stern 2013:3).

THE CHALLENGES FACED BY DEVELOPING COUNTRIES

MNEs contribute to the economic growth of countries through infrastructure development, innovation and job creation. In contrast to the contribution that MNEs make with respect to economic growth, some MNEs are responsible for shifting tax revenues from countries which need these revenues the most for further economic growth and poverty eradication (Mc Nair, Dotley and Cobham 2010:1-2). For this reason, developing countries need to develop effective transfer pricing legislation and regulation, however, developing countries face a number of challenges that they must overcome in order to do so.

This section will consider the challenges faced by developing countries in general regarding transfer pricing and a brief analysis will be made with regards to transfer pricing challenges faced by the BRICS countries. Some of the challenges that will be discussed in this section are:

- The resources and capacity which developing countries have to effectively administer transfer pricing. (Lohse, Riedel and Spengel 2012:6).
- The access or availability of comparable data that developing countries can use to regulate transfer pricing schemes which constitute tax avoidance schemes. (Deloitte 2015:198)

- The power imbalances between MNEs and developing countries in which they operate.

The lack of resources and capacity to regulate transfer pricing in developing countries

Revenue authorities in developing countries have a lack of capacity, expertise and bargaining power to effectively monitor transfer pricing transactions therefore the complexity of transfer pricing and MNE transactions presents a challenge for these revenue authorities. The lack of capacity by revenue authorities of developing countries to monitor transfer pricing transactions entered into by MNEs offers MNEs an opportunity to shift profits from these developing countries to other countries which are also known as 'tax havens'.. (Mc Nair, Dotley and Cobham 2010:1-2)

There is a general consensus that the main challenge facing developing countries that are implementing the arm's length principle is the lack of resources. (Curtis and Todorova 2012:9)

Power imbalances between MNE's and developing countries

A power imbalance is created when two revenue authorities have different transfer pricing expertise and have different capacity to administer transfer pricing transactions. Companies may have an incentive to apportion a greater portion of their profits on international transactions where the revenue authority has the greater capacity to administer transfer pricing in order to avoid disputes with a strong revenue authority which usually exists in a developed country. The impact of power imbalances between countries is likely to be a substantial factor in the challenges faced by developing countries regarding transfer pricing as it may result in a loss of tax revenue for developing countries. (Mc Nair, Dotley and Cobham 2010:2-10)

There are a lack of forums in developing countries to engage with about international tax and more specifically forums dealing with transfer pricing. The UN Committee of Experts on International Tax Matters (the UN Committee) is the only truly multilateral forum which developing countries can engage with on international tax. The challenges faced by developing countries regarding transfer pricing are broadly defined by the UN Committee as the lack of capacity to implement transfer pricing legislation and monitor any misuse of transfer pricing by MNEs whereas MNEs have the resources to enter into complex international transactions. (McNair, Dotley and Cobham 2010:8-9)

The lack of comparable data

The OECD (2010:18) recommends that the arm's length principle be used in assessing transfer pricing transactions. The arm's length principle is widely used internationally by both OECD and non-OECD countries. Developing countries have limited access to comparable data and therefore it is difficult for these countries to apply the arm's length principle. Some developing countries use data extracted from databases such as the European and United States databases as the comparable data in order to determine the appropriate transfer prices for certain transactions. The use of developed countries' databases by developing countries as a source for comparable data may be problematic because of the differences between developed and developing countries such as geographical locations and market conditions (Mc Nair, Dotley and Cobham 2010:10).

Identifying comparable transactions is often time consuming and sometimes impossible. It is difficult for developing countries to obtain comparable information for the following reasons:

- The number of companies in different sectors is few. (Curtis and Todorova 2012:8)
- Developing countries lack the resources to allow for proper analysis of transfer pricing activities therefore the comparable information may be incomplete. (OECD 2014:2)
- Existing databases on transfer pricing analysis usually contain data about developed countries which makes it difficult for developing countries to perform benchmark studies. (Curtis and Todorova 2012:8)
- The economies of developing countries have only started to open up very recently therefore there is limited information and comparable transactions. (Curtis and Todorova 2012:8)

The allocation of profits on international transactions between the entities and countries that participated in the transactions is the biggest challenge when it comes to transfer pricing. (Mc Nair, Dotley and Cobham 2010:3-8)

The arm's length principle

The assumptions behind the arm's length principle are that the tax of MNEs should be evaluated as though they are separate independent and unrelated entities. The assumptions behind the arm's length principle may be problematic because MNEs are frequently created in order to enter into transactions which may not be economically feasible between unrelated parties. The arm's length principle treats transactions between related parties as though they were entered into by unrelated parties. (Mc Nair, Dotley and Cobham 2010:8)

Another downside or challenge of the arm's length principle is that it does not always take into account economies of scale or other privileges that prevail for associated entities. (Lohse, Riedel and Spengel 2012:6).

