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AN INVESTIGATION INTO INTERNATIONAL TRANSFER PRICING GUIDELINES AND THE ANOMALIES ARISING FROM BUSINESS RESTRUCTURINGS BY MULTI-NATIONAL ENTERPRISES

A thesis in fulfilment of the requirements for the degree of

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Abstract

The number of multinational enterprises has increased substantially. In part due to the integration of national economies (the European Union), improvements in communication and technology and the opportunity to reduce costs as a result of globalisation. Transfer pricing and especially business restructuring within multinationals is a fairly new concept. Professional legal and audit firms have different views on how to approach business restructurings.

This research analyses important transfer pricing aspects and the anomalies that arise through business restructurings.

The research method used in this research paper is primarily qualitative, comprising the analysis of various documentary sources of data. Relevant South African and international case law, tax legislation, the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, the Transfer Pricing Aspects of Business Restructurings Discussion Draft and other reports were consulted and analysed. Further the views of recognised legal and tax experts that have been published in technical journals and text books were also considered and examined. A hypothetical example of a business restructuring transaction was constructed in order to illustrate practical issues and different approaches to solving them.

The research has argued that the arm's length principle, which forms the bases of transfer pricing regulation, is not an exact science but theoretically it is the most suitable measure. It may not be able to incorporate all variables, such as the cost savings through synergies of multinational enterprises, but it promotes international trade and investment by ensuring that transactions are based on fair prices. Business restructurings create anomalies in applying the arm's length principle but these anomalies can be dealt with within the regulatory structure. The business restructuring approach recommended is realistic and pragmatic, but more clarity may be needed in certain circumstances. The research has also discussed the avoidance of transfer pricing audits, including having appropriate transfer pricing policies and documentation.

Key words: transfer pricing; business restructurings; arm's length principle; arm's length range; OECD Guidelines; traditional transaction methods; transactional price methods;

Contents

Abstract 2

1 Chapter 1: Introduction 5

1.1 Context 5

1.2 Goals of the research 11

1.3 Research method and design 11

1.4 Outline of the thesis 12

2 Chapter 2: The concept of and principles relating to transfer pricing 14

2.1 Introduction 14

2.2 The reason for multi-national enterprises to exist 14

2.3 Automotive industry example 16

2.4 Introduction to the concept of transfer pricing 17

2.5 The arm's length principle 18

2.5.1 Introduction 18

2.5.2 Definition of the arm's length principle 21

2.5.3 Guidelines for applying the arm's length principle correctly 23

2.6 Conclusion 43

3 Chapter 3: Determining an appropriate arm's length price range 44

3.1 Introduction 44

3.2 Transactional methods 45

3.2.1 Introduction 45

3.2.2 Relationship with Article 9 of the OECD Model Tax Convention 46

3.2.3 Traditional transaction methods 47

3.2.4 Transactional profit methods 56

3.3 Conclusion 66

4 Chapter 4: The concept of business restructurings in relation to the Income Tax Act and OECD Guidelines 67

4.1 Introduction 67

4.2 Treatment of business restructurings 67

4.2.1 Conversion of risk 70

4.2.2 The actual restructuring and the arm's length compensation 75

4.2.3 The application of the arm's length principle after the restructuring 87

4.2.4 Recognition of the actual transaction performed 92

4.3 Conclusion 93

5 Chapter 5: A critical analysis of the OECD Guidelines and the OECD Model Tax Convention in relation to transfer pricing and business restructurings 94

5.1 Introduction 94

5.2 The arm's length principle 95
5.2.1 Article 9 of the OECD Model Tax Convention 95
5.2.2 Guidance for applying the arm's length principle correctly 96
5.3 Critical analysis of business restructurings and the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft 98
5.3.1 Comments on the conversion of risk 101
5.3.2 Comments on the actual restructuring and the arm's length compensation 106
5.3.3 Comments on the application of the arm's length principle after the restructuring 111
5.3.4 Comments on the recognition of the actual transaction performed 113
5.4 Summary of the main concerns 116
5.5 Advance pricing agreements and mutual agreement procedures 120
5.6 Triangular transfer pricing cases 123
5.7 Global best practice in avoiding transfer pricing audits and disputes 125
5.7.1 Start from the outset 126
5.7.2 Building concrete foundations 127
5.7.3 Aligning form and substance 128
5.8 Conclusion 130

6 Chapter 6: Conclusion 131

List of References 135
Personal communications 136

1 Chapter 1: Introduction

1.1 Context

Transfer pricing is defined by the Tax Foundation (2008) as follows:

> The price that is assumed to have been charged by one part of a company for products and services it provides to another part of the same company, in order to calculate each division's profit and loss separately. Generally, transfer pricing rules indicate that one affiliate must charge another affiliate the same price as would be demanded in an 'arm's length transaction' [,a] transaction between two related or affiliated parties that is conducted as if they were unrelated, so that there is no question of a conflict of interest.

The main reason why a company would sell products more cheaply or more expensively than the prevailing market price to a related part of its enterprise may be for the purpose of "earnings stripping". The Tax Foundation (2008) defines earnings stripping as follows:

> Earnings stripping is a process by which a firm reduces its overall tax liability by moving earnings from one taxing jurisdiction, typically a relatively high-tax jurisdiction, to another jurisdiction, typically a low-tax jurisdiction. Often, earnings stripping arrangements involve the extension of debt from one affiliate to another. Debt is accumulated in a high-tax jurisdiction that allows a company to deduct interest payments from their taxable income.

An example of earnings stripping would be where a South African company sells semi-finished goods to a Mauritian related party at a lower selling price when compared to the same product being sold to an independent party. This is to ensure that there will be no or a very small profit in South Africa. When the product is sold in Mauritius, at a market related price, the profit will be higher when compared to the same product being sold by an independent party. This is due to the fact that the independent party would have had to buy the semi-finished good at a higher market related input price whereas the related Mauritian company did not. The higher profit that is achieved in Mauritius will only be taxed at the maximum effective tax rate of 3 percent, compared to South Africa which is 34.55 percent and will lead to a 31.55 percent tax saving for the group as a whole (Jain: 2008; Huxham & Haupt: 2009).

Transfer pricing is not a new issue. The Organisation for Economic Co-Operation and Development ("OECD"), which was established in 1961 in France, has issued certain guidelines in this regard. The problem with the transfer pricing guidelines is that they are not established law but rather a guiding principle. This means that each problem needs to be looked at individually and no two cases are the same.

In a recent transfer pricing dispute between the Internal Revenue Service in America ("IRS") and a company developing and manufacturing pharmaceuticals, Glaxo SmithKline Holdings (Americas) Inc. and its Subsidiaries, the company agreed to pay the IRS approximately 3.4 billion US Dollars in back taxes and interest to resolve all the transfer pricing issues for the tax years from 1989 to 2005. Mark E. Everson, the Commissioner of the IRS at the time, acknowledged that "transfer pricing is one of the most significant challenges for [the IRS] in the area of corporate tax administrations. . . . The settlement of [the Glaxo SmithKline] case is an important development and sends a strong message of our resolve to continue to deal with [transfer pricing issues] going forward" (Altus Economics: 2006).

Countries enact legislation to prevent the erosion of their tax base through aggressive transfer pricing deals by multi-national enterprises ("MNEs"). South Africa's transfer pricing provisions are set out in section 31 of the South African Income Tax Act, 58 of 1962 (referred to hereafter as the Income Tax Act), supplemented by the Income Tax Practice Note: No. 7 (1999) issued by the South African Revenue Services ("SARS") in August 1999. Section 31 must also be read in conjunction with the definition of "connected person" in section 1 of the Income Tax Act. In relation to a company, a connected person is defined in the Income Tax Act as any other company that would be part of the same group of companies as that company if the expression "at least 70 per cent" in paragraphs (a) and (b) of the definition of "group of companies" in this section is replaced by the expression "more than 50 per cent". It also includes any company which holds a minimum of 20 percent of another company's equity share capital, where no shareholder holds the majority voting rights. If a company is controlled or managed by any person who is a connected person in relation to another company the first mentioned and last mentioned companies will be connected persons.

In terms of section 31(2) of the Income Tax Act, where any supply of goods or services has been effected between those persons who are connected persons in relation to one another and at a price which is either less than the price which such goods or services might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's length (such price being the arm's length price or greater than the arm's length price), the Commissioner for SARS may, for the purpose of this section in relation to either the acquirer or supplier, in the determination of the taxable income of either the acquirer or supplier, adjust the consideration in respect of the transaction to reflect an arm's length price for goods or services.

The Commissioner for SARS would only have the right to adjust the transfer price in the taxable income of the South African resident who is a party to the transaction. The Income Tax Act defines a South African resident in section 1 as, *inter alia,* a person (other than a natural person, thus including a company) that is incorporated, established or formed in South Africa or has its place of effective management in South Africa.

The first OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (referred to hereafter as OECD Guidelines) on transfer pricing were established in 1979 and revised and approved by the Committee on Fiscal Affairs on 27 June 1995 and by the OECD Council for publication on 13 July 1995 (OECD: 2001). The publication of 1995 is still the preferred version that SARS and consultants alike work with. There are also many discussion drafts and updates by the OECD for different issues regarding transfer pricing problems.

The number of MNEs has increased substantially over the past years. In part, the reason for this is the integration of national economies, as has happened in Europe, new communication systems and technological progress, such as the internet, and the reduction in costs due to centralised management structures. The OECD (2001) expresses the opinion that the increase in MNEs leads to complex taxation issues for the MNEs as well as the relevant tax administrations because the transactions cannot be looked at in isolation. The tax administration must consider the broad international context to properly analyse the transactions for income tax purposes. The problem for transactions within an MNE arises due to integrated operations as well as the issue of the arm's length principle. The situation becomes even more complex if the countries involved in the cross-border transaction have different legal and administrative requirements

regarding the disclosure of transfer pricing.

In order to value a cross-border transaction the tax administration can use different methods to calculate the margins. The OECD Guidelines (2001) state that it is common practice for tax administrations to look at the functions performed, assets used to perform the functions and the risks assumed by each corporate entity of the MNE in order to establish a profit margin using appropriate methods. SARS follows this practice through section 31 of the Income Tax Act and Practice Note 7. The higher the risk or the more assets that are used or the more complex the function, the higher the profit margin should be and *vice versa*.

This research investigates one of the most relevant and problematic aspects of transfer pricing - business restructurings.

The Committee on Fiscal Affairs (OECD, 2008:6) defines business restructurings as:

> the cross-border redeployment by a multinational enterprise of functions, assets and/or risks. A business restructuring may involve cross-border transfers of valuable intangibles. Business restructurings that are within the scope of the OECD's project primarily consist of internal reallocation of functions, assets and risks within an MNE, although relationships with third parties ... may also be a reason for the restructuring and/or be affected by it.

The OECD (2008) analysed business restructurings and determined that they mainly consist of:

- (i) conversion of fully-fledged distributors into limited risk distributors or commissionaires for a related party that may operate as a principal;
- (ii) conversion of fully-fledged manufacturers into contract-manufactures or toll manufactures for a related party that may operate as a principal;
- (iii) rationalisation and/or specialisation of operations (manufacturing sites, processes, research and development);
- (iv) transfer of intellectual property rights to a central entity within the group (IP company).

Business restructurings are typically accompanied by a reallocation of profits among the members of the MNE group, either immediately after restructuring or over a number of years. Article 9 of the OECD Model Tax Convention (2003), which embodies existing tax concepts and the framework for international tax, discusses the extent to which such a reallocation of profits is consistent with the arm's length principle and more generally how the arm's length principle applies to business restructurings. Barnes (2009) states that the OECD Model Tax Convention is a starting point for tax treaty negotiations as well as a benchmark used by countries to determine a consensus position for cross-border transactions.

The OECD (2008) expresses the opinion that most restructurings of MNEs are done to maximise synergies and economies of scale, to centralise the management of businesses which are alike, to improve the efficiency of the supply chain, as well as taking advantage of internet based programs and technologies. These effects may not be achieved in the same way between independent parties, as they would not receive the same benefits at the same costs. The arm's length principle, however, would treat the transaction as if it was entered into by independent parties which could result in the incorrect application of the arm's length principle and therefore an approach needs to be developed that is realistic and reasonably pragmatic.

The OECD (2008) acknowledged that the treatment of transfer pricing of business restructurings has been an issue of great controversy in 2008 and no conclusion to the problem has yet been found. Business restructurings should not be seen only as an isolated problem, as it can change many aspects of how an MNE is taxed.

Prevention of a problem is preferable to solving it. It may be impossible to avoid every tax dispute or controversy but a South African taxpayer should be able to show that all the necessary steps were taken in order to comply with section 31 of the Income Tax Act. This will help the taxpayer to minimise the chance of a transfer pricing audit in multiple jurisdictions. If there should be an adjustment and/or assessment in relation to the affected cross-border transaction, the taxpayer may be able to show that he acted in a *bona fide* manner by submitting his transfer pricing policy to SARS. Failing to show that the taxpayer acted in good faith may result in severe penalties. The penalties that the Commissioner for SARS may impose for non-compliance with transfer pricing or other transactions are set out in sections 75, 76 and 104 of the Income Tax Act. If, for example, a taxpayer is unable

to demonstrate to SARS that he is transacting at arm's length with offshore related parties, SARS may adjust the transfer price to reflect what they regard as arm's length price for the transaction involved. The amount adjusted by SARS in terms of section 31 will be subjected to the corporate income tax (at the rate of 28 percent) and may be subjected to Secondary Tax on Companies (at the rate of 10 percent). Furthermore, interest may be levied by SARS on the underpayment of taxes, as well as penalties of up to 200 percent of the underpayment of tax.

From an operational view point of an MNE it is important always to weigh up the benefits and risks against the costs associated with having a transfer pricing policy in place. Raby (2009) states that proper transfer pricing documentation can cost a large amount and could ruin certain businesses and might not even be necessary because their cross-border transactions are not material. This thesis will assume that it is worthwhile for the company to have proper transfer pricing documentation in place and will analyse the steps an MNE will have to take in order to avoid the cost of disputes with SARS in relation to transfer pricing legislation.

Further, this thesis will analyse advance pricing agreements, mutual agreement procedures and triangular cases. PricewaterhouseCoopers (2008) defines advance pricing agreements as agreements between a taxpayer and tax administration where the transaction and its pricing are agreed upon beforehand. This may result in more certainty regarding transfer pricing and business restructurings for the taxpayer and tax administration alike.

The OECD Guidelines (2001:G-6) define mutual agreement procedures as "a means through which tax administrations consult to resolve disputes regarding the application of double tax conventions". It can be seen as an arbitration process involving two or more tax administrations to resolve transfer pricing conflicts.

PricewaterhouseCoopers (2008) states that transfer pricing conflicts used to arise between the taxpayer and the two tax administrations involved in the transaction between two countries. However, businesses have changed over the years and more often there may be transfer pricing conflicts between more than two countries. This is also referred to as a triangular case.

1.2 Goals of the research

The main objective of this research is to define and explain the business restructuring process, the regulation of transfer pricing transactions and the strictures that transfer pricing regulations impose on business restructurings. The following aims will be addressed in more detail:

- the basis of transfer pricing, the arm's length principle and the methods used to determine and apply an arms-length price;
- business restructurings, why it creates anomalies within transfer pricing regulation in relation to cross-border transactions and the potential solutions to the anomalies;
- advance pricing agreements and mutual agreement procedures, triangular cases, the vital role they play in business restructurings and how they might help or hinder business restructurings;
- best practice guidelines and how they may be applied to business restructurings; and
- avoiding transfer pricing audits and disputes.

1.3 Research method and design

The research method used in this thesis is primarily qualitative, comprising the analysis of various documentary sources of data. Relevant South African and international case law, tax legislation, the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations and reports are consulted and analysed, as well as the views of recognised legal and tax experts that have been published in technical journals and textbooks. All potential problems relating to business restructurings are analysed from a SARS viewpoint, as well as from the taxpayer's viewpoint.

A hypothetical example of business restructuring transactions is analysed in order to discuss the practical issues that arise and to make recommendations. This attempts to establish whether the recommended business restructuring approach is realistic and reasonably pragmatic.

Due to the fact that certain of the topics addressed above are still relatively new this research thesis makes recommendations on how to deal with certain problems in accordance with the OECD Guidelines and the Income Tax Act.

The research does not cover the following aspects:

- the consequences of the existence of permanent establishments in the countries involved;
- domestic anti-abuse rules and controlled foreign company legislation;
- the domestic tax treatment of an arm's length payment;
- Value-Added Tax and indirect taxes;
- Double Tax Agreements;
- customs duty consequences;
- section 31(3) issues relating to financial assistance;
- mergers or external business restructurings; or
- secondary tax on companies.

As all documents are in the public domain, no ethical considerations apply.

1.4 Outline of the thesis

Chapter 1 presented a brief outline of the context and goals of the research thesis. It explained the research method and design applied to yield the anticipated results, including certain limitations to the scope of the research thesis.

Chapter 2 describes the transfer pricing principles. The chapter introduces a car manufacturing example which is used to explain the basic concept of transfer pricing and, by continuously building on this example, the anomalies arising from business restructurings.

Chapter 3 discusses the traditional transaction methods and the transactional profit methods used to apply the arm's length principle and its relationship with Article 9 of the OECD Model Tax Convention. The chapter explains and analyses each method with the aid of an example which is continued from chapter 2.

Chapter 4 discusses the concept and reason for business restructurings. It further analyses the actual restructure at hand taking functions, assets and risks into consideration and it determines an arm's length compensation. The arm's length compensation is dependent upon four main points, namely:

- conversion of risk;

- the actual restructuring and the arm’s length compensation;
- the application of the arm’s length principle after the restructuring; and
- recognition of the actual transaction performed.

Chapter 4 continues to build upon the examples from chapter 2 and 3 to discuss the concept of business restructurings in practice.

Chapter 5 critically discusses the arm’s length principle having regard to the OECD Guidelines and the OECD Model Tax Convention. Further, the chapter compares the theory of business restructurings as set out in the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) with how it actually is perceived by legal and audit firms to work in practice.

Further chapter 5 determines why business restructurings may create anomalies within the transfer pricing regulation in relation to cross-border transactions and discusses potential solutions to the anomalies. Such solutions may include advance pricing agreements and mutual agreement procedures. Finally, the chapter reviews global best practice in avoiding transfer pricing audits and disputes.

Chapter 6 concludes on the findings of this research thesis and aligns the findings with the goals of the research. It discusses the problems encountered and how further research may solve them.

2 Chapter 2: The concept of and principles relating to transfer pricing

2.1 Introduction

Chapter 2 addresses the first of the research aims, namely, the basis of transfer pricing, the arm's length principle and the methods used to determine and apply an arm's length price. Based largely on OECD guidelines, this chapter introduces and defines all the concepts used in the thesis. A hypothetical example is introduced and used to elucidate transfer pricing and business restructuring issues. The reason for the existence of MNEs is briefly explained, as well as reasons why they may set non-arm's length prices.

The chapter presents a detailed discussion of the arm's length principle and the basis on which an arm's length price should be established, taking into account the

- characteristics of the property or services provided by the MNE;
- the functional analysis;
- the contractual terms;
- the economic circumstances; and
- the business strategies.

After demonstrating that, other than in exceptional circumstances, the actual transactions undertaken should be examined, the conclusion is reached that an arm's length range should be derived, rather than a single value, and that loss-making transactions are not necessarily non-arm's length. General factors to be taken into account are also discussed, including the use of multi-year data, government policies and their impact, international set-offs, the use of a customs duty valuation, the use of more than one transfer pricing method and how non-comparable transactions are dealt with.

2.2 The reason for multi-national enterprises to exist

In order to be able to apply a correct transfer pricing method to satisfy the arm's length principle, it is important to understand the reason for the existence of MNEs when compared to corporate entities going into the market alone. Once the reason is understood, a further analysis is needed to establish how this affects the arm's length principle. Vannoni (n.d.) states that the relevant theoretical approaches which discuss the nature and existence of MNEs are the transaction costs theory, the monopolistic

advantage theory and the resources theory, which are discussed in detail below.

Vannoni (n.d.) defines the ‘transaction cost’ as the cost involved in making an economic exchange between two parties and is the result of imperfect information in markets which behave irrationally and therefore lead to bounded rationality and opportunism. This implies that the cost of gathering the information, bargaining prices and the enforcement costs of a transaction fall within the transaction cost. MNEs exist because they manage to organise these costs more efficiently and therefore have transaction cost savings.

The ‘monopolistic advantage’ which is established through a monopoly is defined by Philip Mohr, Louis Fourie and Associates (2008:246) as “a market structure in which there is only one seller of a good or service that has no close substitutes. A further requirement is that entry to the market should be completely blocked”. It may be argued that there is no such thing as a real monopoly but MNEs may come very close. Examples of MNEs in ‘near-monopolies’ are: Microsoft, SABMiller or Coca-Cola. From such a ‘near-monopoly’ an MNE has certain advantages over smaller companies. One of the obvious reasons is that an MNE within a near-monopoly can charge higher prices for goods or services to its clients or customers when compared to a competitive market. If there is no substitute for a commodity or service, prices are higher because the customer cannot obtain the same good or service more cheaply anywhere else. MNEs gain most advantages by effectively managing inefficiencies that arise in markets, by communicating and assisting each other with information or resources, which is not the case between two competing independent parties.

The final theory, the resource theory, is defined by Wade and Hulland (2004) as follows:

> firms possess resources, a subset of which enable them to achieve competitive advantage, and a subset of those that lead to superior long-term performance. Resources that are valuable and rare can lead to the creation of competitive advantage. That advantage can be sustained over longer time periods to the extent that the firm is able to protect against resource imitation, transfer, or substitution. In general, empirical studies using the theory have strongly supported the resource-based view.

From the theories discussed above one can conclude that the reason for establishing an MNE is to save costs, acquire better information in a market, reduce risks and to be more competitive when compared to an independent corporate entity.

2.3 Automotive industry example

In order to understand the concept of transfer pricing and business restructurings there are certain terms that need to be thoroughly understood. This chapter uses a simple example of an MNE to analyse and discuss the basic principles of transfer pricing. Throughout the thesis the example will be elaborated on until all concepts of business restructurings have been analysed and discussed.

To be able to discuss all aspects of transfer pricing, the example needs to include all major parties that may be involved in a cross-border related transaction, their functions, risks and assets. For this reason the car manufacturing industry was chosen as it may include the following:

- manufacturers (fully-fledged manufacturer, limited risk manufacturer or toll manufacturer);
- distributors (fully-fledged distributor, limited risk distributor or agent) with or without marketing functions;
- research and development departments;
- financial institutions;
- shared cost centres;
- intellectual property or royalties; and
- head office functions, such as shareholder functions.

Car manufacturers have one of the most efficient group structures when compared to other industries. Deloitte (2009:3) believes this is due to the fact that the "automotive industry face[s] the challenge of optimising their activities at many different levels. Achieving a balance between profitability, safety, environmental compatibility, and customer benefit remains pivotal to a company's successful existence in the market." Taxes play a major role within a group structure and transfer pricing audits could potentially bankrupt a company.

In the example to be used in the thesis, a South African car manufacturing group registered as EvoCar started its business as follows. The head office of EvoCar is incorporated in South Africa ("HeadCo (SA)"). HeadCo (SA) manufactures the cars and is responsible for all activities pertaining to the automotive industry. HeadCo (SA) is also the registered owner of all intellectual property ("IP") researched and developed by the EvoCar

group.

A distribution company ("DisCo (UK)") is incorporated at the same time in the United Kingdom to increase EvoCar's market share in Europe. DisCo (UK) will distribute only HeadCo (SA)'s cars initially and is wholly owned by HeadCo (SA). DisCo (UK) takes ownership of the cars once they leave HeadCo (SA)'s factory.

The company's distribution transaction can be depicted as follows:

The solid line shows the flow of goods →

Diagram 1A

This example is the simplest form of a cross-border related party transaction. With the aid of this diagram, the concept of transfer pricing will be critically analysed with regard to the Income Tax Act, OECD Guidelines and business restructurings, describing all the related terms, definitions and aspects. Throughout the chapters Diagram 1A is elaborated on to include certain functions, assets and/or risks in order to fully discuss transfer pricing and business restructuring.

2.4 Introduction to the concept of transfer pricing

As stated in chapter 1, transfer pricing is defined by the Tax Foundation (2008) as:

> The price that is assumed to have been charged by one part of a company for products and services it provides to another part of the same company, in order to calculate each division's profit and loss separately. Generally, transfer pricing rules indicate that one affiliate must charge another affiliate the same price as would be demanded in an 'arm's length transaction' [,a] transaction between two related or affiliated parties that is conducted as if they were unrelated, so that there is no question of a conflict of interest.

From the definition it is clear that it is of the utmost importance to understand the arm's length principle as the whole transfer pricing methodology is based upon the arm's length principle. It should be noted that transfer pricing issues in South Africa can only arise

between related party transactions which are cross border. South Africa does not have any legislation in place for local transfer pricing.

2.5 The arm's length principle

2.5.1 Introduction

The arm's length principle is the basis of transfer pricing, which is not an exact science but rather a methodology which can be interpreted differently by different people. The arm's length principle, simply stated, requires that each inter-company transaction is remitted to the same level that would have applied had the transaction taken place between independent parties, all other factors remaining constant. Although this may sound simple, Raby (2009) believes the actual application of the arm's length principle in practice is notoriously difficult.

The OECD Guidelines (2001:G-1) agree with Raby and state that this is due to the fact that the arm's length principle gives a range of "figures that are acceptable for establishing whether the conditions of a controlled transaction are arm's length and that are derived either from applying the same transfer pricing method to multiple comparable data or from applying different transfer pricing methods."

If the transfer pricing arrangements of MNEs do not reflect the arm's length principle the OECD Guidelines (2001:I-1) are of the opinion that, "the tax liabilities of the associated enterprises and the tax revenues of the host countries could be distorted." Therefore, the arm's length principle is the stepping stone to ensure that an MNE complies with section 31 of the South African Income Tax Act, Practice Note 7 (SARS: 1999), as well as with the OECD Guidelines. The OECD Guidelines (2001:I-1) provide a "background discussion of the arm's length principle, which is the international transfer pricing standard that OECD member countries have agreed should be used for tax purposes by MNE groups and tax administrations."

The reason for establishing an arm's length principle was to ensure that each tax jurisdiction will get its fair share from an affected transaction between related parties. The OECD (2001) further acknowledges that independent parties normally deal with each other within financial and commercial relations which are determined by market conditions.

These market forces that determine the price between independent parties are comparable to the arm's length principle. This means that two independent parties do not have much choice in determining a price between them. If the price is too high the one party will find someone else to contract with and if the price is too low the other party may make losses and will not be interested in doing business under those terms.

When related parties such as EvoCar and its related parties transact with each other, the financial and/or commercial relations may not affect a transaction in the same way as between independent parties. For example EvoCar may try to increase profits on a global basis rather than on a company to company basis, regardless of where the companies are incorporated. This means that EvoCar tries to be as profitable as possible on a global level even if a single entity of the group, such as DisCo (UK), has to make losses. If the transaction had to be done at arm's length between HeadCo (SA) and DisCo (UK) within EvoCar, the group might make losses or may not be as profitable, which is unjustifiable from EvoCar's perspective. This is one of the reasons why it may be so difficult to ascertain an arm's length principle for some transactions. It is very difficult if not impossible to compare such an MNE transaction to an independent party transaction because an independent party would not enter into a contract which will only guarantee losses or fail to provide a proper return on investment. An MNE as a whole can achieve savings due to the loss on one transaction and therefore the transaction makes commercial sense from an MNE perspective. For example, EvoCar may offer a whole range of products in order to be competitive but a certain product can only be produced at a loss. The company manufacturing that product, for example a second manufacturer in China, would generally run at a loss even though the whole group benefits from having the whole product range. From an arm's length perspective, this is not acceptable because an independent party would not transact with another party if it could only realise losses. In this case a tax administration would expect EvoCar to remunerate the loss-making entity, the manufacturer in China, with the arm's length profit that an independent party would seek to achieve.

On the other hand there may be justifiable reasons for losses. For example, at EvoCar's start up stage there may have been high capital costs for the new manufacturing plant and/or manufacturing equipment or if EvoCar plans to penetrate the UK market, and therefore offers its products at a lower price to gain a niche in the market. The OECD (2001) further acknowledges that this is one of the reasons why tax administrations should

not automatically assume that related parties of a global MNE have sought to manipulate their profits, but should recognise that the MNE does have certain loss-leaders for valid economic and commercial reasons.

There are other reasons for MNEs to deviate from an arm's length consideration with regard to the affected transaction and in establishing the actual transfer price. The OECD Guidelines (2001) add that tax jurisdictions should not assume that every transaction between related parties will invariably deviate from an open market transaction. It is common for related parties to negotiate every transaction in order to achieve maximum profits. The directors of each company would like to establish good profit records and therefore would not reduce prices for related parties. The OECD (2001:I-1) further states that:

> There may be a genuine difficulty in accurately determining a market price in the absence of market forces or when adopting a particular commercial strategy. It is important to bear in mind that the need to make adjustments to approximate arm's length dealings arises irrespective of any contractual obligation undertaken by the parties to pay a particular price or of any intention of the parties to minimize tax. Thus, a tax adjustment under the arm's length principle would not affect the underlying contractual obligations for non-tax purposes between the associated enterprises, and may be appropriate even where there is no intent to minimize or avoid tax. The consideration of transfer pricing should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes.

Factors or reasons other than earnings stripping can lead to distortions of transfer prices between related companies. The OECD Guidelines (2001) give the following examples: conflicting governmental pressures, such as customs valuations and price controls, or shareholder pressure which demands that group companies show profits in their financial statements, through intercompany sales which the company might not otherwise have made.

2.5.2 Definition of the arm's length principle

2.5.2.1 Article 9 of the OECD Model Tax Convention and the arm's length principle

Article 9(1) of the OECD Model Tax Convention (2003:12) defines the arm's length principle as follows:

> [When] conditions are made or imposed between the two [associated] 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.

From the above it is clear that it is of utmost importance, for the arm's length principle, to compare conditions made or imposed between associated enterprises with those which would be made between independent enterprises. It is the basis of the arm's length principle to compare independent party transactions to related transactions. The second point made by the above definition is that profits that would have accrued to the MNE if it had dealt at arm's length, should be calculated.

The OECD (2001) states that from a tax perspective, a major reason for establishing the arm's length principle was to ensure fairness throughout the transaction for both transacting parties as well as the tax jurisdictions. In order to maintain tax neutrality, no two parties should be taxed differently for the same activity or transaction undertaken. If a related party transaction were to be treated differently when compared to an independent party transaction it may lead to tax advantages or disadvantages which may distort the relative competitive position of either business structure. Even though it may be very difficult at times to apply an arm's length principle, for example in the production of very specialised goods, it is important to maintain consistency throughout tax jurisdictions to avoid double taxation which may threaten the international consensus. The arm's length principle promotes international trade and investment by keeping transactions 'fair' so that each tax jurisdiction in their respective countries receives a fair share of the affected transaction.

On the other hand Fris (2003) argues that the arm's length principle is inherently flawed mainly due to the fact that the principle does not account for the economies of scale related to integrated systems when compared to independent parties. MNEs are known to have great cost savings through centralised management structures and cost centres. These savings are, however, not considered in the determination of the arm's length range.

Article 9(2) of the OECD Model Tax Convention (2003) stipulates that if one state effectively applies Article 9(1), the other state should make a corresponding adjustment to keep the fundamental bilateral character of the application of the arm's length principle intact.

2.5.2.2 Maintaining the arm's length principle as the international consensus

The OECD Guidelines (2001) acknowledge that the arm's length principle may not always be simple to use in practice but it is sound in theory and gives the closest approximation to a fair price between related parties. The arm's length principle usually allocates appropriate levels of income between off-shore related parties and is therefore accepted by tax administrations. There may be instances when the arm's length principle is flawed but it is the closest method of establishing a fair principle for each tax administration. There are no other acceptable principles or methods to determine values for cross-border related transactions that are fair and sound in theory. The arm's length principle has been accepted internationally by the major corporations and tax administrations and the experience with the arm's length principle has become "sufficiently broad and sophisticated to establish a substantial body of common understanding among [them]" (OECD, 2001:I-6). This understanding ensures that each tax administration receives its fair share of taxes and in addition the corporation does not suffer double taxation.

OECD member countries follow the arm's length principle and try to work closely together with tax authorities to elaborate on the principle to improve its administration with regard to clearer guidance and more timely examinations. Even though South Africa is not an OECD member country, Practice Note 7 (SARS, 1999:par. 3.2.1) states the following: "the OECD Guidelines are acknowledged as an important, influential document that reflects unanimous agreement amongst the member countries, reached after an extensive process of consultation with industry and tax practitioners in many countries. The OECD Guidelines

are also followed by many countries which are not OECD members and are therefore becoming a globally accepted standard."

2.5.3 Guidelines for applying the arm's length principle correctly

2.5.3.1 Comparables and comparability of the arm's length principle

In order for the arm's length principle to be applied it needs to have certain comparables. The OECD Guidelines (2001) state that the main objective of the arm's length principle is to compare a related party transaction to an independent party transaction.

The OECD Guidelines (2001) give five factors determining comparability, namely:

- characteristics of the property or services;
- functional analysis;
- contractual terms;
- economic circumstances; and
- business strategies.

It is important to consider all five factors as any one may change the characteristic of a transaction and therefore determine whether or not a transaction is comparable.

The OECD Guidelines (2001) further acknowledge that in order to establish comparability, it is important that the economically relevant characteristics of the situations within the transaction are comparable. Comparable in this instance means that there are no material differences within the transaction's characteristics that could affect the comparable outcome and if there are any, that the conditions can be accurately adjusted, to eliminate such differences. In order to determine the degree of comparability and its necessary adjustments it is important to understand how a transaction is determined by independent parties. The norm is that independent parties would compare a potential transaction with all available options in the market. The independent party would normally choose the transaction that yields the highest profit margin. This can be achieved by a transaction which has lower costs or yields a higher resale value for its goods or service. For example costs could be cut through shorter delivery options or a price can be increased in less saturated markets. The point is that an independent party would always choose the best economic transaction available.

Characteristics of the property or services

The first factor of the OECD Guidelines (2001) that needs to be considered is that of property versus service transactions. It may be easy to distinguish the two but it is of the utmost importance not to get this wrong. As discussed above, they need to be categorised correctly and only if both the uncontrolled and the controlled transaction have the same characteristics of property or service, are the two comparable.

Functional analysis

The functional analysis is the second factor analysed by the OECD Guidelines (2001). It determines what functions are performed, what assets are used and what risks are assumed in each controlled and uncontrolled transaction. In order to correctly account for the risks undertaken it is important to analyse the group and organisational structures of each enterprise. It may also be relevant to investigate the juridical capacity of the taxpayer in which he performs the functions. The compensation received by an independent party usually reflects its functions performed with regard to assets employed and risks assumed. In order to compare controlled transactions to uncontrolled transactions the functions performed must be comparable.

The OECD Guidelines (2001:I–10) describe some functions that taxpayers and tax administrations might need to identify and compare to have an efficient functional analysis. These include but are not limited to: “design, manufacturing, assembling, research and development, servicing, purchasing, distribution, marketing, advertising, transportation, financing and management.”

The OECD Guidelines also provide guidance on how to approach a functional analysis. Firstly the primary functions performed by the party under examination should be identified. Once the functions performed are documented any necessary

> adjustments should be made for any material differences from the functions undertaken by any independent enterprises with which that party is being compared. While one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transactions that is important (OECD, 2001:I-10).

As mentioned above, transactions are compared by analysing the functions performed with regard to assets used and risks assumed. Therefore it is also important to compare the assets used, such as plant and equipment or intangible property, as well as the nature and characteristic of the asset used. Therefore the market value of the factory used to manufacture EvoCar's cars should be similar to that of a comparable manufacturer. Lastly it is important to compare the actual risks assumed in the comparable transactions. In the open market, risk is measured by the return yield from the risk, meaning the higher the risk the higher the return, also known as the rate of return. This stipulates from a functional analysis point of view that comparable transactions must have the same risks, or that differences in the risks can be adjusted for, in order for a controlled and uncontrolled transaction to be comparable. It is important to analyse the risks in each transaction in order to have a complete functional analysis as the risk factor will be proportionally related to the returns received. The OECD Guidelines (2001:I-10) give a few types of risks to be considered: "market risks, such as input cost and output price fluctuations; risks of loss associated with the investment in and use of property, plant, and equipment; risks of the success or failure of investment in research and development; financial risks such as those caused by currency exchange rate and interest rate variability; credit risks; and so forth."

This process of the functional analysis leads to labelling of all the functions of the parties involved in the affected transaction. Commonly used labels within transfer pricing are:

- fully-fledged manufacturer,
- contract or toll manufacturer,
- fully-fledged distributor,
- limited risk distributor, and
- commissionaire or agent.

To discuss the labels further, refer to the example described above (Diagram 1A):

The solid line shows the flow of goods →

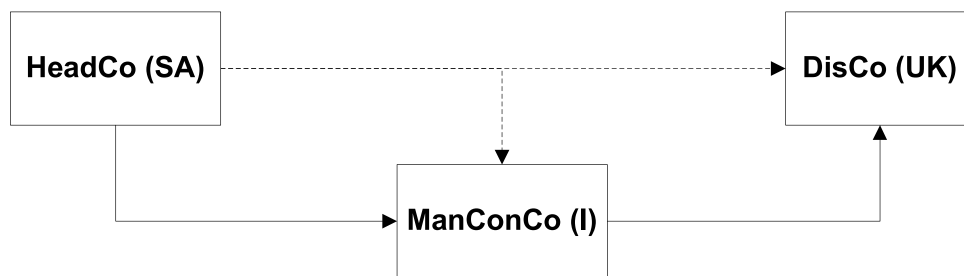
Diagram 1A

HeadCo (SA) could be described as a fully-fledged manufacturer if it develops its own product lines and usually undertakes substantial research and development ("R&D") or uses specialised technology which has been obtained through licensing. As a fully-fledged manufacturer all functions related to the actual manufacturing of the product which are defined by Raby (2009:49) as "vendor qualification, materials purchasing, production scheduling and quality control procedures" and marketing of the product to the end customer, would fall within HeadCo (SA). A fully-fledged manufacturer usually bears many risks related to manufacturing, such as inventory risk and market risk.

On the other hand, a contract manufacturer as defined by Raby (2009:48) provides "manufacturing services to fully-fledged manufacturers. They do not develop their own product lines but offer expertise in performing certain manufacturing functions only." Contract manufacturers may perform certain functions such as material purchasing and production scheduling or may even own inventory. However, over the course of a contract, contract manufacturers do not face direct market risk. This is due to the fact that they have a guaranteed uptake of their product or revenue stream from the other contracting party. Remuneration may be based on either a fee basis or on a pre-established price per unit basis. The contract manufacturer's assets are generally not specialised in comparison to other manufacturers and its intangible assets are limited and normally only consist of know-how pertaining to its manufacturing process (Raby: 2009).

A toll manufacturer as defined by Raby (2009) is a subtype of a contract manufacturer and is very similar, except that a toll manufacturer does not take any legal ownership or title with regard to raw materials or products produced.

In practice, HeadCo (SA) may want to contract out its manufacturing function to a related party in order to be able to concentrate on further marketing functions or provide more in depth management services. In the example HeadCo (SA) is still seen as the actual manufacturer but the product is actually built by the related contract manufacturer ("ManConCo (I)") in India. The new diagram would look as follows.



The solid line shows the flow of goods
The dotted line shows the flow of services
Diagram 2A

Firstly HeadCo (SA) would establish a new manufacturing company in India. Then HeadCo (SA) would provide materials and necessary services required to build certain cars to ManConCo (I) such as know-how. HeadCo (SA) can now provide DisCo (UK) with more in depth marketing services to increase sales in the UK. ManConCo (I) will deliver the finished cars directly to DisCo (UK).

It is important to note that HeadCo (SA) would still carry all the risks related to the manufacturing. For example, if the contract manufacturer is producing a car in accordance with HeadCo (SA)'s contracted blue prints and faults are discovered at a later stage, HeadCo (SA) would have to reflect the loss arising from the write-off in its statement of financial position, not the contract manufacturer. The business restructuring issues for the above example (Diagram 2A) will be discussed in chapter 4.

A fully-fledged distributor is defined by Raby (2009) as a distributor that takes title to the merchandise it has to distribute. The fully-fledged distributor generally assumes inventory risks, credit risks and may have foreign exchange risks, these being the most common risks associated with fully-fledged distributors. One of the determining factors for a fully-fledged distributor is its marketing responsibilities. Unlike the other distributors discussed below the fully-fledged distributor takes full responsibility to market its own merchandise.

Raby (2009) is of the opinion that a limited risk distributor is comparable to a fully-fledged distributor except that its risks and marketing functions are limited.

Finally, Raby (2009) acknowledges that a commissionaire or agent (also known as a manufacturer's representative) takes no ownership of any merchandise it sells. The representative bears neither credit risk nor inventory risk. The structure is comparable to a

toll manufacturer from a distribution point of view. The representative has no marketing responsibilities and is typically paid a commission-based fee calculated on the return or sales revenue it generates from representing the manufacturer.

For example, HeadCo (SA) may want to set up a limited risk distributor or agent in Asia to increase worldwide recognition and market share. HeadCo (SA)'s research of the Asian market is inconclusive with regard to the risks and therefore HeadCo (SA) does not consider it to be viable to create a fully-fledged distributor. The initial risk seems to be too high to risk a substantial capital investment. Instead HeadCo (SA) will create an agent ("Agent (A)") who will receive remuneration according to its costs incurred in selling cars.

The solid line shows the flow of goods
The dotted line shows the flow of services
Diagram 2B

Fris (2003) is of the opinion that from a transfer pricing perspective, when doing a functional analysis, the functions performed using the assets and the risks assumed can be labelled and categorised into one of the above categories. The 'labelled' parties operate more or less exclusively as such. This means that a party will fall within one of the categories and from that a comparison is made with a similar transaction that falls within the same category. It should be noted that it may be difficult to compare additional or complementary roles, activities or functions carried out by the parties concerned that do not fall within the label given to a transaction.

To further illustrate this, when a manufacturer takes on responsibilities for marketing by using its own resources, it would anticipate a higher return from its activities and the conditions of the transaction would be different to those of a toll manufacturer, which is reimbursed for its costs and receives the income appropriate to its activity. The above manufacturer could be defined as a fully-fledged manufacturer and would only tend towards a limited risk manufacturer if it did not assume inventory and other risks. It is

seldom that a manufacturer or distributor falls exactly within one category but they rather have a tendency towards a particular category and are assumed to fall within the particular category and are labelled as such, for comparability reasons.

The OECD Guidelines (2001) make another point that should be considered for the functional analysis. It acknowledges that the economic substance of a purported risk allocation needs to be considered carefully. The reason for this is that in arm's length dealings the party with the risk allocated to it has the most control over the risk. Therefore in a related party transaction the risk allocation must also make sense in such a way that not only one party within a multinational group assumes all the risks. A good example is that of inventory risk; a party would not usually assume any inventory risk if it has no control over the merchandise or any control over the inventory level.

Contractual terms

The third factor from the OECD Guidelines (2001), the contractual terms, generally defines implicitly or explicitly how the responsibilities, risks and benefits are to be divided between the parties. Thus an analysis of the contractual terms should be part of the functional analysis. Sometimes there is no explicit contract between the parties which means that the relationship between the parties needs to be analytically reviewed to gather the required information about the transaction. Independent parties would only enter into agreements or contracts if it actually benefits them. The same holds true for amending an agreement or contract. Independent parties would only agree to change a contract if it benefits both independent parties. This must be kept in mind when comparing an MNE contract to that of an independent party.

Economic circumstances

The OECD Guidelines (2001) fourth factor that determines comparability ensures that the transaction between related parties being compared to that between independent parties, takes the economic circumstances into consideration. An arm's length price may vary across different markets even if the property or service is the same. This can be due to saturated markets or less demand or supply for certain properties or services in certain markets. The reason for this is that certain markets have more substitutes available for property or services than other markets. In order to achieve comparability between the

related party transaction and the independent party transaction the markets in which the transactions take place may not differ materially, and any differences should have no effect on the transfer price or appropriate adjustments can be made. The OECD Guidelines (2001:I-13) provide some examples of economic circumstances that may be relevant to determining market comparability:

> geographic location; the size of the markets; the extent of competition in the markets and the relative competitive positions of the buyers and sellers; the availability (risk thereof) of substitute goods and services; the levels of supply and demand in the market as a whole and in particular regions, if relevant; consumer purchasing power; the nature and extent of government regulation of the market; costs of production, including the costs of land, labour, and capital; transport costs; the level of the market (e.g. retail or wholesale); the date and time of transactions; and so forth.