To address the challenge of profit allocation, the arm's length principle will assist in determining the appropriate price that should have been paid or charged on the international transaction. The arm's length principle simply states that transactions between associated enterprises should not be distorted by the special relationship that exists between the parties. (OECD 2011:2). The arm's length principle ensures that profits made on international transactions by MNEs are properly allocated among the countries in which these MNEs operate while also avoiding double taxation. The implementation of the arm's length principle presents significant challenges not only for resource deprived developing countries but also for developed countries (Mc Nair, Dotley and Cobham 2010:3-8).

Intercompany transactions can be classified into four main categories namely; tangibles, intangibles, services and financing or cost sharing. Important factors influencing the determination of arm's-length price include the type of transaction under review as well as the economic circumstances surrounding the transaction. In addition to influencing the amount of the compensation, these factors may also influence the form of the payment. (PwC 2013:18)

Other challenges of determining the transfer price of intangibles is the fact that they are difficult to detect and are often transferred bundled along with tangible items (United Nations 2012:6).

The arm's length principle has given rise to different methods of determining transfer prices each of which is complex (Lohse, Riedel and Spengel 2012:9). The different methods of transfer pricing will be discussed below together with the limitation of each method which pose additional risks and challenges for the countries adopting the arm's length principle.

Comparable Uncontrolled Price Method (CUP)

The CUP method compares the price of an uncontrolled transaction with the price of a controlled transaction. An uncontrolled transaction is where the parties involved in the transaction are not affiliated and are themselves not part of the same group of companies. In order to use the CUP method, there must be comparable transactions and from these comparable transactions, the OECD outlines the characteristics which need to be considered for comparability. The comparable characteristics include, but are not limited to; product types, quality, availability, assets used and risks assumed contractual terms and economic circumstances. The limitation to the CUP method is the fact that it is not applicable to transactions involving intangible assets as intangibles are unique and thus it is difficult to find a comparable transaction in the market (Lohse, Riedel and Spengel 2012:9).

The growth of the intangible economy has opened new challenges for the arm's length principle (United Nations 2012:6) The challenges with transfer pricing of intangibles lies in the questions such as (Mc Nair, Dotley and Cobham 2010:3-8):

- How can intangibles such as brand recognition be valued within a particular market?
- How a comparable product can be identified against which the intangible can be valued given the unique nature of intangibles?
- How should the potential future value and risk be reflected if the intangibles are transferred between jurisdictions?

Resale Price Method (RPM)

Obtaining the transfer price using the RPM requires that the resale price of the good or service is obtained from a distributor. The resale price obtained from a distributer needs to be reduced by an appropriate gross margin. The RPM implies that the gross margins for all goods and services are comparable, which may not be a realistic conclusion (Lohse, Riedel and Spengel 2012:10). For this reason the RPM method is most suitable to sales and marketing operations such as those typically carried out by a distributor (OECD 2010:4).

Cost Plus Method

The cost plus method is similar to the RPM but instead of obtaining the resale price from a distributor, the cost plus method takes the perspective of a manufacturer. A mark up to the cost of goods sold is added in order to determine the arm's length price. The same limitations apply for the cost plus method as for the RPM. The critique which applies for the cost plus method is whether costs and mark ups are similar over different products and whether costs are even an appropriate starting point. (Lohse, Riedel and Spengel 2012:10)

Profit Split Method

Total profits accruing from controlled transactions are identified and split between associated companies forming part of the transaction using ratios that would have been used in an uncontrolled transaction. A limitation of the profit split method is that measuring the total profit may be a difficult task. Another limitation of the profit split method is that it is questionable whether profit allocation of independent companies provides appropriate ratios (Lohse, Riedel and Spengel 2012:11).