Business strategies

The last factor from the OECD Guidelines (2001) which determines comparability is the business strategy that a party or MNE as a whole may have chosen at the time of the transaction. A business strategy can assume many different aspects. The OECD Guidelines (2001:I-13) give a few examples: “innovation and new product development, degree of diversification, risk aversion, assessment of political changes, input of existing and planned labour laws, and other factors bearing upon the daily conduct of business.” Business strategies such as the ones mentioned above need to be considered before deciding that an independent party transaction is comparable to that of a related party transaction. For example, an MNE may be trying to gain a greater market share within a certain market or to penetrate a new market. For that reason the MNE may offer its merchandise at half price or cheaper than it would normally do in other markets. This does not mean that the transaction is not comparable or that, by default, a related party would not strive for market penetration through cheaper prices. However, it may mean that the transaction is not comparable to that of an independent party within an already established market.

The problem that arises as a result of the implementation of certain business strategies is that the profit levels will be lower during that year and therefore the relevant tax administration would receive a lower tax income. The issue that poses problems is that the tax administration needs to establish the legitimacy of the taxpayer’s claim that he is

trading at arm's length. This may be difficult, if not impossible, to prove because there may be no comparable transaction. Another point that makes the issue even more problematic is that section 79 of the Income Tax Act prevents SARS from re-opening assessments older than three years unless deliberate misrepresentations were made. This means that if a tax administration should realise that a certain transaction was concluded at a value that was too low or too high and there was no demonstrable business strategy behind it, resulting in a non-arm's length transaction, it may be too late to adjust the transaction. The OECD is of the opinion that tax administrations usually scrutinise transactions with potential business strategy implications carefully. In order for the tax administration to satisfy itself it would analyse the consistency of the professed business strategy throughout the MNE (OECD: 2001). To give an example, in Diagram 1A, if HeadCo (SA) is trying to obtain a share in a new market, it would charge a lower price to DisCo (UK) which can then charge a lower price to potential customers. It would not be viable for one party to assume all the costs related to market penetration. Because the market penetration would benefit everyone, both distributor and manufacturer alike, it is assumed that both parties will share the risks and therefore share in the costs. Furthermore marketing and advertising expenditure would increase during the market penetration period, which is evident from the parties' financial statements.

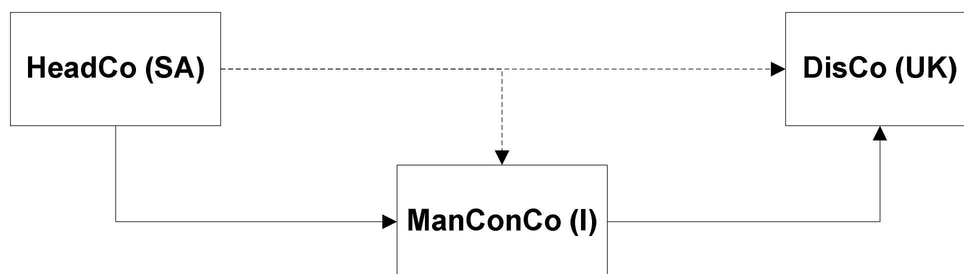
Keeping this in mind and taking the OECD Guidelines (2001) into consideration, tax administrations realise that market penetration may lead to an overall loss and therefore allow the attendant deductions, provided the loss is justifiable and that in similar circumstances an independent party would have been prepared to sacrifice its profitability for the same period, under the same economic circumstances and competitive conditions.

2.5.3.2 Actual transaction undertaken

The OECD Guidelines (2001:I-15) stipulate that "a tax administration's examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them, using the methods applied by the taxpayer insofar as these are consistent" and acceptable from the transfer pricing perspective within the country's legislation. Only in exceptional cases should the tax administration disregard the actual transaction or substitute other transactions for them. The reason for this is that restructuring a transaction may lead to double taxation where other tax administrations do not share the same view on the characteristics of the actual

transaction undertaken.

There are two particular cases in which it is appropriate and legitimate for a tax administration to disregard the structure adopted by the taxpayer when entering into a controlled transaction. The first case arises where the economic substance differs from its form. An example of substance over form is the use of an interest-free loan to finance capital in an economy where an independent party would not structure an investment in this way. This is also known as “quasi-equity” because the loan acts as equity rather than as a loan. The major reason why an independent party would not structure the transaction in that way is because the interest expense may outweigh the actual advantage gained from the increase in capital. In this case the tax administration may disregard the transaction and re-characterise the loan as a capital investment. For example in Diagram 2A, shown below, ManConCo (I) may require certain factories and/or machinery to build the cars to a certain specification. ManConCo (I) cannot borrow money from a bank due to its credit rating, therefore HeadCo (SA) agrees to help ManConCo (I) with finance. However, the loan as suggested is not at arm’s length due to higher interest rate payments which would not make it an economically viable option for an independent party in the same situation.



The solid line shows the flow of goods
The dotted line shows the flow of services
Diagram 2A

In this example that would mean that ManCoCon (I), in taking up the loan, may not deduct its interest expense in full from its profits in order to calculate the appropriate tax payable. The reason for the tax administration not to allow the deduction of the interest expense in this case is that the tax administration is trying to prevent EvoCar from stripping profits and claiming the payment of interest for a loan that is not beneficial and therefore this could be seen as a profit-stripping mechanism. A second case given by the OECD Guidelines (2001:I-16) arises where, “the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those

which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price."

An example of the second case in Diagram 2A could be the sale of intellectual property by EvoCar's HeadCo (SA) to ManCoCon (I). In this case intellectual property could be related to know-how on manufacturing or certain patents. The problem with this transaction is not its form or substance but rather the fact that an independent party would not be willing to sell its intellectual property to another party because it would amount to the related party selling its future income. Another reason given by the OECD Guidelines (2001) why the tax administration may disregard the transaction as it stands is that the profit potential of the intellectual property cannot be adequately estimated and therefore it is difficult to estimate a price for the intellectual property.

From Article 9 of the OECD Model Tax Convention (2003) as well as the OECD Guidelines (2001:I-16) it is clear that

> the character of the transaction may derive from the relationship between the parties rather than be determined by normal commercial conditions and may have been structured by the taxpayer to avoid or minimise tax. In such cases, the totality of its terms would be the result of a condition that would not have been made if the parties had been engaged in arm's length dealings. Article 9 would thus allow an adjustment of conditions to reflect those which the parties would have attained had the transaction been structured in accordance with the economic and commercial reality of parties dealing at arm's length.

When considering the actual transaction undertaken by an MNE such as EvoCar, it is important to keep in mind that related parties usually have more freedom in drawing up contracts and agreements and it is easier for the related parties to amend their contracts and agreements to suit their needs. For example, there may be certain legal, economical or even fiscal reasons to change a contract to ensure that the strategy of EvoCar, globally, is adhered to. As stated in the OECD Guidelines (2001), it is important for the tax administration to determine what the actual underlying reality is behind the contractual arrangements between related parties in applying the arm's length principle. It should be determined what an independent party would have done under the same circumstances.

The OECD (2001) is of the opinion that the tax administration should not disregard a related party transaction just because it is different when compared to an independent party transaction. For example, in EvoCar's related party transaction between HeadCo (SA) and DisCo (UK) (in Diagram 1A), DisCo (UK) may take on all the currency exchange risks, unlike an independent party transaction where the manufacturer usually takes on all the currency exchange risk. This does not mean that the related party is not trading at arm's length but it may indicate to the tax administration that it should examine the economic logic of the structure more closely. Instead of re-characterising the transaction, the tax administration should adjust for the difference in risk, meaning that DisCo (UK), which assumes the currency exchange risk, should be earning a higher profit margin when compared to the independent party transaction.

The evaluation of separate and combined transactions

The OECD Guidelines (2001) recommend that the arm's length principle should be applied on a transaction-by-transaction basis. But the OECD Guidelines acknowledge that there are often situations where separate transactions are so closely linked or continuous that they cannot be evaluated on a separate basis. Examples may include but are not limited to long-term contracts for the supply of commodities or services, the rights for the use of intellectual property and the pricing of similar products within a product line. For these types of transactions it may be more reasonable to assess the transactions on a combined basis rather than each transaction separately, using the most appropriate arm's length method. Even though, from a transfer pricing perspective, it is acceptable to consider combined transactions as one, the tax administration may need to analyse each transaction separately from an income tax perspective.

2.5.3.3 Use of an arm's length range

The OECD Guidelines (2001) acknowledge that the reason for having an arm's length range to determine a comparable margin instead of having a single value to compare a margin for a transaction is that only seldom will it be possible to actually arrive at a single value for a transaction. One of the reasons for that given by the OECD Guidelines (2001) is that transfer pricing is not an exact science and in most circumstances even the most appropriate method may produce a range of figures which are all equally reliable. The arm's length principle in itself only produces a general approximation of conditions that

may have been established between independent parties. Another reason given by the OECD Guidelines for the range which may be more relevant is that different points within the range may represent different prices charged by different independent parties. It is common for independent parties to charge different prices for comparable goods. Lastly, not all comparable transactions examined may actually be comparable, be it through different functions, the assets used or assumption of higher risks. As discussed above, a higher risk, more expensive assets or the performing of more functions when compared to another transaction, could result in a higher profit or loss and therefore in a higher or lower profit margin.

Further the OECD Guidelines (2001) state that an arm's length range may be the result of the use of more than one method to evaluate the same controlled transaction. Both methods may be appropriate to examine the arm's length nature of the transaction compared to an independent party transaction, but each method may produce different outcomes or a range of outcomes. This difference arises from the different nature of each method and the data used. The use of two methods for one transaction may result in a more accurate range but on the other hand the results may be unreliable because they may present two totally different ranges.

The OECD Guidelines (2001:I-20) stipulate that if

> the relevant conditions of the controlled transactions (e.g. price or margin) are within the arm's length range, no adjustment should be made. If the relevant conditions of the controlled transaction (e.g. price or margin) fall outside the arm's length range asserted by the tax administration, the taxpayer should have the opportunity to present arguments that the conditions of the transaction satisfy the arm's length principle, and that the arm's length range includes their results.

The requirement given by the OECD Guidelines (2001) is that each transaction should fall within the acceptable range or, at least, it can be demonstrated that a transaction falls within the range. As to where the transaction falls within the range depends on the functions performed, assets used and risks assumed. If the conditions of a transaction do not justify a certain position within the arm's length range, the tax administration should determine an accurate position for the transaction taking its conditions and characteristics into account. As mentioned previously a total re-characterisation of a transaction should be the last resort of the tax administration.

2.5.3.4 Loss makers

From a transfer pricing point of view it is important to note that independent parties may realise genuine losses. However the OECD (2001) acknowledges that when a related party consistently realises losses, while the whole MNE group is profitable, there may be some transfer pricing issues.

Further the OECD Guidelines (2001) argue that, when determining the reason for the loss making, the tax administration should take the following into account: start up costs, unfavourable economic conditions, inefficiencies or other legitimate business reasons. The important point is that an independent party would not be willing to carry such costs for a long period of time. An independent party would analyse its losses and ensure that either it returns to a profitable position or it would close its business altogether. There is no reason for a business to continue if there is no return on the investment. There may be certain business strategies that an MNE is following but even if there is a market penetration strategy to gain a higher market share through lower prices, this strategy would not last forever.

An obvious common reason for a related party to make only losses is because they are producing vital goods as part of a product line for the MNE as a whole, where the benefits for the MNE are higher than the actual loss realised for the related party. For example, EvoCar has established three fully-fledged manufacturers who supply DisCo (UK) with the cars to be sold. For ease of reference the fully-fledged manufacturers in Diagram 3 are named: FFMan1(C), FFMan2 (I) and FFMan3 (B). The fully-fledged manufactures are incorporated in China, India and Brazil respectively

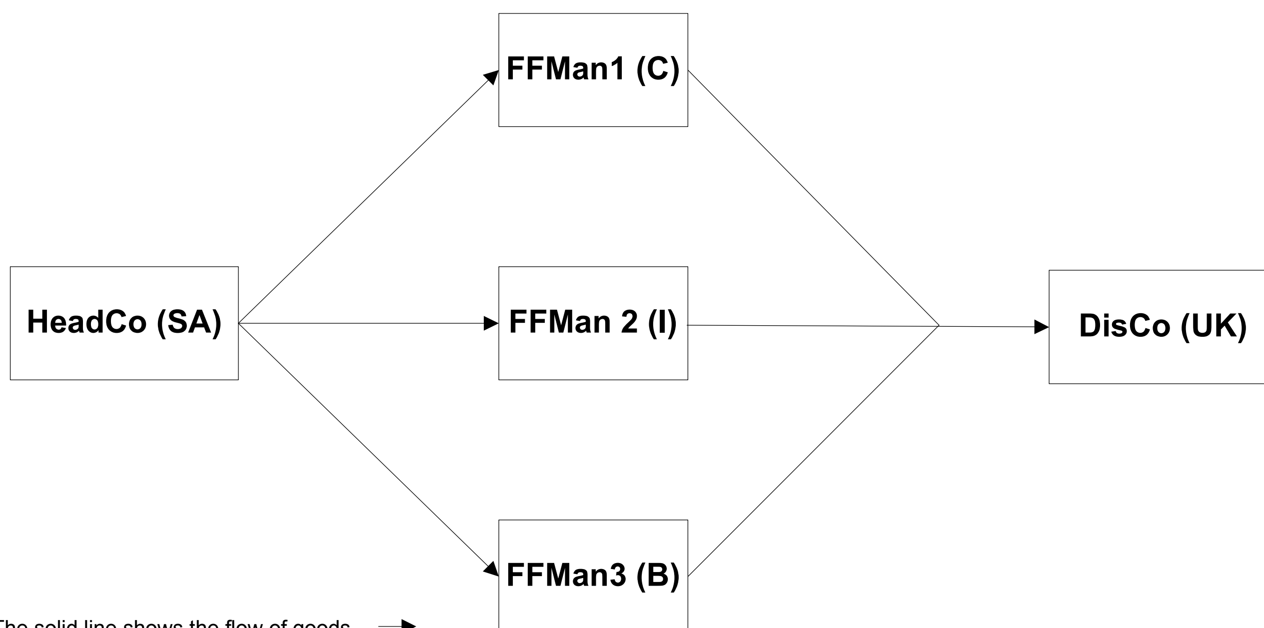


Diagram 3

FFMan1 (C) and FFMan2 (I) both make reasonable returns on their manufacturing. FFMan3 (B) has been running at a loss for the last five years. However, DisCo (UK)'s sales are above average in the market which is due to the wide range of cars that it offers and it achieves a higher return than normal. When looking at EvoCar as a whole, the net returns are higher with the current structure where FFMan3 (B) makes a loss. The reason is that DisCo (UK)'s return offsets FFMan3 (B) losses and achieves a much higher profit after the set-off than it would without the wide range that it offers.

An independent party in FFMan3 (B)'s position would not continue trading without sufficient remuneration for its activities. This means that, even in an MNE where the benefits may outweigh the costs of the company, that company should be remunerated for producing the benefits. In the example above, EvoCar could use the extra revenue to remunerate FFMan3 (B) for it to achieve a similar return to that of FFMan2 (I) or FFMan1 (C), depending on the circumstances. The OECD Guidelines (2001) would approach this problem by comparing what an independent party should receive in this instance for the services rendered and would deem the loss-making entity to receive such an income for the purposes of its tax returns assessable by the relevant tax administration.

2.5.3.5 General comments

There are certain other issues that have been identified as being relevant to transfer pricing and the arm's length principle.

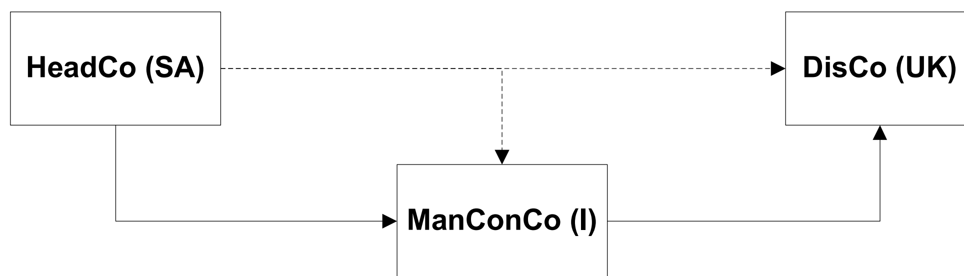
Use of multiple year data

The OECD Guidelines (2001) state that in order to acquire all the necessary information to understand the controlled transaction in its entirety it is helpful to analyse the current year as well as prior years. The reason for examining prior years is that it gives the examiner a better picture of how the transaction was influenced and how it should have been influenced were it being traded at arm's length. For example, analysing prior years may give a better insight into the controlled transaction's history, considering the relevant business and product life cycles which may have a material effect on the transfer pricing conditions that should be assessed to determine comparability. The same holds true for the uncontrolled transaction, to ensure that the transaction is actually comparable to the controlled transaction.

Effect of government policies

The OECD Guidelines (2001) set a general rule for government policies such as price controls, price cuts, control over payments, interest controls, controls over royalty payments, exchange control, anti-dumping policies or even subsidies to particular sectors of the market, which should be treated as conditions of the market in a particular country. The question that needs to be answered is whether an independent party would still be willing to do business with these government policies in place.

In order to understand whether an independent party would undertake a transaction with government policies in place, the actual policies that may affect the pricing should be examined. An independent party would not be willing to provide services or products without a profit, but a country with certain price controls will affect the obtainable profits. Government policies may even disallow certain payments. This means that the party cannot pay out money for a certain transaction, which may lead to double taxation.



The solid line shows the flow of goods →
The dotted line shows the flow of services ⇢
Diagram 2A

For example, as previously discussed in Diagram 2A, ManConCo (I) wishes to pay its interest expense to HeadCo (SA). However, the Reserve Bank stops the payment due to government policies. EvoCar as a whole may be subject to double taxation for its interest expense. This is due to the fact that the interest expense is added back to the profit of ManConCo (I) for income tax purposes because the payment was not allowed by the government in India and HeadCo (SA) is deemed by the government in South Africa to have received the interest on the loan. There is no easy answer to this and a solution suggested by the OECD Guidelines (2001) is to see the intervention as the arm's length principle. In the above example that would mean that the interest income should not be regarded as deemed income by South Africa, which would eliminate the issue of double taxation.

It may be very difficult to compare transactions in such circumstances, as independent parties usually would not be willing to take the risk of non-payment and therefore there may be no comparable transaction.

International set offs

An international set off occurs when two cross-border related parties provide benefits to each other, and set off the payment in full or part with a benefit instead of paying for the actual benefit received. As an example, EvoCar could share its intellectual property or know-how between HeadCo (SA) and ManConCo (I) and *vice versa*. In order to have an international set off, the actual benefits need to be quantified and analysed in terms of the arm's length principle. The OECD Guidelines (2001) have no problem with actual international set offs as long as they are at arm's length and the tax administration agrees to the terms. In South Africa the Reserve Bank prohibits international set offs and all- in and out-bound transactions are required to be received and paid for.

Use of a customs valuation

The OECD (2001) confirms that the customs administration usually adopts an arm's length approach to similar goods of independent parties to value goods imported from related parties to ensure fair customs duty. Both tax administrations and customs officials value a transaction at the time of import or transfer which means that the valuation of the customs official may be useful to the tax administration.

Further the OECD (2001) states that a difference between the customs values and values declared for transfer pricing purposes may cause the tax administration to conduct an enquiry into the affairs of a company. There are similarities in the objectives and policies of a customs duty valuation and a transfer pricing valuation, but this does not necessarily imply that a transfer price which is acceptable for income tax purposes will be suitable for customs duty purposes, and *vice versa*. A taxpayer may try to set a low price for customs duty purposes in order to save on customs duty but, on the other hand, the taxpayer may want to set a high price on imported goods in order to increase the tax deduction.

Use of transfer pricing methods

The most widely accepted transfer pricing methods adopted by global tax administrations will be discussed in detail in chapter 3. To correctly apply the arm's length principle with transfer pricing methods, a condition imposed on financial or commercial transactions between related parties should be consistent with the arm's length principle. It is important to note that no one method will suit every possible situation and that no one method can simply be rejected. The OECD is of the opinion that the relevant tax administrations should not make minor or marginal adjustments to transactions just because they do not like a particular method or believe the method is not suitable (OECD: 2001). The OECD Guidelines (2001) state that a taxpayer may also use his own method not dealt with in the OECD Guidelines, provided the transfer price established through the method satisfies the arm's length principle in accordance with the OECD Guidelines.

There are many different methods that a taxpayer can use but the arm's length principle does not require more than one method to be used for one transaction. The OECD Guidelines' (2001) reason for this is that it would place a heavy burden on the taxpayer, who would incur higher costs to be tax compliant. It may also create undue reliance on the approach chosen. In the process of calculating the correct transfer price, a taxpayer may consider more than one method but usually chooses the most appropriate one and then uses this method throughout the years. There may be cases for which it is very difficult to find a suitable method. In such cases the OECD Guidelines (2001:I-27) state that a "flexible approach would allow the evidence of various methods to be used in conjunction. In such cases, an attempt should be made to reach a conclusion consistent with the arm's length principle that is satisfactory from a practical viewpoint to all the parties involved, taking into account the facts and circumstances of the case, the mix of evidence available, and the relative reliability of the various methods under consideration."

It is not possible to provide specific rules for every single case that may arise. The general rule given by the OECD Guidelines (2001) is to choose a method that is most suitable to give an accurate result through establishing the most direct means to compare commercial and financial relations between the related parties It is important to keep all useful information about the controlled transaction and ensure that a method does not disregard particular information. The reason to analyse this useful information is that it may help to fully understand the controlled transaction and therefore may lead to a different interpretation of the transaction, which may lead to the use of another method.

Non-comparable transactions

Another practical difficulty in applying the arm's length principle to every single cross-border transaction is that related parties often engage in transactions that independent parties may not engage in. The main reason for this is that an MNE such as EvoCar will look for the greater good of the whole group company whereas a single legal entity will only do what is best for itself. The OECD Guidelines (2001:I-4) give an example where:

> the owner of an intangible may be hesitant to enter into licensing arrangements with independent enterprises for fear of the value of the intangible being degraded. In contrast, the intangible owner may be prepared to offer terms to associated enterprises that are less restrictive because the use of the intangible can be more closely monitored. There is no risk

> to the overall group's profit from a transaction of this kind between members of an MNE group. An independent enterprise in such circumstances might exploit the intangible itself or license it to another independent enterprise for a limited period of time (or possibly under an arrangement to adjust the royalty). However, there is always a risk that the intangible is not as valuable as it seems to be. Therefore, an independent enterprise has to make the choice between selling the intangible and so diminishing the risk and safeguarding the profit, and exploiting the intangible and taking the risk that the profit will vary from the profit which could be gained by selling the intangible. Where independent enterprises seldom undertake transactions of the type entered into by associated enterprises, the arm's length principle is difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises.

There are some other factors that may complicate a comparison between an independent party transaction and a related party transaction, for example, where a transaction between HeadCo (UK) and ManConCo (I) in Diagram 2A involves a specific or specialised process that is not readily available, such as certain research and development procedures. This transaction could not be compared with an independent party transaction. In most cases no two transactions are exactly the same, which means that certain hypothetical adjustments have to be made to the affected transactions in order to make them comparable.

Administrative burden

Applying the arm's length principle may lead to an administrative burden in a sense that each single transaction will have to be compared to an independent party transaction. This means that both the MNE and the tax jurisdiction will have to gather information regarding each transaction undertaken. The OECD Guidelines (2001) stipulate that this may be a time consuming exercise and it may be difficult to obtain adequate information regarding the affected transaction. As a result immaterial transactions usually do not require a full transfer pricing analysis to ensure that the transaction complies with the transfer pricing guidelines or with section 31 of the Income Tax Act.

2.6 Conclusion

Chapter 2 described all the related terms, definitions and aspects of transfer pricing with the aid of an example. The arm's length principle was analysed in detail as it is the fundamental principal of transfer pricing. It is important to keep in mind that the arm's length principle is not an exact science. It may be very difficult to apply in certain circumstances but theoretically it is the fairest approach available at present.

In order to discuss transfer pricing concepts further the appropriate arm's length price range is discussed in the next chapter. This may shed some light on why anomalies may arise from business restructuring by multi-national enterprises.

3 Chapter 3: Determining an appropriate arm's length price range

3.1 Introduction

The previous chapter discussed the concept of transfer pricing in detail, as well as the arm's length principle and the basis on which it should be established. Various factors that may have an impact on the arm's length price were also explained. The hypothetical example used to illustrate transfer pricing in the context of business restructurings was introduced and used to explain aspects of the arm's length principle.

The present chapter completes the analysis required to address the first aim of the research, which is to discuss the basis for transfer pricing, the arm's length principle and the methods used to determine and apply an arm's length price.

The methods discussed in the chapter are:

- the traditional transaction methods, comprising the comparable uncontrolled price method, the resale price method and the cost-plus method;
- the transactional price methods, comprising the profit-split method and the transactional net profit method; and
- the non-arm's length method, consisting of the global formulary method.

The relationship of the methods with article 9 of the OECD Model Tax Convention (2003) and the advantages and disadvantages of and the difficulties encountered with each of the methods are discussed and, where relevant, illustrated with the use of examples.

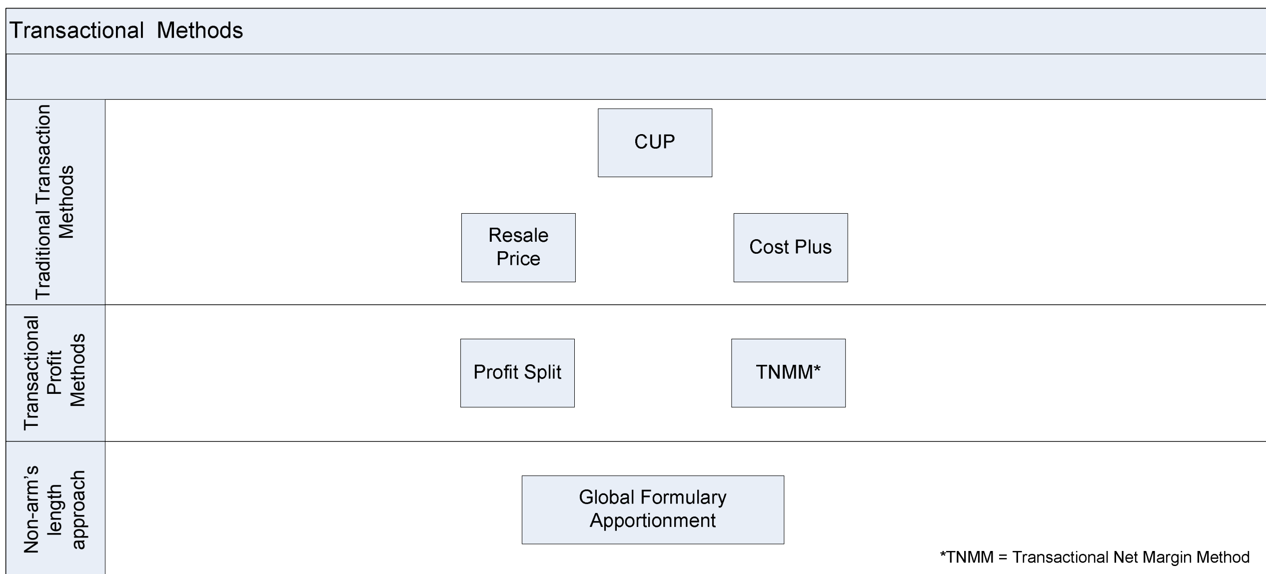
The aim of chapter 3 is to give a thorough understanding of the methods available to determine and apply the arm's length price. The examples provide a better understanding of how the methods apply.

3.2 Transactional methods

3.2.1 Introduction

The transactional methods are used to calculate an appropriate arm's length price range. There are two different sets of transactional methods given by the OECD Guidelines (2001): the traditional transaction methods and the transactional profit methods. The traditional transaction methods are the comparable uncontrolled price method ("CUP"), the resale price method and the cost plus method, which are the methods preferred by the OECD Guidelines (2001) to be used in order to calculate the arm's length range. However, if a transaction does not meet the requirements of a traditional transaction method, the taxpayer may consider the transactional profit methods, which include the profit split method and the transactional net margin method.

The most appropriate methods from the viewpoint of the OECD Guidelines (2001) are illustrated in the following diagram, from the most preferred at the top to the least preferred at the bottom.



(Own diagram)

3.2.2 Relationship with Article 9 of the OECD Model Tax Convention

As discussed in the previous chapter, Article 9 of the OECD Model Tax Convention (2003:12) states that:

> [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.

To put the above into context the Commentary on Article 9 (2003:141) authorises a tax administration

> for the purpose of calculating tax liabilities [to] re-write the accounts of the [associated] enterprises if as a result of the special relations between the enterprises the accounts do not show the true taxable profits arising in that State.

The true taxable profits are those that would have been achieved if the MNE had traded at arm's length. Therefore the Commentary to Article 9 does not apply to transactions done in open market situations or arm's length transactions. Simply put by the OECD (2001), this means that an account may only be re-written if a special condition or a condition that was not at arm's length was present during an MNE transaction.

The OECD Guidelines (2001:II-2) state that the

> most direct way to establish whether the conditions made or imposed between associated enterprises are arm's length is to compare the prices charged in controlled transactions undertaken between those enterprises with prices charged in comparable transactions undertaken between independent enterprises. This approach is the most direct because any difference in the price of a controlled transaction from the price in a comparable uncontrolled transaction can normally be traced directly to the commercial and financial relations made or imposed between the enterprises, and the arm's length conditions can be established by directly substituting the price in the comparable uncontrolled transaction for the price of the controlled transaction.

There will not always be comparable transactions available to use in this approach and it may be necessary to use less direct methods to establish if the conditions of a related party transaction conform to the arm's length principle. The different approaches and methods, including direct and indirect methods, are described below.

3.2.3 Traditional transaction methods

The traditional transaction methods used to apply the arm's length principle consist of the CUP method, the resale price method and the cost plus method. The traditional transaction methods are the methods preferred by the OECD Guidelines and the taxpayer should always try to use these methods first and only if one of these three methods cannot be applied to a controlled transaction should recourse be had to other methods.

3.2.3.1 Comparable uncontrolled price method

The CUP method is the method most preferred by the OECD Guidelines (2001). It compares the price charged for a property or service between independent parties to a price charged for a property or service between related parties in comparable circumstances. In essence the CUP method is applied to transactions which are identical or at least very similar between related and independent parties with only immaterial differences if any, for which reasonable and accurate adjustments can be made (OECD: 2001).

The OECD Guidelines (2001) state that the CUP method is the most direct and reliable way to determine the arm's length price, but it may be very difficult to find a comparable transaction between independent and related parties, without any material differences. In practice a small difference in the character of a certain good, such as its quality, may influence the price of the transaction even if the business activities of the independent and related parties are equivalent. In this case certain adjustments are necessary in order to use the CUP method. For example, EvoCar's product range may not be comparable to any other car manufacturer as it may be using a special engine in a certain range. A thorough functional analysis should be carried out before determining whether the use of a CUP is appropriate.

It is important to note that the effects on the price arising from broader business functions must be taken into account, rather than just product comparability, in order to determine if the CUP method is applicable. The OECD Guidelines (2001:II-3) stipulate that:

> Where differences exist between the controlled and uncontrolled transactions or between the enterprises undertaking those transactions, it may be difficult to determine reasonably accurate adjustments to eliminate the effect on price. The difficulties that arise in attempting to make reasonably accurate adjustments should not routinely preclude the possible application of the CUP method. Practical considerations dictate a more flexible approach to enable the CUP Method to be used and to be supplemented as necessary by other appropriate methods, all of which should be evaluated according to their relative accuracy. Every effort should be made to adjust the data so that it may be used appropriately in a CUP method. As for any method, the relative reliability of the CUP Method is affected by the degree of accuracy with which adjustments can be made to achieve comparability.

To better understand the CUP method the following example illustrates the application of the CUP method and the adjustments, where necessary, in order to make the transactions between related and independent parties comparable.

Assume that an independent distributor sells cars, received from an independent manufacturer, of the same type, quality and quantity as DisCo (UK), in the same period. The quality refers to the raw materials and machinery used and the way the cars are built as well as how the cars handle in day-to-day circumstances. The type refers to the actual chassis, engine and other important parts and brands used in the cars. Lastly, quantity refers to the actual units sold by the independent party and DisCo (UK). It is important that these facts are similar because a different quality in the cars or total output may change the price of the cars due to lower or higher input costs. The timing of the transaction and where the parties are within the value chain must be similar. This ensures that DisCo (UK) is compared to an independent distributor and not a manufacturer within the same financial year. Lastly, all other relevant factors such as marketing, warranty and insurance of delivery must be similar. The timing must be comparable due to different economic circumstances in different periods. The sales of cars have decreased over the last few years and therefore one could expect prices to change compared to ten years ago, due to equal or greater supply and lower demand. If all of the above circumstances and conditions are comparable, without any material differences, the most appropriate method to use is the CUP Method.

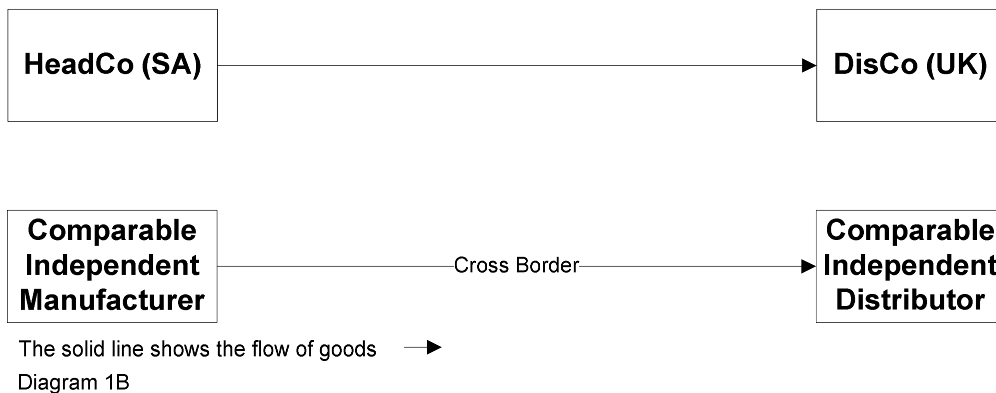


Diagram 1B

There may be cases where most of the conditions are the same in an independent party transaction and a transaction between two related parties, except for a minor condition. For example, in the independent party transaction the manufacturer retains ownership of the cars, and therefore has more risk and a higher selling price when compared to HeadCo (SA)(Diagram 1B) which transfers its ownership of the cars as soon as they leave the factory. Therefore DisCo (UK) carries more risk of losing stock during delivery and may wish to insure its goods. Usually one can easily adjust for such a difference in price. If the goods are insured in the related party transaction one can simply subtract the additional cost and then compare the two prices. However, if it is not possible to make a reasonably accurate adjustment, the reliability of the CUP Method would be diminished. It may then be necessary to choose a less direct method.

The OECD Guidelines (2001) acknowledge that a CUP could also exist between a related party transaction and that of the same supplier in the related party transaction and an independent party. For example, in Diagram 1C below, HeadCo (SA) supplies cars to DisCo (UK) as well as to the independent distributor (Diagram 1B above). If all the functions performed, assets used and risks assumed by DisCo (UK) and the independent distributor are the same, there may be a CUP. Keeping the other factors discussed above in mind, one could compare the two transactions to analyse the transfer price between the two related parties, namely HeadCo (SA) and DisCo (UK). This CUP may also be referred to as an internal CUP, because EvoCar makes its own comparable uncontrolled transaction.

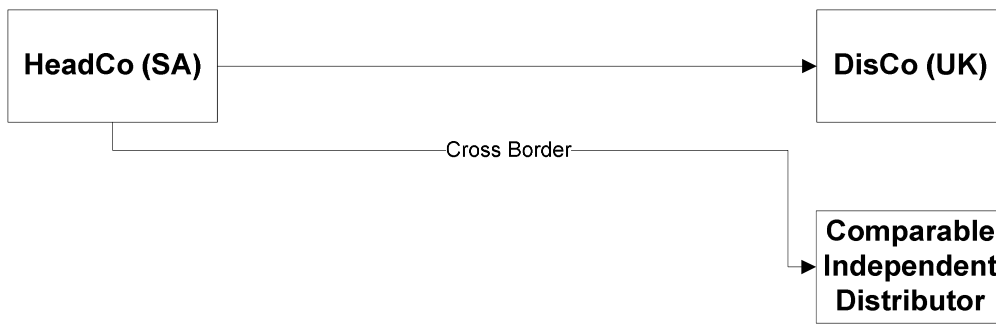


Diagram 1C

3.2.3.2 Resale price method

The OECD Guidelines (2001:II-5) explain that:

> The resale price method begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price (the resale price) is then reduced by an appropriate gross margin (the "resale price margin") representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. What is left after subtracting the gross margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. customs duties), as an arm's length price for the original transfer of property between the associated enterprises. … The resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions. Also, the resale price margin earned by an independent enterprise in comparable uncontrolled transactions may serve as a guide.

To make the above definition of the resale price method clear it is explained with the aid of Diagram 1D below.

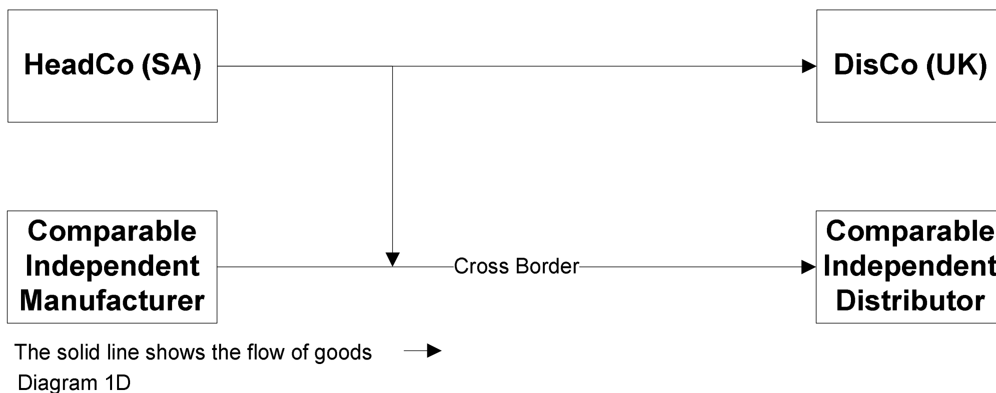


Diagram 1D

In order to apply the resale price method, the tested party is required to resell a product purchased from a related party. In the above example, Diagram 1D, DisCo (UK) on-sells cars which it purchased from HeadCo (SA). There are two ways to compare the related party transaction to that of a comparable transaction. Either the transaction is compared to the transaction shown above between Comparable Independent Manufacturer and Comparable Independent Distributor or it is compared to a transaction between the same manufacturer and an independent distributor, such as HeadCo (SA) and Comparable Independent Distributor. Once a comparable transaction has been identified the resale price margin needs to be determined. A comparison of the related party transaction to that of a comparable transaction including the same manufacturer is seen to be more reliable as that of a separate manufacturer. The reason is that HeadCo (SA) would be less willing to modify its price structure in a transaction with an independent party than with another related party and there should be fewer differences to adjust for. If there is no such comparable transaction, i.e. a transaction involving the same manufacturer, HeadCo (SA), then the related party transaction should be compared to the independent party transaction. In Diagram 1D this is Comparable Independent Manufacturer and Comparable Independent Distributor. After the resale price margin has been calculated, the next step is to ensure that there are no other conditions that may influence the transaction, such as customs duties. After the resale price is reduced by the resale price margin and any other costs associated with the purchase of the product, the arm’s length price is determined.

In order to apply a resale price method it is important that none of the differences, if any, between the comparable transactions could influence either transaction materially and therefore distort the resale price margin in the open market. If there should be a difference in comparables, these must be adjusted for correctly in order to apply the resale price method. It is easier to adjust for differences with a resale price method approach than with the CUP Method approach, because a few differences in a product usually have less of an

impact on gross margins than actual prices. This is explained by the OECD Guidelines (2001:II-6) as follows:

> In a market economy, the compensation for performing similar functions would tend to be equalized across different activities. In contrast, prices for different products would tend to equalize only to the extent that those products were substitutes for one another. Because gross profit margins represent gross compensation, after the cost of sales for specific functions performed (taking into account assets used and risks assumed), product differences are less significant.

Taking the above into consideration, the resale price method may be appropriate when comparing coffee machines with kettles because the sale of such goods should result in similar compensation. The CUP Method may not be applicable as one cannot expect the prices of coffee machines and kettles to be the same. However, the resale price method would produce a better result if conditions are more comparable. Differences in products may reflect the use of different functions, for example certain intellectual property.

The OECD Guidelines (2001) set out other points to consider when applying the resale price method:

- The reliability may be affected if there are differences in the way the independent party conducts business compared to the related parties. The reason for this may be that certain inefficiencies in management may increase costs which inherently increase the resale price margin.
- The more value is added by the selling party to the product before it is on-sold the more difficult it will be to apply the resale price method. The reason for this is that it may be difficult to adjust the transaction for the value added particularly where the identity of the product is changed. The same is true for the creation or maintenance of intellectual property because it is very difficult to adjust for the value-added contribution by the intellectual property.
- A resale price margin is more accurate the shorter the timeframe from purchase to resale. The reason for this is that the time of holding a good may change its costs, for example storage costs, exchange losses or insurance costs.
- The amount of the resale price margin is proportionally affected by the level of activities performed by the re-seller. A re-seller that only performs the actual passing on of the good as an agent would have a smaller resale price margin

compared to a reseller that is involved in extensive marketing, has full ownership of the goods, advertising, financing stocks, and so forth. The reason for a higher resale price margin is that more functions carry more risks and therefore the party should be remunerated for this, in comparison to an agent that carries no risk.

- It is important to establish if the reseller has the exclusive right to sell the good, as this may increase the price of the good as well as the resale price margin.
- One should ensure that the accounting practices are comparable. The reason for this is that in order to compare the resale price margin, the operating and/or selling expenses should be comprised of the same costs. For example research and development costs may fall under operating expenses or cost of sales depending on what accounting method is used.

The OECD Guidelines (2001) stipulate that the resale price method is probably most useful where it is applied to marketing operations.

3.2.3.3 Cost plus method

The cost plus method is very similar in its application to the resale price method. The difference in the cost plus method is that, instead of calculating a resale margin and its relating arm's length price, all costs incurred in rendering a specific service or supplying a product are added up and a cost plus margin is added to the total cost in order to arrive at an arm's length price.

The OECD Guidelines (2001:II-11) state that:

> the cost plus method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to a related purchaser. An appropriate cost plus mark up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction. This method probably is most useful where semifinished goods are sold between related parties, where related parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services.

The OECD Guidelines (2001) state that in order to ensure the cost plus mark up is applied at arm's length, it should preferably be compared to a cost plus mark up on a comparable uncontrolled transaction either between two independent parties (Comparable Independent Manufacturer and Comparable Independent Distributor), or where the same related supplying party transacts with an independent party under the same circumstances as with its related party (HeadCo (SA) and Comparable Independent Distributor). Refer to Diagram 1D below. The same principles for a comparable uncontrolled transaction apply. In order for a transaction between two related parties and that of independent parties to be comparable none of the conditions may materially affect a transaction and, if there is a material difference, it must be adjustable to render the difference immaterial (OECD: 2001).

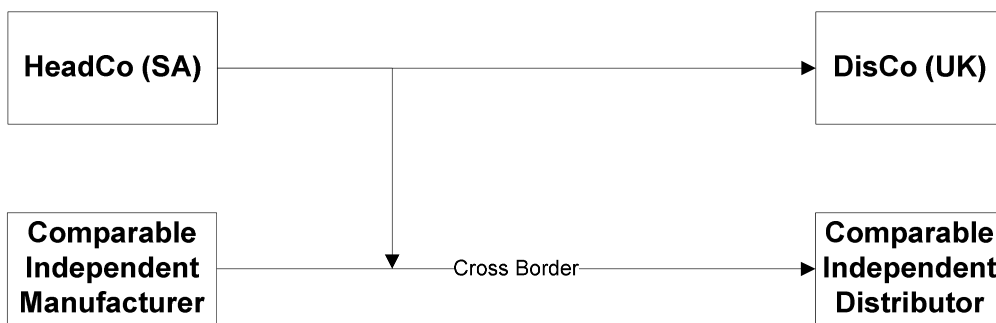


Diagram 1D

The OECD Guidelines (2001) acknowledge that the cost plus method may need fewer adjustments than the CUP Method due to its methodology of not comparing prices but rather the cost factors. This may lead to different comparisons within transactions and more weight is given to cost factors that influence the arm's length consideration rather than on the price itself.

There are difficulties that may arise in the application of the cost plus method, particularly in the determination of costs. Every company will have to recover its cost in order to stay in business. The problem with certain costs is that there is not always a link that can be established between revenue realised and costs incurred as they may have been realised in different years. For example, certain marketing strategies may take a year to increase revenues. This may make it difficult to apply the cost plus method because the actual costs between the parties are dissimilar. A good example from the OECD Guidelines (2001:II-12) is: "where a valuable discovery has been made and the owner has incurred only small research costs in making it."