Transactional Net Margin Method (TNMM) and Comparable Profits Method (CPM)

In order to determine the transfer price of a transaction entered into by a taxpayer, both the TNMM and the CPM require a comparison of the taxpayer with a group of similar stand-alone companies. The stand-alone companies selected need to operate in the same field, perform similar functions and distribute comparable products. A challenge faced when applying either the TNMM or the CPM is that it is difficult to identify and quantify operating profits of transactions as these can be affected by many factors. (Lohse, Riedel and Spengel 2012:11)

Transfer pricing challenges in BRICS countries

The general challenges discussed above apply to all BRICS countries as they are developing countries. The challenges specific to the OECD guidelines on transfer pricing apply specifically to Russia, India, China and South Africa as these countries are the ones who apply the OECD guidelines to their own transfer pricing legislations whereas Brazil does not apply OECD guidelines in its transfer pricing legislation.

All BRICS countries, excluding Brazil, use the OECD guidelines on transfer pricing as a starting point in developing their own transfer pricing legislation. The Brazilian transfer pricing system is absolutely unique and differs from the rules found in the OECD guidelines on transfer pricing (Hattingh 2015:12).

Brazil's transfer pricing rules took effect on 1 January 1997, have been very controversial. Contrary to the OECD guidelines, Brazil's transfer pricing rules do not adopt the internationally accepted arm's-length principle. Instead, Brazil's transfer pricing rules define maximum price ceilings for deductible expenses on inter-company import transactions and minimum gross income floors for inter-company export transactions (PwC 2013:284).

Through the provision of safe harbours and exemptions, the transfer pricing rules in Brazil were designed to facilitate the monitoring of inter-company transactions by the Brazilian tax authorities while they develop more profound technical skills and experience in the domain, indicating that the Brazilian tax authorities may lack the necessary skills to regulate transfer pricing.While incorporating these transaction-based methods, the drafters of the Brazilian transfer pricing rules excluded profit-based methods, such as the TNMM and this is contrary to the OECD Guidelines (PwC 2013:284).

Brazil's complex tax structure, large tax burdens and high government spending have resulted in the increase in institutional risk and a decline in foreign direct investment. The unique transfer pricing rules in Brazil may increase a company's tax burden due to exposure to higher taxes and potentially a double taxation (Tinoco and Ayub 2014).

Russia's transfer pricing legislation and policies are influenced by the OECD guidelines on transfer pricing. The tax law in Russia and the interpretation of the tax laws by the Russian tax authorities is inconsistent. Due to the problems identified with the Russian tax laws, there is a reliance on the courts to develop tax law, however case law on transfer pricing does not exist in Russia (PwC 2013:5-9).

The Indian transfer pricing regulations are based on the arm's length principle. The Indian tax authority has experienced administrative challenges in respect of transfer pricing legislation. India relies on comparable data in the determination of an arm's length price; however, market price and commodity volatility in India and the rest of the world has resulted in comparability analysis being a challenge for the tax authorities.

The quantification of the incremental profits from location specific advantages (LSA) among associated enterprises is a challenge in transfer pricing as India believes that it provides certain LSAs which are not take into account in the determination of the arm's length price. The LSAs that India provides are; skilled labour, access to a growing market, a large customer base and a developed distribution networ. (PwC 2013:494).

Tax authorities in countries with low labour costs such as India and China often claim that some of the excess profits resulting from outsourcing should be taxable within their respective countries which are currently not being taken into account in the arm's length principle (Curtis and Todorova 2012:10).

MNEs want to improve efficiencies within their groups therefore this has resulted in MNE groups sharing resources internally and therefore increasing the number of intercompany transactions. The sharing of resources between MNE groups has resulted in an increase in intercompany service transactions. The determination of the arm's length remuneration on the intercompany service transactions has proved to be one of the main challenges for the Indian transfer pricing administration (United Nations 2012:11).

Cross border financing within MNE groups has increased therefore increasing the number of intercompany loans and guarantees. Transfer pricing of intercompany loans is considered to be one of the most complex transfer pricing issue in India. The main transfer pricing issue with intercompany loans is the benchmarking of these loans in order to arrive at an arm's length interest rate applicable to these loans (United Nations 2012:11).

Like many other African countries, South Africa is a resource rich country. South Africa has expressed concerns regarding the application of the arm's length principle as this principle attributes significant value to intellectual property (Curtis and Todorova 2012:10). The significant value placed by the arm's length principle on intellectual property may be unfair for a resource rich country in determining the tax base of a transaction attributable to that country. There has been significant debate over the past few years regarding the share of revenue between MNEs and African governments (Curtis and Todorova 2012:10). In attempting to address the challenge, the allocation of the tax base between intellectual property and physical resources, South Africa has recently passed amendments to its transfer pricing legislation to protect the country's natural resources (Curtis and Todorova 2012:10). The amendments to the South African legislation on transfer pricing will be explored in greater detail in Section Four.

Comparable data to be used when determining transfer prices is generally not available for South African companies. South Africa only has limited requirements for filing statutory accounts and these requirements are restricted to publicly listed entities which explain why there is little comparable data available (Deloitte 2015:198).

SARS still needs to receive additional human resource support to audit compliance with established transfer pricing legislation and guidelines (Hattingh 2015:16).

SOUTH AFRICA'S RESPONSE TO TRANSFER PRICING, PROFIT SHIFTING AND BASE EROSION

The development of transfer pricing legislation in South Africa

South Africa is one of the first countries in Africa to adopt specific transfer pricing rules that originated in 1995 (Deloitte 2015:7). The earlier rules of transfer pricing in South Africa provided SARS with the discretion to adjust the consideration paid or received if a transaction was not at arm's length (Deloitte 2015:7). Although South Africa first implemented transfer pricing regulation in 1995, SARS has only recently began to focus on transfer pricing (Curtis and Todorova 2012:22). The more outdated the 1995 transfer pricing rules in South Africa became, the more the South African government recognised the importance for updating the transfer pricing rules to be more in line with international standards (Deloitte 2015:7). South Africa began to incorporate into its transfer pricing legislation some transfer pricing rules followed in New Zealand and Australia which are both OECD member countries (Deloitte 2015:7).

The pronouncements made by the then Minister of Finance, Pravin Gordhan, in the 2012 Budget Speech with regards to transfer pricing led to amendments in South Africa's transfer pricing regulations which are contained in section 31 of the Income Tax Act 58 of 1962 (ITA) (Sweidan 2015).

Prior to the revised section 31 of the Income Tax Act 58 of 1962 (ITA), as amended, which took effect from 19 July 1995, transfer pricing was regulated by the compliance with article 9 of the OECD Model Tax Convention Treaty or its equivalent. Profits were either adjusted in terms of the general deduction formula if expenditure was grossly excessive, or in terms of the old section 103(1) of the ITA for general anti-avoidance.

Where property was disposed of for a consideration not constituting an arm's length amount, the Commissioner could deem it to be a donation in terms of section 58 of the ITA, resulting in the deemed donation being subject to donations tax at a rate of 20%.

Prior to the amendments made to section 31 of the ITA, SARS issued a Practice Note 7 (PN7) in 1999 which provides taxpayers with guidelines regarding transfer pricing. The documentation guidelines in PN7 reflect the OECD guidelines on documentation (Curtis and Todorova 2012:22). The guidelines in the PN7 are not legally binding which is considered to be one of the weaknesses in the transfer pricing regime of South Africa (Jantjies 2015:24).

In general, section 31 of the ITA, after the amendments, stated that all transactions should be concluded at arm's length and that any benefits received by the parties forming part of an intercompany transaction or a related party transaction should be treated as a dividend and taxed at a rate of fifteen per cent (Jantjies 2015:22). The transfer pricing section of the ITR14 corporate income tax return should be completed if any scheme, transaction, operation or agreement set out in section 31(1)(a) of the ITA has been entered into. The requirement to completing the transfer pricing section of the ITR14 removes the requirement that transactions must not have been at arm's length in order to fill out the transfer pricing section (Daya and Salusbury 2016).

The new transfer pricing legislation is more aligned to global standards and has extended SARSs' power to adjust not just the consideration but also the terms and conditions of non-arm's length transactions. The amendment of section 31 has resulted in the onus being placed on the taxpayer to prepare the taxpayers tax return on an arm's length basis here as under the previous legislation, the Commissioner or SARS had the discretion to adjust the consideration. The key issue is that the burden of proof has shifted from SARS to the taxpayer (Deloitte 2015:8,198).