It is important to adjust for such costs correctly. Another important aspect of the cost plus method is that a comparable mark up needs to be applied to a comparable cost basis. When determining if a mark up from a comparable uncontrolled transaction is applicable a closer look must be had at its cost basis. This means a mark up may not be comparable if the functions involved in the cost base differ between the potential comparable transactions. For example, in Diagram 1D, HeadCo (SA) renders marketing services when supplying goods to Comparable Independent Distributor to help market the cars. However, HeadCo (SA) renders no marketing services when supplying goods to DisCo (UK) for the same cars delivered. The latter transaction should receive a lower cost plus margin because DisCo (UK) should be remunerated for its marketing function and not HeadCo (SA). Therefore the price to DisCo (UK) should be lower. This may render the potential comparable uncontrolled transaction incomparable and the OECD Guidelines (2001:II-13) state that “therefore, differences between the controlled and uncontrolled transactions that have an effect on the size of the mark up must be analyzed to determine what adjustments should be made to the uncontrolled transactions' respective mark up.”

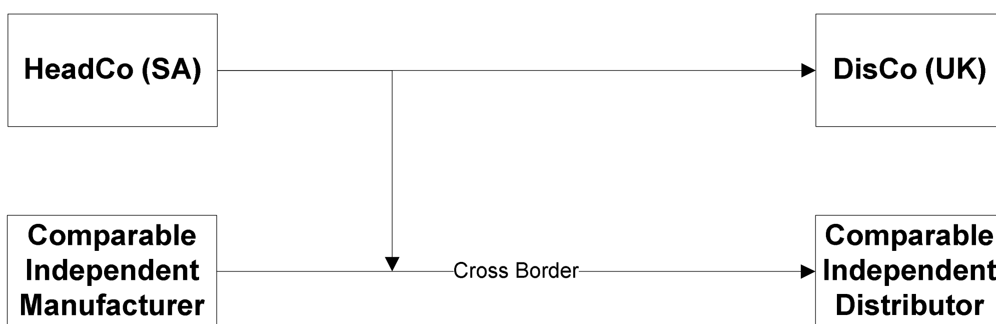


Diagram 1D

The OECD Guidelines (2001) consider other points when applying the cost plus method as follows:

- The comparability of the accounting methods and principles used and applied to ensure consistency between the potential comparable parties; this is important to ensure that the same types of costs are used to calculate a comparable cost base.
- Some costs, such as labour or material costs, vary over time and therefore it may be appropriate to average these costs over a period of time. It may also be appropriate to average costs for fixed assets where production output fluctuates. The averaging of costs may give a more comparable cost base and can be applied to different costs as long as it makes economic sense.

There is no general rule or guidance that sets out all the situations that may arise from a cost plus method perspective but the OECD Guidelines (2001:II-16) state that: "[t]he various methods for determining costs should be consistent as between the controlled and uncontrolled transactions and consistent over time in relation to particular enterprises."

3.2.4 Transactional profit methods

Traditional transaction methods are the methods preferred by the OECD Guidelines (2001) as they are the most direct means to establish whether commercial and financial conditions between two transactions are at arm's length. However, in the modern day economy, complex business structures and the difficulties of obtaining certain relevant information, may put practical problems in the way of actually applying these more direct comparison methods. Where there is insufficient information or no reliable information, transactional profit methods may be considered.

The transactional profit methods examine the profits of related party transactions. The OECD Guidelines (2001:III-1) state that the only "profit methods that satisfy the arm's length principle are those that are consistent with the profit split method or the transactional net margin method as described."

It is unusual for companies to enter into a contract where the profit is a condition made or imposed in a transaction and in reality companies almost never use a transactional profit method to establish their prices. Nonetheless the OECD Guidelines (2001:III-1) state that profits "arising from a controlled transaction can be a relevant indicator of whether the transaction was affected by conditions that differ from those that would have been made by independent enterprises in otherwise comparable circumstances. Thus, in those exceptional cases in which the complexities of real life business put practical difficulties in the way of the application of the traditional transaction methods and provided all the safeguards" required are present, the application of a transactional profit method may be consistent with the arm's length principle.

It is important to note that one cannot apply a transactional profit method simply because it may be difficult to find relevant data. The OECD Guidelines (2001:III-2) state that: “The same factors that led to the conclusion that it was not possible to reliably apply a traditional transaction method must be reconsidered when evaluating the reliability of a transactional profit method. Rather, the reliability of a method should be assessed … including the extent and the reliability of adjustments to the data used.”

The OECD Guidelines only accept methods based on profits if they are compatible with Article 9 of the OECD Model Tax Convention.

3.2.4.1 Profit split method

The OECD Guidelines (2001:III-3) explain the application of the profit split method as follows.

> Where transactions are very interrelated it might be that they cannot be evaluated on a separate basis. Under similar circumstances, independent enterprises might decide to set up a form of partnership and agree to a form of profit split. Accordingly, the profit split method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction ... by determining the division of profits that independent enterprises would have expected to realise from engaging in the transaction or transactions. The profit split method first identifies the profit to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged. It then splits those profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length. The combined profit may be the total profit from the transactions or a residual profit intended to represent the profit that cannot readily be assigned to one of the parties, such as the profit arising from high-value, sometimes unique, intangibles. The contribution of each enterprise is based upon a functional analysis …, and valued to the extent possible by any available reliable external market data. The functional analysis is an analysis of the functions performed (taking into account assets used and risks assumed) by each enterprise. The external market criteria may include, for example, profit split percentages or returns observed among independent enterprises with comparable functions.

One of the advantages of the profit split method given by the OECD Guideline (2001) is that it does not rely directly on closely comparable transactions and therefore can be used if no comparable transaction can be determined from available data. The profit split in the transaction is based on functions performed by each party. The more functions are performed and risks assumed with the assets used, in comparison to the other party, the more profit should be allocated to that party. The profit split method does not analyse the division of profit to each party but it analyses the functions performed and whether the contribution made is in accordance with the profit received in order to transact at arm's length. This makes it possible for the profit split method to take specific and unique facts and circumstances into consideration which may not be found in independent transactions, while still maintaining an arm's length approach by reflecting what an independent party would reasonably have done in a similar position.

The OECD Guidelines (2001) analysed another advantage of the profit split method. The advantage is the profit split method analyses both parties and therefore it is less likely that one party will end up with extreme and unjustified profits. This is especially helpful when analysing a transaction involving intellectual property. This two-sided approach is also advantageous in ensuring a fair division of profits from economies of scale or other joint efficiencies achieved by MNEs that satisfy both taxpayer and tax administrations.

On the other hand the OECD Guidelines (2001) determined that there are a few disadvantages when applying the profit split method. One of the main disadvantages is that the method is less direct in the comparison of transactions with independent parties. This may lead to a more subjective result in allocating the profits. Another disadvantage is the actual application of the profit split method. At first glance the profit split method may seem easy and quicker to apply than other methods because the method relies on less information from independent parties. This is due to the fact that independent parties do not usually use a profit split method to determine their transfer prices unless they are acting within a joint venture. However it may also be difficult to find relevant information from related parties. Even if all the information required is examined, it may still be difficult to measure the combined revenue and costs of each related party participating in the transaction. The reason for this is that in order for the profit split method to work one would have to state all the relevant book entries on a common basis and make the relevant adjustments to each accounting policy, practice and its currency. The application of the

profit split method may be even more difficult when it is applied to operating profit because it may not be clear what operating expenses are associated with the actual transaction and how to allocate the costs (OECD: 2001).

To further understand the profit split method, it is illustrated in an example below with the aid of Diagram 4.

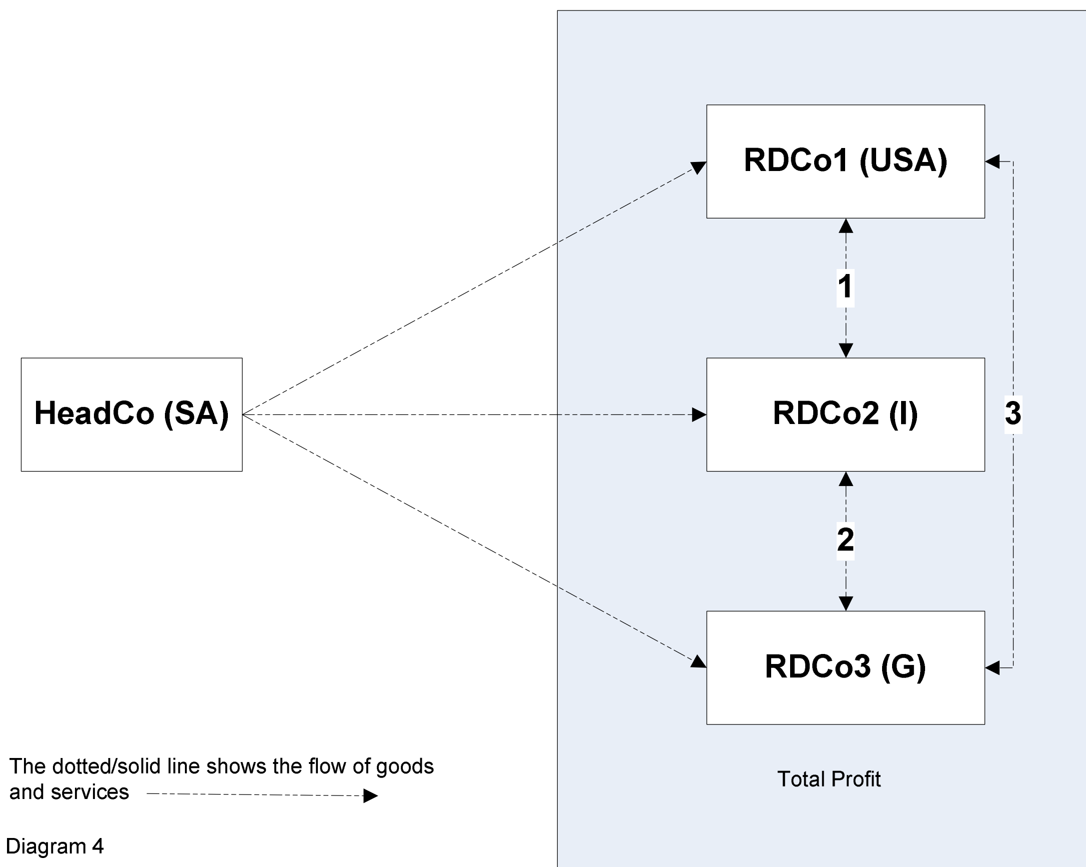


Diagram 4

In Diagram 4, above EvoCar has three interrelated party transactions shown as 1, 2 and 3. The interrelated transactions depend on each other, meaning that one transaction would not be commercially and economically viable without the other transactions occurring simultaneously. This makes the set up of the transactions unique and it may be very difficult, if not impossible, to find a direct method to compare these transactions to an independent party. Therefore the profit split method, even though less direct, may be more appropriate to apply as it allows for adjustments for unique transactions.

An example of a transaction where the profit split method is appropriate with regard to Diagram 4 above can be demonstrated as follows. EvoCar incorporated three companies, RDCo1 in the USA, RDCo2 in India and RDCo3 in Germany, involved in the research and

development of new engines for EvoCar's vehicles and the manufacturing of relevant prototypes. The research and development of new engines is very specialised and performed by skilled employees in all three related entities (RDCo1 (USA)/RDC02 (I)/RDCo3 (G)). Due to the nature of the transaction and the type of industry, it is very difficult to find a comparable transaction. A profit split method may be applicable in this example because all three related entities work together to research and develop new engines and it cannot be valued as a single transaction, because without any of the related companies there may not have been an outcome. Another reason which justifies the use of a profit split method rather than a traditional method is that it may be impossible to gather required information from independent parties due to the confidentiality restrictions within the industry. In order to apply a CUP method, cost plus method, or a resale minus method, one would need to know all the details of the transactions in order to estimate the value added and to determine the relevant arm's length price. An independent party would not be willing to publish its secrets and relevant information to a tax administration if it were in the same industry as the related party.

When applying a profit split method the OECD Guidelines (2001) acknowledge that the potential profit to be achieved and split between the related parties is only an estimate of what independent parties would do and therefore may change due to unforeseen economical circumstances, as the estimates are based on current circumstances for future events. This is particularly important for the relevant tax administrations. When considering an accurate split, they need to realise that in certain instances the taxpayer could not have foreseen the actual outcome and a taxpayer should not be penalised for a wrong estimate. If this is not taken into consideration, the tax administration could penalise or reward the taxpayer by using the profit split method, which is contrary to the arm's length principle. Independent parties could not have foreseen future impacts either and may have made the same wrong estimates.

There are different ways of estimating the division of profits between related parties, based on potential or actual profits. That is why the OECD Guidelines (2001) express the opinion that the tax administration should follow the same approach as the related party to ensure the estimation of the division of profits is at arm's length. If however the related party has not determined the conditions in the controlled transaction on a profit split method basis, the tax administration would evaluate the conditions on the actual profit realised by each related entity.

The OECD Guidelines' (2001) usual approach to allocating profits to each related party in the participating transactions analysed, is by valuing each function performed, risk assumed and assets used by each related party involved. This is also known as a contribution analysis. The value of the function performed, risk assumed or assets used should be proportional to the amount of profits or losses to be earned from the participating controlled transaction. If possible the estimated division of profit may have to be amended with available independent party information with regard to their division of profits in similar circumstances. Obviously where the division of profit can be measured directly with an independent party it might not be necessary to estimate the value of each controlled party from its functions performed, risks assumed and assets used. Generally in the contribution analysis the relevant operating profit is combined to ensure correct and fair profit to be allocated to each party. In some instances where an MNE has general expenses, the gross profit of all the related parties may be combined and then the total cost of the group may be deducted from the gross profit.

Another approach analysed by the OECD Guidelines (2001) is also known as the residual analysis which divides the profits of the related parties within the controlled transactions in two stages. In the first stage profits would be allocated to each related party based on the basic type of transaction performed. This 'basic return' for the type of transaction performed would be based on market returns achieved for similar types of transactions performed by independent parties. Once the basic return has been allocated accordingly to each party a residual profit or loss should remain because the basic return does not account for unique and valuable assets owned by each party. In the second stage this residual profit is allocated among the parties taking into account how this residual would have been divided between independent parties considering the facts and circumstances of the functions performed, risks assumed and assets used. Further the OECD Guidelines (2001:III-7) state that: "Indicators of the parties' contributions of intangible property and relative bargaining positions could be particularly useful in this context."

The residual profit derived in the residual analysis approach may be derived from the application of traditional methods discussed above. There are many approaches an MNE may base its profit split method on. Any of these applications may be acceptable as long as the approach is similar to that of an independent party or it determines a fair profit split in line with an arm's length profit split. The OECD Guidelines (2001:III-8) state that the

"overriding objective should be to approximate as closely as possible the split of profits that would have been realised had the parties been independent enterprises operating at arm's length."

3.2.4.2 Transactional net margin method

The OECD Guidelines (2001:III-9) describe the transactional net margin method as follows:

> The transactional net margin method examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction... Thus, a transactional net margin method operates in a manner similar to the cost plus and resale price methods. This similarity means that in order to be applied reliably, the transactional net margin method must be applied in a manner consistent with the manner in which the resale price or cost plus method is applied. This means in particular that the net margin of the taxpayer from the controlled transaction ... should ideally be established by reference to the net margin that the same taxpayer earns in comparable uncontrolled transactions. Where this is not possible, the net margin that would have been earned in comparable transactions by an independent enterprise may serve as a guide. A functional analysis of the associated enterprise and, in the latter case, the independent enterprise is required to determine whether the transactions are comparable and what adjustments may be necessary to obtain reliable results.

The OECD Guidelines (2001) acknowledge that the transactional net margin method has distinct advantages as well as disadvantages. One of the advantages is that the net margin method is less likely to be affected by transactional differences compared to actual prices as used in a CUP Method. The transactional net margin method may also be more lenient when it comes to comparing differences between functions in controlled and uncontrolled transactions, unlike the CUP method. One of the reasons for the leniency is that companies may have different gross profit margins due to different functions which reflect in the operating expenses. But one can assume that net profits in similar transactions, even with some differences in functions, should remain similar (OECD: 2001).

Another advantage described by the OECD Guidelines (2001) that the transactional net margin method has over the profit split method is that it does not have to determine the functions performed, assets used or risk assumed by more than one of the related parties. Practically one would find the simplest related entity and ensure it is dealing at arm's length. This can be more cost efficient because less time is spent in analysing the required information. It is not necessary to obtain every single related company's financial statements and records of all their activities. This is very advantageous if an MNE has entities with very complex business structures in terms of its functions performed.

On the other hand the OECD Guidelines (2001) also note that the transactional net margin method has weaknesses, one of which is that a net margin can be more easily influenced through certain factors than the price of a commodity or the gross margin. This may make it difficult to accurately and reliably determine an arm's length transaction based on net margins.

A further disadvantage of the transactional net margin method identified by the OECD Guidelines (2001) is similar to that of the other methods explained above. There may not be sufficient information available to compare the controlled transaction to an uncontrolled transaction. This may be due to independent parties not publishing their financial information for similar transactions or that the information provided is not detailed enough to extract a net margin.

The advantage of the one-side approach discussed above is also a disadvantage because the transactional net margin method is only applied to the simplest related party. The OECD Guidelines (2001) further reflect that even though the one-sided approach is no different from other methods, the resale minus and cost plus method also have this feature, the problem is highlighted with the transactional net margin method due to the fact that it is less reliable to consider only the net margins. The net margin may also be more easily influenced than the gross margin or price of a commodity. The OECD Guidelines (2001:III-12) state that there are different factors which may directly influence the net margin of a company as follows:

> threat of new entrants, competitive position, management efficiency and individual strategies, threat of substitute products, varying cost structures (as reflected, for example,

> in the age of plant and equipment), differences in the cost of capital (e.g. self financing versus borrowing), and the degree of business experience (e.g. whether the business is in a start-up phase or is mature). Each of these factors in turn can be influenced by numerous other elements. For example, the level of the threat of new entrants will be determined by such elements as product differentiation, capital requirements, and government subsidies and regulations.

From the above it is clear that even if two companies are in the same industry and have the same functions the difference in market share or its competitive position may result in different profitability.

The OECD Guidelines (2001:III-11) mention another disadvantage that should be considered.

> There may also be serious difficulties in determining an appropriate corresponding adjustment when applying the transactional net margin method, particularly where it is not possible to work back to a transfer price. This could be the case, for example, where the taxpayer deals with associated enterprises on both the buying and the selling sides of the controlled transaction. In such a case, if the transactional net margin method indicates that the taxpayer's profit should be adjusted upwards, there may be some uncertainty about which of the associated enterprises' profits should be reduced.

It is important to note that the transactional net margin method is the method least preferred by the OECD Guidelines, but in some instances this method may provide a practical solution to otherwise insoluble transfer pricing problems. However, the transactional net margin method must be used sensibly and with appropriate adjustments to ensure comparability (OECD: 2001).

3.2.4.3 Global formulary apportionment

The global formulary apportionment has been suggested as an alternative to the arm's length principle to compare a cross-border related transaction and its related profits for each participating tax administration. The OECD (2001) expresses the opinion that some tax administrations have tried to use the method without success. The global formulary apportionment method is not seen as a suitable method to determine the arm's length price and the OECD Guidelines do not recommend the use of the global formulary

apportionment.

The OECD Guidelines (2001:III-20) provide a description of how the method works.

> A global formulary apportionment method would allocate the global profits of an MNE group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined and mechanistic formula. There would be three essential components to applying a global formulary apportionment method: determining the unit to be taxed, i.e. which of the subsidiaries and branches of an MNE group should comprise the global taxable entity; accurately determining the global profits; and establishing the formula to be used to allocate the global profits of the unit. The formula would most likely be based on some combination of costs, assets, payroll, and sales.

The global formulary apportionment should not be confused with the transactional net margin method. The two may sound similar but there are certain distinctions, the main one being that the global formulary apportionment method has a pre-determined formula that it has to adhere to. That in itself is contrary to the arm's length principle as no independent party would agree to such a formula.

The OECD Guidelines (2001) state that advocates promoted the use of the global formulary apportionment method as an alternative because it would have greater administrative convenience and certainty for taxpayers. Another belief is that with an MNE it is very difficult, if not impossible, to estimate business reality as most transactions are believed to be interrelated and therefore one cannot determine what contribution each single related party makes to the total profit of the MNE. Lastly the OECD Guidelines (2001) state that this method would reduce the taxpayer's compliance cost as only one set of accounts is needed for the whole group.

The global formulary apportionment method is not accepted by OECD member or observer countries and therefore is not a realistic alternative for the arm's length principle. The reason given by the OECD Guidelines (2001) is that the global formulary apportionment does not achieve the protection against double taxation or ensure taxation of the profit by a single fiscal authority. In order to achieve this, it would require extensive international coordination and consensus on the global formulary apportionment method. The difficulty in this is that every single tax administration must agree to the method and its predetermined formula. A common accounting system would have to be chosen and

adopted within all the tax jurisdictions, even the non-member countries. To achieve this may be very time consuming, extremely difficult and there is no guarantee of no double taxation, because if one tax administration does not apply the method in its jurisdiction there would be a problem.

There are other concerns such as that the global formulary apportionment disregards market conditions. However for the purpose of this thesis it is sufficient to understand that the method and the transition to a global formulary apportionment system present

> enormous political and administrative complexity and require[s] a level of international cooperation that is unrealistic to expect in the field of international taxation. Such multilateral coordination would require the inclusion of all major countries where MNEs operate. If all the major countries failed to agree to move to global formulary apportionment, MNEs would be faced with the burden of complying with two totally different systems (OECD, 2001:III-22).

3.3 Conclusion

This chapter has described the various traditional transactional methods and transactional profit methods that can be applied to approximate an arm's length price between related parties. The hierarchy of the different models has been discussed and each method was further analysed with a practical example. The advantages and disadvantages of each method and the difficulties experienced in their application were also discussed.

Now that it is clear how the arm's length principle is applied in arriving at a transfer price, the concept of business restructuring will be discussed in chapter 4.

4 Chapter 4: The concept of business restructurings in relation to the Income Tax Act and OECD Guidelines

4.1 Introduction

The second aim of the research was to discuss business restructurings, why it creates anomalies within transfer pricing regulation in relation to cross-border transactions and potential solutions to these anomalies. The present chapter explains the restructurings of MNEs and the reasons for such restructurings. Four issues, in particular, relating to business restructurings are discussed:

- the conversion of risk;
- the actual restructuring and the arm's length compensation;
- the application of the arm's length principle after the restructuring; and
- the recognition of the actual transaction performed.

Each of the issues are analysed in detail and explained with the aid of the EvoCar example.

The aim of chapter 4 is to give a thorough understanding of business restructurings and how the arm's length principle is determined by different changes in functions, assets and risks.