Transfer pricing in South Africa has been through a series of incremental changes since the amendment of section 31 of the ITA in 2012. In 2014 South Africa saw draft legislation that sought to change the rules on benefits gained from related party transactions as a dividend which was enacted in early 2015 (Deloitte 2015:8,198).

South Africa also has legislative remedies supporting transfer pricing and combatting base erosion and profit shifting through the:

- Introduction of interest limitation rules and anti-avoidance rules for hybrid instruments;
- Introduction of broader withholding tax rules;
- Restrictions on deductions for certain intellectual property transactions;
- Exchange control restrictions impacting the ability to pay certain fees;
- Self-assessment provisions and inherent requirements for transfer pricing documentation;
- ITR14 and International Financial Reporting Standards (IFRS) disclosure requirements for cross border transactions;
- Stringent controlled foreign company rules;
- Davis Committee recommendations. (Deloitte 2015:10)

The above legislative remedies show the progress South Africa has made with regards to combatting profit shifting and base erosion.

On December 23, 2016, South Africa issued its regulations implementing the country-by-country reporting (CbCR) standards for MNEs. These regulations entrench CbCR requirements in SA's transfer pricing regime, and follow legislative changes in SA related to the OECD's Base Erosion and Profit Shifting (BEPS) initiative, specifically Action 13. The regulations are effective for tax years beginning on or after January 1, 2016. (PwC 2017:1) It is clear from the above that South Africa has made a lot of progress with regards to transfer pricing. On the other hand a lot more still needs to be done regarding transfer pricing legislation and regulation such as; addressing the skill challenges faced by SARS in order to be able to be effectively regulating transfer pricing as well as appropriately determining the arm's length price.

South Africa has also appointed a committee to consider the 15 action plans recommended by the OECD BEPS program from a South African perspective which has led to the publication of a series of reports by SARS and the Davis Tax Committee (Deloitte 2015:198). In the past few years, the challenges faced by both developed and developing countries regarding transfer pricing has been rigorously addressed by the UN and OECD (Baxter 2015). The recommendations made by the UN and the OECD regarding transfer pricing will be explored in greater detail in section 5. South Africa only has observer status at the OECD however some South African officials were involved in the work of the party that developed the OECD guidelines on transfer pricing and BEPS as well as the development of the UN work on transfer pricing (Baxter 2015).

On 15 December 2015, following the OECD's final report on the 15 Action Plan to Base Erosion and Profit Shifting, SARS issued a draft notice relating to transfer pricing documentation requirements to align the requirements to that of the recommendations in *Action 13 Report- Transfer Pricing and Country by Country Reporting* of the OECD's 15 Action Plan report. On 11 April 2016 SARS issued draft regulations which entrench country-by-country reporting in the domestic legislation. SARS also updated the ITR14 corporate income tax return which includes significant transfer pricing disclosure requirements such as a breakdown of intragroup interest royalties and service fees by jurisdiction (Daya and Salusbury 2016).

South Africa has already implemented and adopted many legislative remedies to counter base erosion and profit shifting and is advanced with disclosure requirements (Deloitte 2015:12). On 24 February 2016 the Minister of Finance, Pravin Gordhan, announced the introduction of a voluntary disclosure program. The voluntary disclosure program allows taxpayers with offshore assets and income to regularise their tax defaults and/or exchange control contraventions (SARS 2016). On 20 July 2016 legislation regarding the voluntary disclosure program was released by Treasury (KPMG 2016:1).

SARS (2016) has information exchange agreements which can be divided into four categories as follows:

- USA FATCA Intergovernmental Agreement: this is an agreement between the tax administrators of the United States of America and South Africa to exchange tax information automatically under the double taxation agreements between the two countries.
- Standard for Automatic Exchange of Financial Accounting Information: this is also referred to as common reporting standards. It is a global model for automatic exchange of information under the Model Competent Authority Agreement to which South Africa is a signatory.
- Multilateral Mutual Assistance Agreements: these are agreements between countries to exchange tax information and also assist in the collection of taxes.
- Bilateral Tax Information Exchange Agreements: these are agreements between the tax administrators of two or more countries to enable them to exchange tax information upon request.

South Africa has recruited and developed a dedicated transfer pricing audit team at SARS to audit potential transfer mispricing. The team at SARS focuses on auditing transactions and entities that are suspected of engaging in profit shifting activities (Hattingh 2015:23). The results from thirty audits conducted by the transfer pricing audit team at SARS has been a recovery of tax revenue of approximately R5.8 billion from the years 2012 to 2014 (Deloitte 2015:5). The transfer pricing audit team has also worked on double tax agreements or tax treaties and other international agreements with other countries (Hattingh 2015:23).

South Africa has robust measures through its controlled foreign company rules and exchange controls to compliment the already robust transfer pricing legislation (Deloitte 2015:12). South Africa's robust transfer pricing regime is not without weaknesses and difficulties some of which have already been discussed in the previous section.

Weaknesses in the South African transfer pricing legislation

Even though transfer pricing legislation has been updated, there are still some weaknesses in the legislation such as the lack of focus on non-residents (Hattingh 2015:24). Some of the weaknesses and areas for development in South Africa's transfer pricing regime are the following (Hattingh 2015:24):

- SARS has limited resources and capacity to implement the audit plan to audit transfer prices.

- There is a strong reliance on the use of alternative dispute resolution to resolve transfer pricing disputes as opposed to litigation, which gives a greater degree of certainty.
- There is no APA (Advance Pricing Agreement) programme in South Africa which encourages greater compliance and eases international trade and foreign direct investment.
- There is limited guidance on interactions with double tax agreements.
- There is still a lack of clarity as to whether transfer pricing documentation should be mandatorily or voluntarily be disclosed.

In the 2016 Budget Speech, it was noted that areas that would receive specific attention would be: unacceptable transfer pricing practices, treaty shopping and highly geared financing structures. The areas highlighted in the Budget speech to receive specific attention echoes the increased international focus on transfer pricing.

In the past few years, the transfer pricing challenges which face many countries have been “rigorously” addressed by the UN and OECD. South Africa has in place robust and comprehensive transfer pricing rules in accordance with best practice. However, as mentioned above South Africa’s transfer pricing regime still has its own challenges that still need to be dealt with.

RECOMMENDATIONS BY THE OECD AND UN ON HOW DEVELOPING COUNTIRES CAN ADDRESS THEIR TRANSFER PRICING DIFFICULTIES

This section will consider different recommendations made by different bodies such as the OECD and the UN, applying them for developing countries. The OECD guidelines on transfer pricing are however only applied by certain countries, most of which are developed countries. More and more developing countries such as South Africa are starting to implement the OECD guidelines in their tax legislation (United Nations 2013:22).

The first section will explore the recommendations made by the UN regarding transfer pricing challenges for developing countries. The second section will consider, in brief, the latest recommendations made by the OECD regarding transfer pricing which can be applied for developing countries.

Section one: UN Manual on transfer pricing for developing countries

Safe harbour rules limit or prevent the application of certain tax rules to certain taxpayers. Introduction of safe harbour rules may result in an increase in taxpayer certainty and a reduction in tax compliance and administration costs. The reduction in tax administration costs due to the safe harbour rules will allow the excess resources to be used to focus on non-compliance cases where higher tax revenue may be generated (United Nations 2013:22).

Many companies’ capital is made up of a much greater contribution of debt than of equity. It is usually more beneficial from a taxation viewpoint to hold more debt than equity due to the tax deduction the firm will get on the interest paid on the loan, whereas there is no deduction for dividends paid in many jurisdictions. Limitation rules can be introduced by countries which limit the amount of interest deduction in the determination of a taxpayer’s taxable income. The limitation of the interest deduction may limit the shifting of profits into different jurisdictions through excessive debts by way of intercompany loans (United Nations 2013:23-24).

A country can introduce controlled foreign corporation (CFC) rules in order to prevent taxpayers from shifting income into foreign companies incorporated in low tax jurisdictions. CFC rules will treat income from foreign corporations as taxable income in the taxpayer's resident company. CFC rules should only be applied on retained earnings of foreign subsidiaries (United Nations 2013:24).

An important element to the implementation of transfer pricing legislation is the documentation requirements. When countries decide on the documentation requirements, they should take into account the compliance costs which they are imposing onto the taxpayers which are required to produce the documentation. Another issue that countries need to consider is whether any benefits arise as a result of the documentation requirements and whether this benefit can be justified by the documentation burden placed on taxpayers.(United Nations 2013:24).