4.2 Treatment of business restructurings

The treatment of business restructurings from a transfer pricing perspective has been an issue of great controversy and no solution to the problem has yet been found. However it was agreed by the OECD, that the OECD Guidelines and arm's length principles should not apply differently to restructuring and post-restructuring transactions than to transactions structured in that way from the outset (OECD: 2008).

The Committee on Fiscal Affairs ("CFA") defines business restructuring as:

> the cross-border redeployment by a multinational enterprise of functions, assets and/or risks. A business restructuring may involve cross-border transfers of valuable intangibles.

> Business restructurings that are within the scope of the OECD's project primarily consist of internal reallocation of functions, assets and risks within an MNE, although relationships with third parties ... may also be a reason for the restructuring and/or be affected by it (OECD, 2008:6).

The OECD (2008) analysed business restructurings and determined that they mainly consist of:

(i) Conversion of fully-fledged distributors into limited risk distributors or commissionaires for a related party that may operate as a principal;

(ii) Conversion of fully-fledged manufacturers into contract manufactures or toll manufactures for a related party that may operate as a principal;

(iii) Rationalisation and/or specialisation of operations (manufacturing sites, processes, research and development);

(iv) Transfer of intellectual property rights to a central entity within the group (for example an IP company).

The main aspect of business restructurings is the reallocation of profits within the group of an MNE either immediately after the restructuring or a few years later. The issue arising from the restructuring is that it must comply with Article 9 of the OECD Model Tax Convention and therefore be in line with the arm's length principle. It is important to establish that the business restructuring by the related group is in line with what an independent party would do. It needs to be determined if the reallocation is consistent with that of the arm's length principle or more generally how the arm's length principle applies to business restructurings. The difficulty created by the arm's length principle within business restructurings is stated by the OECD (2008:7) as follows:

> The implementation of integrated business models and the development of global organisations, where they are done for bona fide commercial reasons, highlight the difficulty of reasoning in the arm's length theoretical environment which treats members of an MNE group as if they were independent parties.

Alicandri (2009:4) of the Tax Executives Institute, Inc. gives a more comprehensive list of reasons for business restructurings:

- allowing more expedient and efficient globalization and expansion of cross-border activity into new jurisdictions
- creating a nimble organizational structure that adapts more rapidly in response to

changes in customer or supplier markets

- affording faster deployment of resources and innovation in product development and design and thus faster times to market
- increasing transparency in management accounting, thereby improving the visibility of the value drivers in business lines and providing management with an opportunity to provide guidance for improving efficiency and growth
- redistributing decision-making authority to facilitate the MNE's core objectives and strategies, *e.g.*, to implement matrix organizations or segregate marketing from manufacturing functions
- improving business portfolio management (especially where the MNE has multiple business and product lines) and managing changes in the business, product, or service mix
- permitting more efficient sharing of best practices, *e.g.*, in manufacturing, marketing, and service across jurisdictional boundaries or across lines of business
- affording closer access to suppliers and customers by consolidating global operations and key people functions in regional centres of excellence, thus driving value up and down the supply chain
- pooling risks to make the company stronger and more financially secure in recessionary times
- Optimising cash flow in the supply chain and in financing the legal structure of the enterprise
- reducing investments in working capital thereby increasing free cash flow
- increasing the visibility of inventory management in the supply chain thereby (1) reducing investments in stock through better deployment of inventory in the various markets and (2) obsolescence risk
- improving the sourcing of raw material and other supplies
- aligning globally or regionally with customer or supplier organizations that are also globalising or consolidating along regional lines
- improving the management of customer accounts receivable and supplier payables
- streamlining the supply chain to improve efficiency and drive down costs
- enhancing the use of Internet-based technology thereby increasing speed of response to market conditions and customer or supplier demands and reducing costs
- increasing specialization, thereby permitting personnel to focus on critical tasks they must do well in order to achieve excellence, *e.g.*, a plant manager can focus on managing production in the most efficient and environmentally sustainable fashion when she no longer has sales responsibilities
- enhancing human resource management, including succession planning and the

deployment of skilled people where most needed

- improving teamwork
- reducing transfer-pricing risk by standardizing business operations and documentation
- enhancing cash flow by improving the administration of indirect taxes, *e.g.*, by reducing the number of required VAT registrations and consolidating the tax compliance functions, for which the enterprise serves as a tax collector
- to correct for gradual changes in a business

In addition, MNEs are increasingly focused on developing centralised centres of expertise – whether for research and development, design, engineering, development, product launch, marketing, or services.

Business restructurings as discussed in the present thesis do not deal with restructurings that result from mergers or acquisitions and only deals with internal restructurings of an MNE.

Business restructurings should not only be seen as a single issue as it can change many aspects of how an MNE is taxed. There are four main issues determined by the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) which will be discussed below:

- conversion of risk;
- the actual restructuring and the arm's length compensation;
- the application of the arm's length principle after the restructuring; and
- recognition of the actual transaction performed.

4.2.1 Conversion of risk

The conversion of risks is very important in the context of business restructurings. The reason for this given by the OECD (2008) is that business restructurings usually result in the conversion of local operations into low risk operations as seen in 2.5.3.1 in Diagram 2A. This leads to a lower allocation of profits due to the decrease in risks which may be achieved with a guaranteed profit allocation. The entrepreneurial risks such as marketing risk and inventory risk, for example, are borne by the other related party who will also receive the residual profit or loss in some cases. This point is crucial for tax administrations because the tax administration must ensure that the risk transfer and its

consequences are in accordance with the arm's length principle in relation to the business restructuring itself and to post restructuring transactions.

Article 9 of the OECD Model Tax Convention (2003) starts by examining the contractual terms between related parties to identify the risks borne by each party. However, the contractual obligation is only respected if it has economic substance, in other words, if it is similar to a contract that an independent party would agree to. Therefore it is not enough to analyse the contracts between related parties, but sufficient information must be collected to show that such a business restructuring would be entered into by independent parties as well. The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) acknowledges further points that should be considered as follows:

- if the related parties actually conform to the risk allocation;
- is the risk allocation at arm's length with regard to potential profits;
- is the risk economically significant; and
- are there any transfer pricing consequences with regard to the risk allocation.

4.2.1.1 Examination of adherence to the risk allocation

To examine if a related party adheres to its risk allocation is an essential part of the functional risk analysis and the OECD (2008) states that it should commence with a review of the contractual terms between the related parties. Once the terms of the contract have been determined it needs to be established if the related parties actually conform to the terms. The best evidence concerning the actual allocation of the risks is the business conduct of each party. For example, HeadCo (SA), as the manufacturer, sells cars to DisCo (UK), the distributor. The two related parties have contracted all the market risks to the manufacturer. However, when looking more closely at the transaction it becomes clear that the distributor actually takes on currency exchange risks because the distributor is not given a varying transfer price from the manufacturer to ensure that the cost of the cars is constant. In this case, if there is no adjustment made to eliminate the currency exchange risk for the distributor, the OECD (2008) expresses the opinion that the tax administration may wish to challenge the allocation of the currency exchange risk.

The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) acknowledges that there may be instances when there is no formal contract between related parties, but there should be evidence in other correspondence between the related parties. If there is no evidence of any contract between two related parties then the OECD assumes that the parties are dealing as independent parties. It is important to note that when independent parties deal with each other the divergence of interest will ensure that each party will hold the other party to the contract and that a contract will only be amended or ceded if it is in the interest of both parties. This divergence of interest between related parties may not exist within a related party transaction and therefore it is important to examine the conduct of the parties in relation to the terms in the contract.

4.2.1.2 Determining if the terms of the contract are at arm's length

As previously discussed, if the risks assumed by the related parties are similar to those of independent parties then the contractual risks between the related parties are considered to be at arm's length. It is more difficult to ascertain that the risks are at arm's length when there are no comparables. As discussed, however, there are different methods to determine the arm's length price. The OECD (2008) states that if there is no comparable independent party transaction that does not mean that the actual transaction of the related parties is not at arm's length. However, for an independent party to assume more risks in a transaction it would be expected to earn more potential profits.

The risk allocation goes hand in hand with the actual control over a transaction. The OECD Transfer Pricing Aspects of Business Restructurings Discussion draft (2008:16) defines control with regard to risks as:" the capacity to make decisions to take on the risk (decision to put the capital at risk) and decisions on whether and how to manage the risk internally or using an external provider." This definition of control separates the monitoring of a risk and actually transferring a risk. The difference is that even though a company may want to outsource certain functions, the ultimate decision and therefore the risk may still lie with the company. For example in an investment fund the risk lies with the party who actually invests the money. Even though the investment manager may have some decision-making capacity within the fund in deciding what to invest in, within its parameters, the control of the finance is with the investing party. The investing party makes the ultimate decision as he can decide which area he wants to invest in, whom to hire, he sets all the objectives and if the fund makes losses these are carried by the party

who invested the initial capital and not the fund manager. This shows that the fund manager has some control over the investment, but the ultimate control still lies with the investing party and therefore the ultimate risk lies with the investing party.

4.2.1.3 Determining whether the risk is economically significant

The OECD (2008:19) identified that “one important issue is to assess whether a risk – and, as a consequence, the transfer of that risk, where applicable – is economically significant”. This is because not all transferred risks of related parties have any significant profit or loss potential attached to them, taking into account the size of the risk, the possibility of its realisation and its preventability. The acceptance or transfer of immaterial risk should not change the potential profit or loss of that transaction, as an independent party would not be willing to lose potential profits for transferring an immaterial risk.

The OECD (2008) is aware that it may be quite a delicate exercise to determine if a risk is material or not. The most straight-forward way would be to analyse accounting statements of the related parties to verify if a potential risk has a contingent liability reflected on the balance sheet of the particular related party. If there is no contingent liability it would seem as if management does not think it is likely that the risk will actually materialise and therefore one can argue the risk is immaterial. If the potential risk is recognised by a contingent liability it gives a good indication of the value of the risk and, in most cases, it will be material. It is important to note that not all risks can be quantified and therefore may not carry a value and cannot be represented on the financial statements of a company. Such risks include but are not limited to customer appetite or possible discrepancies in pricing.

4.2.1.4 Determining the transfer pricing consequences for the risk allocation

The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008:20) states that

> In general, the consequence for one party of being allocated the risk associated with a controlled transaction, where such a risk allocation is found to be consistent with the arm’s length principle, is that such party should:

(i) Bear the costs, if any, of managing (whether internally or by using related or unrelated service providers) or mitigating the risk (e.g. costs of hedging or insurance premium);

(ii) Bear the costs that may arise from the realisation of the risk. This also includes, where relevant, the anticipated effects on asset valuation (e.g. inventory valuation) and/or the booking of provisions, subject to the application of the relevant domestic accounting and tax rules; and

(iii) Generally be compensated by an increase in the expected return…

To illustrate this in an example, HeadCo (SA) is a fully-fledged manufacturer in South Africa who distributes goods to DisCo (UK) who is a fully-fledged distributor, as shown in Diagram 1A below and discussed in chapter 2.3.

The solid line shows the flow of goods →

Diagram 1A

DisCo (UK) would like to strip out its risks for economic reasons by converting into a limited risk distributor. In this case the transfer of risks also results in the transfer of functions and assets as these are interrelated. For example DisCo (UK) will transfer its marketing function and all relevant assets to HeadCo (SA) and therefore carries less risk with regard to return on investment. The first step in the restructuring entails determining which party assumes what risks just before the restructuring. This can be done by looking at the contracts between HeadCo (SA) and DisCo (UK) as well as the four points discussed in the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft in 4.2.1. To keep the example simple it is assumed that DisCo (UK) performed all functions related to a fully-fledged distributor.

The actual restructuring will be considered next.

4.2.2 The actual restructuring and the arm's length compensation

The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) explains that a business restructuring may involve the transfer of functions, assets and risks between related parties. Further, restructurings may also be a result of the termination of a contract or its non-renewal, as well as substantial re-negotiation of existing arrangements. In order to properly understand a business restructuring and its effects on the compensation for each party, one needs to understand the changes that have taken place in the restructuring process, how the changes affect the functional analysis of the parties, what the business reasons are for both parties to the business restructuring and what options would have been available to independent parties in similar conditions. Only if these topics are understood can one determine an arm's length compensation for the restructuring itself.

The following points from the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) describe this in more detail:

- Comprehend the actual restructuring itself;
- The reallocation of profit and loss potential due to business restructurings;
- The transfer of intangible assets; and
- Indemnification to the transferor for detriments suffered from the restructuring itself.

4.2.2.1 Comprehend the actual restructuring itself

Business restructurings vary from transaction to transaction and may involve different numbers of parties. In order to comprehend a restructuring entirely the OECD (2008) states that one needs to identify the restructuring transactions, functions, assets and risks transferred before and after the restructuring. This means that it is necessary to have two functional analyses of each party, one for each party before the restructuring and one after the restructuring. This will help to determine what functions, assets and risks have been transferred from which party. This will also help to evaluate the rights and obligations of each party and if these will change during the restructuring. In order for the business restructuring to be at arm's length the functions, assets and risks as well as the obligations and rights transferred must reflect the economic principles that generally are upheld by independent parties.

As previously discussed, MNEs increasingly restructure to provide more centralised management functions. The role of synergies and economies of scale within an MNE have vast advantages and increase efficiencies and lower costs which is the main factor driving business restructurings. The related party involved in the restructuring should document all the benefits and disadvantages from the restructuring itself in order to support its business restructuring, when justifying the point to the tax administration. This document will help to support the MNE's decision to restructure the business. Before the actual restructuring itself, the related party should also consider all other realistic options available to it in order to determine if the restructuring is something an independent party would also consider. Benefits may not include only higher potential profits but could also be better quality products or a greater market share, which it may not have been able to achieve without the business restructuring.

A last point to note is that synergies of an MNE may not always work out as planned and a restructured party may actually incur losses. The OECD Transfer Pricing Aspects of Business Restructurings Discussion draft (2008) recommends that tax administrations do not use hindsight, and change the transaction back to its original position, as that interferes with the basis of the arm's length principle. However, that does not mean that if the discrepancy in the planned profitable outcome which resulted in a loss was due to another related party not performing as agreed, that the underperforming party should carry the actual loss incurred and compensate the other related party.

The OECD (2008:23) mentions one important point to be taken into account:

> the arm's length principle applies on a separate entity rather than group-wide basis, local synergy gains or losses may contribute to the profit/loss potential of the restructured entity, and may need to be taken into account in the analysis of the transfer pricing consequences of the restructuring, depending on the rights and other assets of the restructured entity at the time of the restructuring.

The last point to consider from the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) with regard to the actual business restructuring itself is the arm's length options realistically available to the restructured entity. An independent party would compare the potential restructuring to other available transactions before making its decision and would only choose the available restructure if

it is the most attractive option. When comparing all the options available each party needs to examine which option is the most attractive one taking into account the potential profits, compensation and indemnifications of the restructuring and include the option of not entering into the business restructuring at all. There may be instances where the restructured entity has no option available but to enter into the restructuring and therefore has to accept the conditions of the restructure regardless. This may happen in instances where a party prematurely exits a contract with just cause, in accordance with the exit clause of the contract. Therefore the restructuring would still be at arm's length but no other options at the time of the restructuring may be available.

From the above discussion it is clear that it is important to determine whether the transfer of functions, assets and risk is motivated by sound commercial reasons at the level of the MNE group as a whole or if the restructuring is at arm's length from the perspective of both the transferor and the transferee. The reason for this is that an independent party, if it can legally prevent the contract cancellation, would not be willing to restructure its business if there is no potential benefit to its own operation, which means from an MNE perspective, even though a transfer may result in better synergies to the whole group, the actual restructuring may not be at arm's length.

It is important to keep in mind that the business restructuring must be at arm's length from the perspective of the related party who performs the restructuring and not the perspective of the MNE as a whole.

To better understand the points discussed above they are explained in an example below which continues from example 4.2.1.4.

When converting a fully-fledged distributor to a limited risk distributor, many transactions may be converted, for example, inventory functions, marketing functions and finance functions. To keep this example simple, it only concentrates on the marketing function of the conversion to a limited risk distributor.

This makes the identification of the actual restructuring simple as it is the marketing function only. DisCo (UK) will cease to render marketing services and transfer the whole function to HeadCo (SA). The risks transferred are those related to the marketing function such as bad publicity due to bad marketing or money spent on marketing that has no effect on the market. Assets transferred with regard to the marketing function include, for example, client lists and any intellectual property related to marketing.

The advantage of converting to a limited risk distributor for DisCo (UK) in unpredictable economic times is that it achieves a constant predetermined return. This means that in bad economic times DisCo (UK) will still achieve an adequate profit margin which it would otherwise not achieve. On the other hand, is a disadvantage because during good economic times when higher profits may be achievable, DisCo (UK) will still receive the same constant predetermined return, which is usually lower.

DisCo (UK)'s other options realistically available with regard to the marketing function would be to outsource the service. One can argue either way that to outsource the service will result in a better and cheaper service or to render the service internally will be better and cheaper. Generally the latter can be argued due to the points discussed in chapter 2.2 which can be summarised as follows. MNEs increasingly restructure to provide more centralised management functions. The role of synergies within an MNE as well as the economies of scale have great advantages and increased efficiencies and lower costs, which is the main factor driving business restructuring.

EvoCar would save money due to economies of scale or synergies, or EvoCar would be able to facilitate internal functions which result in more efficient management and therefore in cost savings. Any of the above points can be considered to be sound commercial reasons for a business restructuring.

4.2.2.2 The reallocation of profit and loss potential due to business restructurings

In order for business restructurings to be in accordance with the arm's length principle it is expected that the transfer of functions, assets and risks should result in a reallocation of profit or loss potential between the transferee and transferor.

The main problem identified by the OECD (2008) is to determine how the transferee should compensate the transferor for the reallocation of risks and its potential profits or losses and *vice versa*. It is important to distinguish between the profit or loss potential of a transaction, and the right or asset that is transferred, which carries the potential profit or loss. The arm's length principle does not require actual compensation for the profit potential as such, but the right or assets transferred do require compensation under the arm's length principle. The two meanings are closely interrelated and if an asset holds considerable profit potential it is assumed to receive a higher compensation when compared to that of a right with no profit potential.

The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008:25) examines the value of rights and assets through their actual profit or loss potential and stipulates that the reallocation of risks should take into account:

- Whether compensation by the transferor to the transferee for the transfer of potential losses and liabilities would be agreed between independent parties at arm's length, taking account of both the amount of the possible losses and the probability of the risk's materialising, and whether it would be preferable for the transferor to pay the transferee to take over the activity rather than to simply stop performing the activity and incur the associated windup costs;
- Whether compensation by the transferee to the transferor for the associated transfer of profit/loss potential would be agreed between independent parties at arm's length, taking account of the other options realistically available to the parties, and of the future profit/loss expectations in relation to the risk at hand. Accounting standards for evaluating risks can prove very helpful in that respect;
- Consequences attached to the subsequent exercise of activities by the transferor and the transferee in accordance with their new risk profiles.

In order for the compensation payable as a result of the business restructuring and the transfer of profit and loss potential to be at arm's length, a number of factors should be determined. These include but are not limited to the following as identified by the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008):

- the other options realistically available to the transferor and transferee in order to ensure that the actual restructuring is at arm's length, based on the rights and assets and the compensation determined with regard to the profit or loss potential;

- the expected return after the restructuring for each related party involved; as previously discussed a higher risk profile should result in higher potential profits or losses; and
- the compensation that may be payable to the party that surrenders its future profit potential through the surrender of certain rights and assets.

Continuing the example from 4.2.2.1 where DisCo (UK) is the transferor and HeadCo (SA) is the transferee, the reallocation of the marketing function and its risks and assets may result in the reallocation of a profit or loss potential. In good economic times it would more than likely be a profit situation and in bad economic times it would more than likely be a loss situation. This profit or loss potential that HeadCo (SA) assumes does not result in any kind of remuneration to DisCo (UK). However DisCo (UK) is appropriately remunerated for the transfer of the marketing function and its assets and risks such as the sale of its client list.

4.2.2.3 The transfer of tangible and intangible assets

Business restructurings can involve the transfer to a foreign related party of tangible assets such as equipment and/or intangible assets such as intellectual property. The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) states that generally tangible assets do not raise any issues with regard to transfer pricing from a business restructuring perspective, but the valuation of the intangible asset may at times be tricky. When a party cedes its right to the ownership of a tangible asset such as inventory there are different methods to value the inventory. The use of the appropriate method depends on which party is less complex within the transaction and, therefore, can be valued with greater certainty, as well as the timing of the transaction. The following three methods from the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) are examples and only give some possibilities on how to value tangible assets.

1. By reference to comparable uncontrolled prices, the arm's length principle should be applied to the price of the tangible, taking all the issues into consideration discussed under the CUP method, for example market prices.
2. Another way to calculate the transfer price of tangibles could be by using the resale price to customers, minus an arm's length remuneration for all functions to

be performed that will no longer occur due to the restructuring. The functions in this example can entail distribution and marketing functions.

3. Another approach to determine a transfer price for tangibles could be to start with the manufacturing cost and add an arm's length mark up to the cost to fairly value the manufacturing functions performed, assets used and risks assumed.

The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) recognises that the transfer of intangible assets is more difficult than tangible assets due to the difficulty in actually identifying the intangible transferred and its valuation. The reason why it may be so difficult to identify the intangible is that it may not be legally protected or even registered and not all intangibles are recorded in the financial accounts. A few examples of intangible assets include patents, trade names, know how, designs, models and trade secrets. It is an important part of business restructurings to identify all intangibles transferred and their value to ensure that the restructurings are performed at arm's length. Lastly, the arm's length price of the intangible property right transferred should take into account the perspective of the transferee and transferor alike.

A good example in the context of business restructurings with regard to the transfer of intangibles is the specialisation of manufacturing sites within an MNE group such as EvoCar, in the car manufacturing industry. Before the restructuring there may be many car manufacturers within a group in different geographical locations which manage and own a series of patents as seen in Diagram 5A below. There are three manufacturers, one in the USA, one in India and one in Germany. For ease of reference the manufacturers are named Man1 (USA), Man2 (I) and Man3 (G) respectively. The patents owned by the three car manufacturers may overlap and at times certain car manufacturers may even pay royalties to independent parties to receive certain intangible assets.