Advance pricing agreements or arrangements (APAs) are becoming popular with MNEs as these MNEs have often recently depended on APAs. APAs are pricing methodologies which countries can set in advance in relation to a certain type of transaction. APAs are considered by taxpayers to be one of the safest way to avoid double taxation. For developing countries, there are some advantages and disadvantages of introducing APAs as well as some implementation issues (United Nations 2013:24-25). The advantages, disadvantages and implementation issues of APAs will not be explored in this report.

An important part of transfer pricing legislation is the time which the law allows for transfer pricing audits and assessments. Countries should ensure that they do not set too long of a period which adjustments are possible because it may lead to taxpayers facing very large financial risks. Countries should ensure that the timing set for audits is in line with international standards in order to minimise the risk of double taxation. All countries, whether developing or developed, should have domestic transfer pricing regulation in order to eliminate or minimise double taxation (United Nations 2013:25).

Transfer pricing rules need to be enforced to ensure that all parties affected by the measures comply. Countries that do not effectively implement transfer pricing rules, may lose out tax revenues to countries which enforce their transfer pricing rules. (United Nations 2013:26)

The above-mentioned recommendations are not an exhaustive list of the recommendations made by the UN regarding transfer pricing for developing countries.

The principles of the OECD guidelines on transfer pricing have been largely adopted into the amended section 31 of the Income Tax Act.
SARS controls transfer pricing through section 31 by adjusting the price charged between multinational entities (where one of those entities is a tax resident) which are different to what would have been concluded at an arm's length basis between unrelated persons and to tax the entity concerned according to the adjustment, as well as raise penalties and interest.

In order to do this an international model of the arm's length principle, as set out in the OECD guidelines, has been adopted. SARS promotes the use of the OECD guidelines for such a purpose and prescribes that these guidelines are to be used in interpreting what an arm's length transfer price is in South Africa (Adams & Adams 2016:1).

South Africa also has regulation over CFC's in s9D of the Income Tax Act which addresses profit shifting risks by South African residents into lower tax jurisdictions.

Section two: OECD guidelines on transfer pricing.

This section will consider the latest recommendations made by the OECD with regards to transfer pricing.

The OECD action plan to transfer pricing and base erosion specifically addresses the transfer pricing documentation as well as transfer pricing of intangibles. In action 8, the OECD raises the importance of the arm's length principle and describes it as the cornerstone of transfer pricing rules. The arm's length principle provides a standard for tax administrators as well as taxpayers to evaluate transfer prices (OECD 2015:9).

In order to assess a transaction between associated enterprises, consideration should be made by analysing the contractual relations of the parties to the transaction as well as analysing the conduct of the parties (OECD 2015:10).

CONCLUSION

Transfer pricing is a complex issue not just for resource restricted developing countries but also for developed countries. Developing countries need to ensure that they regulate transfer pricing in order to protect their tax base while also ensuring that they do not impede foreign direct investment which they need for economic growth. The regulation of transfer pricing is essential for a developing economy, however regulating transfer pricing is not an easy task for developing countries as already addressed in this report. A balance needs to be found between regulating and protecting a country's tax base and allowing for greater economic growth.

The arm's length principle is a widely accepted tool for determining transfer prices. It is important that developing countries incorporate an element of the arm's length principle into their transfer pricing legislation to ensure the country maintains its global competitive advantage. The implementation of the arm's length principle is not an easy task for tax authorities in developing countries due to the lack of comparable information, the lack of skills and other resources to be able to effectively implement transfer pricing regulation.

South Africa also faces the transfer pricing challenges like any other developing countries; however South Africa is ahead of many developing nations when it comes to transfer pricing regulation. South Africa now has in place comprehensive transfer pricing regulations. A lot still needs to be done in South Africa with regards to transfer pricing despite the comprehensive rules currently in place such as developing skills within the transfer pricing division at SARS to be able to effectively collect tax due to it and investigate any transfer mispricing.

The OECD and the UN have played a major role in addressing the challenges faced by developing countries. Both the OECD as well as the UN echo the importance for a country's transfer pricing regulation to be in line with international standards through the application of the arm's length principle while also ensuring that the country's specific needs and challenges are addressed by the transfer pricing regulation.

It is important to note that there is no model or template transfer pricing legislation that works in every situation. Transfer pricing legislation should address the needs of a particular country. (United Nations 2013:60)

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