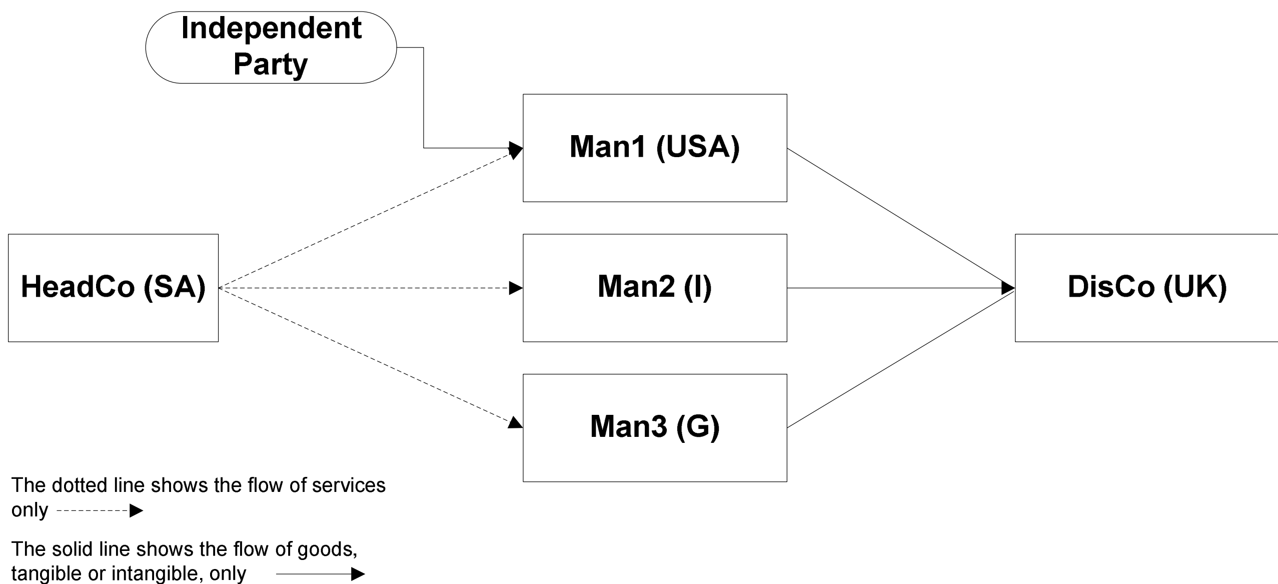


Diagram 5A

From EvoCar's group perspective taking into account the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) it may be more viable economically to centralise all the patents and manage them from the head office and specialise each manufacture by the type of manufacturing process needed in each geographical area rather than by patents owned. As seen in Diagram 5B this may help to identify a duplication of patents and may increase production due to specialised manufacturers and the head office, HeadCo (SA), has a better control of stocks and can ensure a quicker turnaround time. For example, instead of each manufacturer, Man1 (USA), Man2 (I) and Man3 (G) building a whole car, after the restructuring each manufacturer will be specialised to produce certain parts of a car and collectively produce one model of a car. For example, Man1 (USA) may build the engines, Man2 (I) may build the car's chassis and Man3 (G) may assemble all the parts and add finishing touches to the car. In order to achieve this EvoCar will give contractual rights to each manufacturer for the products falling in the new areas of competence by using patents previously owned by other related parties or itself as shown in Diagram 5B below.

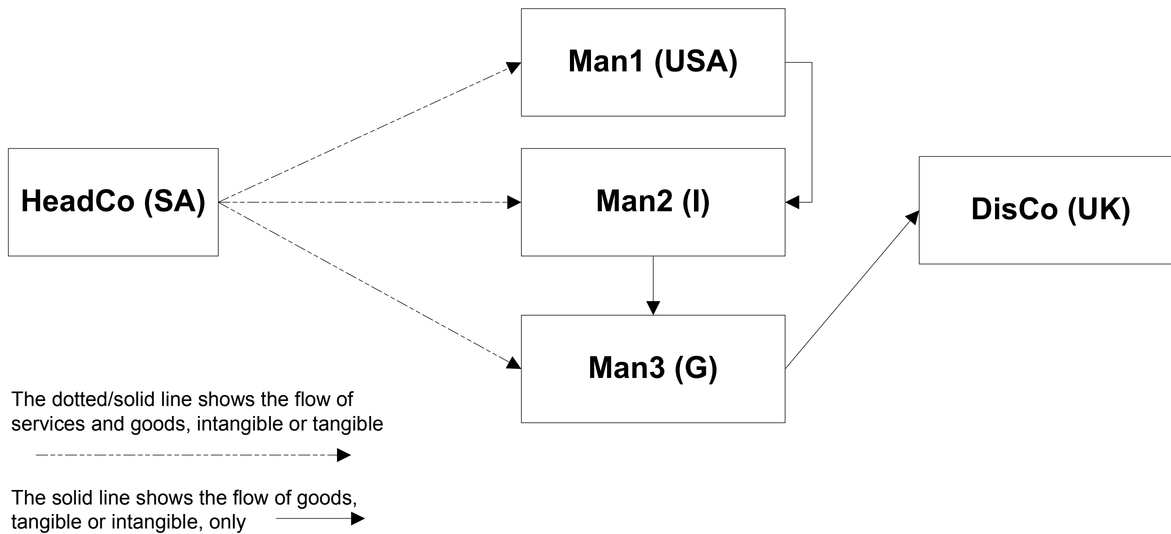


Diagram 5B

One issue that arises with the transfer of intangible assets is explained by the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008:29) as follows.

> The arm's length principle requires an evaluation of the conditions made or imposed between related parties, at the level of each of them. The fact that centralisation of intangible property rights may be motivated by sound commercial reasons at the level of the MNE group does not answer the question whether the disposal is arm's length from the perspectives of both the transferor and the transferee.

This may pose a problem particularly when a related party, Man1 (USA), disposes of its intangible property rights to another related legal entity, HeadCo (SA), but after the business restructure, continues to use the intangible asset and may even pay royalties for the use of the previously-owned patent. This highlights the fact that the conditions of the transfer should be assessed from the perspectives of both the transferor and the transferee. As previously discussed, when analysing from the perspective of the transferor, other options available to the transferor should be taken into account, such as the option not to transfer the intangible asset at all. It is important to consider the arm's length principle and compare the transfer to what an independent party would have done. The OECD (2008) agrees that in most instances an independent party would not be willing to transfer its intangible property if, without it, it could no longer manufacture its products, unless the transfer of the intangible property may result in further research and development by the transferee which will benefit both parties.

The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) states that the transfer of intangible property is even more complex when the intangible property does not have an established value and especially if the gap between the expected future profits that were estimated at the time of the restructuring differs vastly from the actual profits derived by the transferee. This could raise the question whether the valuation of the transfer was at arm's length and was *bona fide*, taking the available information at the time of the restructuring into account. If this was not the case, the transfer price may be adjusted. An example of such a possible transaction is that of pre-exploitation rights within large MNE mining companies such as BHP Billiton.

Other intangible assets considered by the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) are local intangibles and contractual rights. Local tangibles may be non-transferrable as they are inherent to the local market and operation, for example, a customer list. If an MNE group would like to strip all risks from a related party it could achieve this by royalty payments. The transferee would remunerate the transferor for the patent as the actual intangible would not leave the transferor. However, the transferor is remunerated for the intangible property in order to transfer all the risks associated with the intangible property to the transferee. Contractual rights can also be seen as intangible property and should be remunerated at arm's length from the perspective of both the transferor and the transferee.

Business restructurings may involve the transfer of an ongoing concern. The only difference between the transfer of an entire concern and a single function as stated by the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) is that the transfer of a going concern entails the total bundle of assets and liabilities associated with particular functions, assets and risks. The difference is that the total bundle may be valued differently compared to valuing each single function, asset or risk associated with the transfer. This difference is often seen as goodwill and should not create any problem provided the transfer of the concern is at arm's length from the perspective of both the transferor and the transferee.

4.2.2.4 Indemnification of the transferor for detriments suffered from the restructuring itself

The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) states that in a business restructuring the transferor may have certain expenses or disadvantages due to the termination of contracts or substantial renegotiations, such as restructuring costs, re-conversion costs and a loss of profit potential. To ensure that the restructuring is at arm's length, it should be determined what an independent party would have agreed to as indemnification under similar circumstances. Indemnification in this instance can be any compensation that may be paid to the transferor from the transferee for the disadvantages suffered. This may entail, but is not limited to, up-front payments, the transferee sharing in the restructuring costs, or lower purchase prices in the context of post-restructuring operations. It should also be noted that contract terminations do not always end up in adverse consequences and expenses and therefore do not guarantee a right to an indemnification. To ensure that an indemnification is at arm's length four points should be considered.

Firstly the OECD (2008) argues that it needs to be ascertained if the arrangement that is terminated, not renewed or substantially renegotiated is in writing and provides for an indemnification clause. Independent parties would usually only modify or ignore contracts, if it is in the interest of both parties, otherwise the one party would hold the other party to the contract and its indemnification clause. If there is no indemnification clause in the contract between the two related parties it does not mean that the termination, non-renewal or renegotiation is at arm's length but rather the contrary, as an independent party would not have entered into such a contract in the first place.

Secondly the OECD (2008) considers whether the terms of the contract and its indemnification clause or other type of guarantee are at arm's length. To determine if a contract is actually at arm's length, it should be analysed in the light of whether an independent party would have agreed to such terms, with other options realistically available under similar circumstances. The substance of the agreement must be analysed. For example, in some instances, a contracting party may have to invest large amounts in its production line in order to be able to deliver on the undertakings made in the contract. In such instances it is expected that the contract should have a longer term with higher indemnities when compared to the situation where no initial investments are needed to

adhere to the contract, in order to arrive at an arm's length return. Some contracts may ensure that both parties bear the risk of termination of the contract by splitting the termination costs evenly. In some other cases the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008:35) states "it may be that, on the basis of an examination of the substance of the arrangement and of the actual conduct of the related parties, an implicit longer term contract should be implied whereby the terminated party would have been entitled to some indemnification in case of early termination."

It should be considered whether certain indemnification rights are provided for by commercial legislation. If there should be such legislation that would mean that even if there is no indemnification clause in the contract, there are still certain indemnification rights and terms and conditions that each party must adhere to. Keeping this in mind, if there is no indemnification clause in the contract but commercial law has certain requirements relating to the termination of specific types of agreements, these rules should be followed and therefore the contract may still be at arm's length. However, the OECD (2008) expresses the opinion that related parties would rarely seek to have such indemnification by the related party enforced by the courts.

Further the OECD (2008) considers whether an independent party would have been willing to actually indemnify the other party who suffers adverse effects from the termination or renegotiation of the agreement. As previously described it is always important from a transfer pricing perspective to take account of both perspectives of the transferor and transferee. It may not always be possible to derive a single answer for each case but the responses should be based on the examination of the facts, circumstances and economic rationale for the termination for each case. One should determine what the benefits are for each party involved in the restructuring and any other options realistically available to the parties at arm's length.

A last point worth mentioning from the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) with regard to the actual restructuring and the arm's length compensation is that not all restructured entities losing functions, assets or risk or suffer a loss of expected future profits. It may be the case that the transferor, instead of losing a profit-making opportunity, may actually be saved from a loss-making opportunity. The same principles apply as discussed above, but a question may arise if the transferee should be compensated by the transferor for taking over this loss-making

activity. The norm is to compare the loss making activity to what an independent party would have done.

4.2.3 The application of the arm's length principle after the restructuring

The transfer pricing approach and determination of the arm's length principle for post-restructuring controlled transactions have not yet been finalised by the OECD. This section of the thesis will discuss the current situation and the proposed method and conclusions by the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) on how to deal with such post-restructuring controlled transactions. It is important to keep in mind that the arm's length principle and OECD Guidelines should not apply differently to post-restructuring transactions compared with transactions that were structured in such a way from the outset. There are, however, certain issues which deserve special consideration. The following points should be considered when analysing business restructuring transfers (OECD: 2008).

4.2.3.1 General guidance on choosing a transfer pricing method

The methods and guidance on transfer pricing methods have been discussed in detail. The general transfer pricing methods should not be applied differently to post-restructuring controlled transactions.

4.2.3.2 Difference between business restructuring and structuring

It has been emphasised previously that a post-restructure transaction should not be treated differently to a transaction structured as such from the outset. The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008:40) gives the following reason for this:

> Doing otherwise would create a competitive distortion between existing players who restructure their activities and new entrants who implement the same business model without having to restructure their business. Comparable situations must be treated in the same way. The selection and practical application of an appropriate transfer pricing method must be determined by the comparability analysis, including the functional analysis of the parties and a review of the contractual arrangements. The same comparability standard and the same guidance on the selection and application of transfer pricing methods apply

irrespective of whether or not an arrangement came into existence as a result of a restructuring of a previously existing structure.

A point to note is that the comparability analysis of a restructuring might change when comparing the transaction pre-restructure to post-restructure. Therefore, the OECD (2008) concludes that it is essential to list all the functions, assets and risks from both the perspective of the transferor and the transferee. However, the transfer pricing method should be applied to the functions performed, assets used and risks assumed, hence the transfer pricing method may change in relation to the post-restructuring transaction when compared to the pre-restructuring transaction, but the same principles still apply when compared to a transaction structured as such from the outset.

The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) acknowledges that there may be differences between the starting position of a newly set up operation and that of an arrangement which replaces an existing arrangement due to prior contractual and commercial relationships. From an arm's length perspective this may affect the negotiation options realistically available to the transferee and transferor, as well as the conditions of the whole business restructure arrangements. For example, Man1 (USA) from Diagram 5B has proven to HeadCo (SA) that it is able to manufacture quality products on time. It may not necessarily have a trial period clause, whereas new arrangements may have a trial period clause in the new agreement.

The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) identified that an issue that may arise in the transfer of functions, assets and risks is the determination of remuneration. The issue is whether a party's remuneration should only be affected before it is converted, while it is converted or after it is converted, or a combination of the three possibilities. In order to establish how and when a related party should be remunerated, the risks transferred should be considered. It is important to determine if the risk transferred existed at the time of the restructuring or only after. For example, DisCo (UK), a fully-fledged distributor, is restructured to a limited risk distributor, continuing the example from 4.2.1.4. Before the restructuring DisCo (UK) has provisions for bad debts, but the bad debt risk is transferred to HeadCo (SA) and therefore the now limited risk distributor carries no bad debt risk. In order to determine how DisCo (UK) should be remunerated it must be clarified which party carries the risk of the bad debt prior to the restructuring, or when the risk is actually transferred, and should be remunerated

accordingly. The longer the risk was assumed by DisCo (UK) or the more likely a bad debt is to be realised, the less DisCo (UK) would be remunerated for the transfer of bad debts. The same principle, as in this example, applies to issues of timing for research and development or certain sales activities.

4.2.3.3 Selection and application of transfer pricing methods to post-restructuring controlled transactions

The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) states that the selection and application of a suitable transfer pricing method to a post-restructuring controlled transaction should be the same as for a normal transaction. Because a transaction has been restructured does not mean that it should be treated differently from a new transaction. As discussed previously, that would lead to either advantages or disadvantages for taxpayers of restructured transactions. Therefore a post-restructuring controlled transaction must be tested against a comparability analysis which explains in detail what functions are performed, the assets used and risks assumed and which party performs, uses or assumes them. During the comparability analysis particular attention should be paid to intangible assets and their correct allocation to the right party and if the allocation of intangibles and their risks satisfy the arm's length principle.

As previously discussed, for related party transactions the same traditional and transactional methods apply for restructured transactions with the same preferred rankings. In order to choose the correct method both parties should be considered to determine which party uses what assets to perform certain functions and the risks assumed. The OECD (2008) expresses the opinion that the method itself should be chosen to suit each party's characteristics, but the characteristics can only be properly classified if both parties' functions, assets and risks are understood.

There may be cases when a taxpayer's comparability analysis does not agree with the view of the tax administration. This is not a specific business restructuring issue but it may aggravate the problem due to the effectiveness and consistency with the arm's length principle as presented by the taxpayer. The OECD (2008) gives the following example where a taxpayer may believe that the restructured entity carries no more risk, whereas the tax administration believes the restructured party still carries intangibles or bears significant market risks.

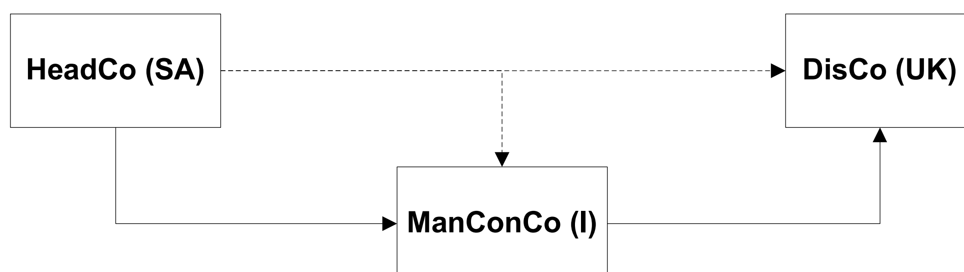
The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008:47) identifies a main issue arising from the selection of a transfer pricing method as follows:

> Post-restructuring arrangements may pose certain challenges with respect to the identification of potential comparables in cases where the restructuring implements a business model that is hardly found between independents.

The OECD (2008) notes that the identification of potential comparables should be made with the objective of finding the best available data. However, it may also be necessary to determine what an independent party would have done in the same circumstances in order to arrive at an arm's length remuneration.

4.2.3.4 Relationship between up-front compensation and remuneration over time for the restructuring and post-restructure

The OECD (2008) encountered cases where the related parties to a business restructuring decided to forgo the receipt of part or all the up-front compensation and instead will be remunerated over time by changing the transfer price between the related parties. For example, HeadCo (SA) would like to contract out its manufacturing function as discussed in 2.5.3.1 (refer to Diagram 2A below). Instead of HeadCo (SA) receiving an up-front compensation from ManConCo (I), ManConCo (I) agreed that it will buy the raw materials from HeadCO (SA) at a higher price than normal over a certain period of time in order to offset the compensation that should have been received in an arm's length situation.



The solid line shows the flow of goods
The dotted line shows the flow of services
Diagram 2A

The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008:49) summarises this as follows:

> In other words, in this situation where the taxpayer will have an ongoing business relationship as supplier to the foreign party that carries on an activity previously carried on by the taxpayer, the taxpayer and the foreign party have the opportunity to obtain economic and commercial benefits through that relationship (e.g. the sale price of goods) which may explain for instance why compensation through an up-front capital payment for transfer of the business was foregone, or why the future transfer price for the products might be different from the prices that would have been agreed absent a restructuring operation.

4.2.3.5 Difference between profits earned before and after the restructuring

The requirements of Article 9 of the Model Tax Convention (2003) would not be met by a before-and-after comparison of profits. However, such a comparison can be useful to gain valuable indications to assess the risks assumed or transferred in combination with functions performed and assets used. With this in mind the OECD (2008) believes that a before-and-after comparison could help to better understand the restructuring itself and assess whether the business restructuring is actually at arm's length. A proper comparability analysis would be required with a functional analysis to determine if the restructuring is at arm's length.

4.2.3.6 Location savings

The OECD (2008) explains that location savings may be achieved by an MNE through reallocating certain functions of its related parties to another country to save costs. Costs can include labour costs or real estate costs. A problem may arise where such location savings result from a business strategy that has significant savings and the question of how to allocate such savings among the parties. The norm would be to check what an independent party would do in similar circumstances, depending on the functions performed, assets used and risks assumed by each party, as well as their respective bargaining powers.

4.2.4 Recognition of the actual transaction performed

The recognition of the actual transaction carried out is a vital part and an important starting point for any transfer pricing analysis. As previously discussed it is important to look at the contracts drawn up between the restructuring parties, but it is the actual transaction that determines its characterisation. The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008:53) states that:

> MNEs are free to organise their business operations as they see fit. Tax administrations do not have the right to dictate to an MNE how to design its structure or where to locate its business operations. MNE groups cannot be forced to have or maintain any particular level of business presence in a country. They are free to act in their own best commercial and economic interests in this regard. In making this decision, tax considerations may be a factor. Tax administrations, however, have the right to determine the tax consequences of the structure put in place by an MNE, subject to the application of treaties and in particular of Article 9 of the Model Tax Convention. This means that tax administrations may perform where appropriate transfer pricing adjustments in accordance with Article 9 of the Model Tax Convention and/or other types of adjustments allowed by their domestic law (e.g. under general or specific anti-abuse rules), to the extent that such adjustments are compatible with their treaty obligations.

It is important to study and examine the actual transaction undertaken by the related parties and not only the contractual terms. As discussed previously, Article 9 of the Model Tax Convention (2003) gives a tax administration the right to adjust the profits of the taxpayer where the conditions of a controlled transaction do not agree with what an independent party would have done in comparable circumstances. The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) adds that the rights of a tax administration in a business restructuring are the same as discussed for a normal transaction structured in a particular manner from the outset.

4.3 Conclusion

This chapter presented a detailed analysis of business restructurings and the consequences, from a transfer pricing perspective. It discussed the four issues that may arise from business restructurings in functions, assets and risks, namely:

- conversion of risk;
- the actual restructuring and the arm's length compensation;
- the application of the arm's length principle after the restructuring; and
- recognition of the actual transaction performed.

The discussion dealt with both pre- and post-restructuring situations. The chapter emphasised the point that, even though there are certain guidelines on how to deal with business restructurings, each case needs to be determined on its own merits as no two cases are the same. At first some cases may appear to be the same but it is important that all the facts are understood correctly in order to conclude on the correct transfer pricing approach for the business restructuring and the related arm's length principle.

The next chapter will critically analyse the OECD Guideline's approach to business restructurings. It will compare the theory of the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft to how it actually is perceived to work in practice by well known legal and audit firms.

5 Chapter 5: A critical analysis of the OECD Guidelines and the OECD Model Tax Convention in relation to transfer pricing and business restructurings

5.1 Introduction

The previous chapters dealt with the first two aims of the research. They dealt with the concept of transfer pricing and business restructurings, setting out the principles and definitions applying in determining when a transaction triggers the arm's length principle and the relevant transfer pricing methods. The present chapter discusses the last three aims:

- advance pricing agreements and mutual agreement procedures, triangular cases, the vital role they play in business restructurings and how they might help or hinder business restructurings;
- best practice guidelines and how they may be applied to business restructurings; and
- avoiding transfer pricing audits and disputes.

This chapter critically discusses the arm's length principle having regard to the OECD Guidelines (2008) and the OECD Model Tax Convention (2003). In addition, the chapter compares the theory of business restructurings as set out in the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) with how it actually is perceived by legal and audit firms to work in practice.

As previously discussed, South Africa is not an OECD member country but it follows the OECD Guidelines, as such it is influenced by any principles or methods published by the OECD including the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008).

The chapter will discuss why business restructurings may create anomalies within the transfer pricing regulations in relation to cross-border transactions and will discuss potential solutions to the anomalies. Such solutions may include advance pricing agreements and mutual agreement procedures. Finally, the chapter examines global best practice in avoiding transfer pricing audits and disputes.

5.2 The arm's length principle

According to Fris (2009) the arm's length principle is sound in theory, but there are arguments that it is inherently flawed. The most observable fact is that the arm's length principle does not account for economies of scale related to integrated systems when compared to independent parties. For example MNEs are known to have great cost savings through centralised management structures and cost centres as discussed above, but these savings are not taken into account in the determination of the arm's length range. The main advantage of an MNE is that of cost savings due to synergies and other cost saving opportunities discussed previously.

5.2.1 Article 9 of the OECD Model Tax Convention

Cross-border transactions have changed as a result of different business models adopted in different periods. Earlier business models had manufacturing structures which delivered their products directly to the distributors. In the modern day business model it is common to have an MNE with central cost centres and IP companies or virtual management structures that service many different related companies. Article 9 of the OECD Model Tax Convention (2003) may be outdated. The OECD Model Tax Convention (2003:12) as it stood on 15 July 2005 states in Article 9(1) that "conditions are made or imposed between the two enterprises in their commercial or financial relations" and in Article 9(2) it states "of that State". At the time of the last OECD Model Tax Convention update it was assumed that only two parties would be involved in a transaction and therefore only the issue of two related parties and their tax administrations was taken into account.

Article 9 of the OECD Model Tax Convention should be updated so as to include more than two parties to a transaction. Fris (2003:201) states that:

> today's integrated business models generally involve not only two, but more enterprises in joint operations. Art. 9(1) [of the OECD Model Tax Convention] should therefore be read as "two *or more* enterprises", whereas Art. 9(2) [of the OECD Model Tax Convention] should emphasize that "the other states" must make the corresponding adjustment(s).

5.2.2 Guidance for applying the arm's length principle correctly

As alluded to in chapter 2, the arm's length principle requires that each inter-company transaction is remitted to the same level that would have applied had the transaction taken place between independent parties, all factors remaining constant. In order to determine if transactions are similar each entity can be classified into a certain group. For example, DisCo (UK) may be classified as a limited risk distributor, or HeadCo (SA) as a fully-fledged manufacturer.

This classification of parties into certain categories may lead to an inflexible approach and may be incorrect in certain instances. The reason is that each transaction has to be labelled, which is done by analysing its functions, risks and assets. The norm with labelled parties is that once they are classified, they would operate exclusively as such and, if not, they are deemed not to be comparable. Therefore Fris (2003:196) is of the opinion that "parties are either eliminated from the comparison that serves to identify arm's length behaviour or adjusted in their outcomes by applying a 'synthetic' approach in bringing together distinct additional or complementary roles, activities or functions carried out by the parties concerned." According to Fris (2003) the current model fails to bring together functions, assets and risks in a coherent model. To understand the issue better the problem is illustrated with an example.

The situation can be illustrated by an example from Brandenburger and Nalebuff (1996). There is one party with 26 black cards and 26 parties each holding one red card. Each pair of cards, one red and one black card, is worth R100 but unpaired cards are worthless on their own. The negotiation between the parties is free. The only restriction is that the 26 parties with one red card each cannot get together and bargain as a group. If the party with the 26 black cards would offer R20 for a red card to any party, would that other party accept? The question is who is in a stronger position and if there is a stronger position why is that so? The general consensus from the example is that parties that react impulsively tend to accept an offer such as the R20, however, parties that do not accept the offer and wait for a better one have the most likely outcome of a 50 – 50 split. In this example that would be R50 per card.

By way of comparison, the same situation as above applies, except that the player with the 26 black cards now only has 23 black cards. In this example the player with the black cards has about 12 percent less than in the prior example. From this it seems clear that the split now should be 44 – 56. Is this assumption correct? If the party with the black cards offers R20 to a party with a red card is that party not better off with the money than having only a red card, which is worthless? If a player does not accept the offer of R20 he might end up with nothing, in which instance even R10 would be better than a red card. From this it is clear that the arm's length principle lacks certain coherence.

Fris (2003:196) summarises the problem as follows:

> The context for the arm's length game is constituted by the value chains in which parties concerned play their role and to which they contribute their added value. But in order to understand how parties would behave 'at arm's length', one must first be able to more accurately identify the relevant characteristics of the players (the parties involved in the related transactions); this should be done with a view to map more realistically the 'similar circumstances' underlying appropriate applications of the arm's length principle.

This statement is especially true with regard to an MNE. The reason for related parties to operate as part of an MNE is to add value, as discussed in detail in chapter 2.2 and even though the benefits are known to the tax administrations and the OECD alike, Fris (2003) believes these benefits are still not considered when applying the arm's length principle.

In theory the value-chain and its consequences may be easily understood but in practice it would be very difficult to apply. The reason for a synthetic approach to the arm's length principle which analyses the basics of a transaction and only its main value-adding drivers is to make it easier to define and compare transactions for every party involved, which in turn may result in a smaller tax compliance burden for the taxpayer. The problem has been analysed but no solution has yet been found for labelling transactions in such a way as to account for the value-chain of each transaction.

5.3 Critical analysis of business restructurings and the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft

The concept of business restructurings and the related treatment of transfer pricing is relatively new. The latest OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008), which limits itself to internal restructurings only, reflects substantial work in the field. However, there are certain issues that may require a more thorough understanding. Baker and McKenzie (2009:2) are of the opinion that many "tax administrations have now publicly expressed concern about such transactions, and some have already initiated examination, litigation, or legislative efforts."

Demade (2009) and Baker and McKenzie (2009) are of the opinion that consensus between OECD members in relation to the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) may be lacking and this may lead to the risk of double taxation due to ambiguous definitions. With the new draft, the OECD has introduced new terms which have not been defined adequately. In order to provide more certainty in the draft, the following terms should be defined beyond question: profit potential, location savings, all alternative options realistically available and commercial rationality. Without each tax jurisdiction understanding the meaning of each term, there may be a risk of double taxation due to potential different tax treatments in each tax jurisdiction. It is important to note that any change in definition or the adoption of a new definition should not be contemplated without careful consideration by stakeholders and especially policymakers and the relevant tax administrations, to ensure that the issue of double taxation is dealt with accordingly.

A general matter which in Vrind's (2009) opinion should be addressed more clearly in the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) is that no tax administration should be able to dictate to an MNE how it should run its business. The tax administration should only be able to adjust the MNE's taxable income.

The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) should also consider the treatment of intangibles. Vrind (2009) is of the opinion that it should be made clear by the OECD Guidelines which intangibles are transferable and may lead to an actual transfer of intangibles. For example, only legally enforceable intangibles can be seen as transferable.

Another important point raised by Baker and McKenzie (2009:4) that should be considered is the following:

> A literal reading of some portions of the Discussion Draft might suggest that business restructurings may be taxed differently from other transactions in some respects, notwithstanding the initial statement rejecting such an approach. We [Baker & McKenzie] submit that this would be inappropriate as a matter of policy. In addition, it is unclear how special rules for business restructurings would work in practice; given the Discussion Draft's broad and imprecise definition of business restructurings, the scope of special rules likely would not be clear enough to enable voluntary compliance and equitable administration. Provisions of the Discussion Draft that could be read to suggest different treatment for business restructurings should be clarified.

The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) identifies the existence of contracts between related parties and the review of the contracts as an important part of a business restructuring and its conversion of risks. This may result in an increased administrative burden for the taxpayer. The United States Council for International Business (Walker, 2009:2) summarises the intercompany agreements, functional and economic analysis and accounting treatment from the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) as follows:

- Contractual arrangements concerning the restructuring;
- Business reasons for the restructuring;
- Transactions involved in the restructuring;
- Options realistically available to achieve the objectives of the parties other than the transactions selected;
- Identification of intangibles involved in the restructuring, and their profit-making potential;
- Identification of functions, assets, and risks involved in the restructuring;
- Presence of indemnification to the transferor;
- Terms of any termination or renegotiation of any existing agreements;
- Application of two-sided as well as one-sided TPM [transfer pricing method] analysis, indicating, as it has in other contexts, that profits split methods (two-sided) may need to be used to confirm a one-sided method (such as TNMM);
- Identification of potential comparables;
- Functional analysis of what has actually changed before and after the restructuring;
- All other elements of the transaction in question that is pertinent to the respective elements of the Discussion Draft.

Keijzer and Dijckmeester (2009) are of the opinion that another more important issue that may arise through this is that there is an increased focus on a form above substance terminology, which is not in accordance with the OECD Guidelines. The norm is to look at the substance of a transaction over its form.

The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) discusses a two-sided review in order to assess business restructurings from the perspective of the transferor as well as the transferee. However Baker and McKenzie (2009) are of the opinion that the OECD Guidelines should be applied in the same manner to all situations and therefore there should not be a special rule for restructured entities.

Baker and McKenzie (2009) emphasise that the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft should be in alignment with the OECD Guidelines and indicate consistently throughout the draft that the current OECD Guidelines do not permit re-characterisation of the taxpayer's transactions except for two very limited cases which do not normally arise in business restructurings.

Huibregtse of the Transfer Pricing Association (2009) suggests that the OECD should implement a threshold for business restructurings. The threshold should be measured on the shift in profits between the related parties. The reason for this suggestion is that an MNE may go through hundreds of business restructurings which must be documented in detail as the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft reads at present. This may result in a heavy tax compliance and administrative burden for the MNE.

Neuenschwander (2009) from Deloitte discusses the importance of the difference in decision making between related and independent parties. Often related parties do not have the same decision making process for transactions when compared to independent parties. Neuenschwander (2009:3) believes that the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft should

> recognize that decisions to proceed with business restructurings within MNEs are usually made at the group level, not by individual subsidiaries acting alone. We [Deloitte] believe that it would be more useful if tax administrations were to focus on the outcome of what an MNE has done, rather than on the process by which the MNE arrived at that point.

> Requiring subsidiaries of MNEs to document something they do not otherwise do would be an extension of the [OECD] Guidelines, and would impose a substantial compliance burden. MNEs should not be required in their internal operations to replicate an approach that would be adopted between independent enterprises.

5.3.1 Comments on the conversion of risk

It has been established that the contractual arrangements between the restructuring parties are the stepping stones for determining which party bears the risk. Keijzer and Dijckmeester (2009) state that this may be difficult in practice, especially for MNEs as they do not document everything in contracts, but an MNE may have internal policies or directives which determine the allocation and control of risks. This means that contracts between MNEs usually only cover the essentials and internal documentation should also be examined, in addition to the contracts in place. The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) suggests that where no contract is in place between two related parties it is necessary to determine if the actual allocation of risks is similar to that which independent parties would agree to in similar circumstances.

It should also be determined who has the control over the risk and who has the financial capacity to bear the risk, in order to determine if the allocation of risks is at arm's length. The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) raises the question of which related party has the greater control and therefore should carry the risk. From an MNE perspective this may not be as easy. The OECD tries to weigh each party's level of control and related risk to determine if the allocation is at arm's length. However, in practice, the control of an MNE may be manifested through many different instruments, for example, binding policies, operating boards and council or authorisation rules. This indicates that, even though an independent party will only rely on the contract, from a related party perspective, the substance of the transaction must be taken into account in order to ensure that there is no confusion. Keijzer and Dijckmeester (2009:3) believe that the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) should "reconfirm that only risks relating to the corporate structure and related contracts between legal entities are relevant for tax purposes, not the organizational structure that allows ... [the] MNE to function as one. This distinction is a pillar of the 1995 Transfer Pricing Guidelines."

The framework, in terms of which the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft discusses risks, may result in detailed assessments of how risks are controlled. Ernst & Young (2009:7) believe that the analysis should provide the bigger picture "i.e., the general pattern of control of risk."

Ernst & Young (2009:7) state that

> [t]his is important because we [Ernst & Young] believe that the proposed guidance may be interpreted as increasing the scope to challenge the allocation of risks to a greater extent than is practical or necessary. The allocation of risks by the taxpayer should in the first instance be respected and only be open to challenge by tax administrations in extreme cases. Challenges should be limited to cases in which there is a systematic mis-alignment between the contractual allocation and control of significant risks to the point that the arrangement lacks economic substance and business purpose.

Implementing the approach discussed by Ernst & Young may give taxpayers greater certainty with regard to their risk allocation.

The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) also mentions the fact that if there are no contracts in place between related parties, the tax administration may speculate about how, in practice, independent parties would have dealt with the same issue with regard to the control of the risk. Hannes (2009:25) from McDermott, Will & Emery suggests that a tax administration

> should respect a taxpayer's allocation of risks with an affiliate, even in the absence of a third-party contract that allocates risks similarly, if the related parties' actual conduct with respect to who bears the risk is consistent with the terms of the contract… [T]he only potential viable exception to this general rule is where it is demonstrated by the tax authority, with empirical evidence, that unrelated parties in similar circumstances consistently do not share risks in the manner in which the related parties have chosen by contract and have implemented through their conduct and that the choice of the affiliates results in a distortion of income or expense that cannot be reasonably addressed by a reallocation of income or expense.

The suggestion made by Hannes (2009) of McDermott, Will and Emery emphasises that a tax administration should not be able to freely second-guess contracts and behaviours of related parties by assessing how an independent party would have dealt with the allocation of risk. As previously discussed, only because an independent party may not enter a similar agreement, it does not mean that the contract itself is not economically sound. If a tax administration analyses a transaction in the manner that it thinks an independent party would treat it rather than treat the transaction as it actually works, the arm's length principle becomes irrelevant. The reason for this is that the actual transaction must be compared to an independent party transaction from which any differences are analysed. The arm's length principle does not give the tax administrations any right to hypothesise transactions. This suggestion may also help by decreasing the tax burden of compliance.

Ernst & Young (2009) believe that the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft should provide more detail on what control really means. MNEs choose virtual management structures in order to collectively control economically significant risks within the group. The definition of control as stated in the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft does not clearly state how a virtual management structure should be dealt with. Ernst & Young (2009:6) goes into further detail by questioning what control really means: "ultimate responsibility, primary share of collective responsibility, or something else."

Andrus, Dykes, van Linden & Plotkin (2009:7) of PricewaterhouseCoopers recommend that the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft should:

> state clearly and straightforwardly, that a taxpayer's allocation of commercial risk must be respected by tax administrators where: (i) the allocation of risk is reflected in contemporaneous written agreements; (ii) the conduct of the parties is substantially consistent with those agreements; and (iii) the entity asserted to be bearing a risk has the managerial and economic wherewithal to assume, manage and bear the risk.

This would help MNEs to understand clearly what is required of them in order to have risk allocations in business restructurings accepted by the relevant tax administrations.

The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) considers accounting statements to be a source of information from which to determine whether a risk is economically significant. Keijzer and Dijckmeester (2009) state that even though accounting statements may be a good reference point for determining the significance of risks, the actual relevance should not be overestimated. Firstly financial statements have a purpose other than to determine significance of risk. The term “significant” with regard to risk may be interpreted differently by different people and may not match the materiality level of the MNE from a transfer pricing perspective. Financial statements are governed by strict rules that determine materiality levels of risks and the probability of the risk materialising, but further guidance is needed. One of the main reasons not to use only the financial statements to determine risks is that the financial statements will reflect the costs and outcome of managing the risk rather than the potential risk. Financial statements report historical costs. Lastly, many potential risks that an MNE faces are not quantifiable and therefore would not even be shown in the financial statements.

The problem arising with the concept of “economically significant” is to determine which risks fall under this definition. Chandler (2009) of KPMG states that risk profiles may differ. For example, there are risks that may occur all the time, but which are not material. Then there are risks that may not occur at all, except for unforeseen extraordinary circumstances, but if they do occur they may be devastating for the business. There may also be risks that were thought to be minor but actually turned out to be significant. An example of the latter would be the bad loans resulting from sub-prime housing loans. Chandler (2009:13) from KPMG suggests that the Transfer Pricing Aspects of Business Restructurings Discussion Draft should “acknowledge that there are significant complexities to the evaluation of risk and that these complexities may vary with industry and with the specific circumstances of specific taxpayers.”

Instead of using financial accounting statements to determine the economic significance of risk, the United States Council for International Business believes that a "standard functional analysis identifying the functions, assets and risk borne by each party is a more practical way to characterize the types of risks transferred that then can be quantified by a standard financial risk model" (Walker, 2009:4).

Hannes (2009) is of the opinion that the OECD should have regard to another point when determining whether a related party has control over a risk, in addition to the points discussed in the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft. In order to determine if a related party has control over a risk it should be determined if that party has the actual financial capacity to cover such a risk. For example, if a risk could reasonably amount to R100 million but the financial capacity of that party is only R1 million and the party is not insured to cover that risk if it should materialise, it can be concluded that the party does not have the necessary control over the risk. A tax administration should therefore make an appropriate reallocation of the risk. In order to keep the arm's length principle intact, the tax administration should not be able to simply allocate the risk to the other related party involved in the transaction, but should determine, with the aid of contracts, which party in practice bears the risk and try to allocate the risk accordingly.

The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) uses the term 'goodwill' which Chandler (2009:17) believes "has widely varying interpretations and therefore references to goodwill are likely to be interpreted in significantly different ways by different tax authorities." Further Chandler (2009) from KPMG is of the opinion that the term 'goodwill' should be replaced with the statement used in the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008:53):

> MNEs are free to organise their business operations as they see fit. Tax administrations do not have the right to dictate to an MNE how to design its structure or where to locate its business operations. MNE groups cannot be forced to have or maintain any particular level of business presence in a country.

The OECD Guidelines should not approach a related party transaction differently to that of an independent party transaction just because the parties are related. For example, if EvoCar is moving one of its manufacturing plants to a different location for economically sound reasons, EvoCar should not have to pay compensation to any related party unless it is bound to do so by a contract. Chandler (2009) is of the opinion that the mere fact of a related party moving to another location should not trigger a payment as no independent party is required to pay compensation for moving countries either.

From another viewpoint, if this is not recognised in the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft it may lead to confusion and unfair discrimination which may result in double taxation. For example, a car manufacturer invests in certain suppliers to try to cut the costs of the total manufacturing process. Due to the investment the suppliers now fall under the related party definitions, but because the MNE has no experience in the distribution industry it actually has more unexpected costs and decides to revert to its previous manufacturing business only and sell off the previous acquired distributors. By pulling out of the distribution market, the manufacturer may be expected to pay the distributor certain compensation if stipulated in a contract. Chandler (2009) is of the opinion that currently one could interpret the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft in such a way that the manufacturer has to pay 'exiting' penalties. As this was an investment decision and had nothing to do with transfer pricing, the MNE should not be penalised just because the investment was in a related party, rather than an independent party. This example takes the case to the extreme, but some tax administrations may try interpret investing options in such a way and try to increase the country's revenue.

5.3.2 Comments on the actual restructuring and the arm's length compensation

The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) discusses the importance of related companies evaluating and documenting other possible options available to them to strengthen their case that business restructurings have been at arm's length. In theory this may be acceptable but, in practice, an MNE follows its business vision and mission for the group as a whole. It appears that the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft neglected to take into account the reason why MNEs exist and how they operate in practice. Keijzer and Dijckmeester (2009) state that an organisational structure of an MNE may follow its

business vision, which may be truly global, and therefore would not consider each single related party involved in the decision making. To expect an MNE to evaluate and document every available option for each legal entity and perform an analysis would be too costly and time consuming. This may severely hamper an MNE's business process and place a heavy burden on the taxpayer, which may not be acceptable.

The OECD should consider providing a safe haven for MNE restructurings when the restructuring is considered to have commercial rationality. The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) states that each restructuring of an MNE must be looked at in isolation and at each individual taxpayer level, regardless of what the overall MNE's mission and vision is. Alicandri (2009:8) who speaks on behalf of the Tax Executives Institute, Inc. believes that "most business restructurings are driven by sound commercial reasons apart from tax savings. Assuredly, when management determines that a restructuring is necessary an MNE's tax advisors will seek to obtain the most beneficial tax result for the restructuring as well as the post-restructuring transactions." The tax administrations should accept business restructurings where the MNE can show that its post-restructuring effective tax rate falls within a reasonable range for the different tax administrations involved. Therefore, it should be acceptable as being commercially rational and at arm's length.

It should be established in the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008:23) that not having adequate documentation with regard to other "options that would have been realistically available to the restructured entity" does not imply that a transaction is not at arm's length. Otherwise this may place a heavy compliance burden on the taxpayer. The principle of 'substance over form' established in the OECD Guidelines should continue to apply. Keijzer and Dijckmeester (2009) are of the opinion that the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft should provide a more balanced approach with regard to documentation and the increasing compliance burden on taxpayers. To document other options may also be very difficult due to timing differences. Each option may change and many factors may be unknown during the decision making process. Another point to consider is that a restructuring decision of an MNE may be based on financial as well as non-financial factors. These non-financial factors may be impossible to quantify.

Dunahoo, Sprague and Boykin (2009) from Baker and McKenzie are of the opinion that the suggestion of the Transfer Pricing Aspects of Business Restructurings Discussion Draft with regard to implied terms in contracts, based on speculation as to what other parties may have done, is inappropriate. The OECD Guidelines indicate that a transfer pricing analysis should set an arm's length price for the arrangement and/or transaction actually entered into by the related parties. Considering this, it is inappropriate to assume or infer terms that are not negotiated by the related parties in the contract. Dunahoo, et al. (2009:7) is "starting to see some tax administrations attempting in the examination context to impute significant changes in the terms of the parties' agreements as a first resort, even attributing ownership of IP from one entity to another. The Discussion Draft should clarify that such analyses are inconsistent with the Guidelines."

The Tax Executives Institute, Inc. (Alicandri, 2009:10) summarises the above as follows:

> First[ly], the requirement is open ended and seemingly requires taxpayers to consider and document a range of possible alternatives to the restructuring transaction. Second[ly], the standard introduces considerable subjectivity into the examination of arm's length conditions. Rather than examining the transaction actually entered into by a taxpayer, tax authorities would be permitted to consider what other options 'might' have been considered by independent third parties. On balance, we believe the proposed standard considerably lowers the threshold in the current TP Guidelines for recharacterising transactions… tax authorities will be given discretion to substitute their judgment for what constitutes a 'commercially rational' transaction. As a practical matter, the standard is likely to discourage much needed business restructurings and require taxpayers to maintain inefficient business operations.

Ernst & Young (2009:11) go a step further with regard to other options realistically available to the taxpayer and suggest that "the burden of proof should rest with tax administrations to demonstrate that the option chosen at the time by the taxpayer was perverse, or not credible". However, as previously mentioned, this analysis should be done with information reasonably available to the taxpayer and the tax administration should not use hindsight.

The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) discusses the issue of compensation for the transfer of assets and risks, but it does not go into detail or specify what constitutes a transfer. Walker (2009) from the United States Council for International Business is of the opinion that where, in particular situations, related parties engaged in long-term contracts or long-standing relationships alter that contract or relationship under a termination clause, that should not constitute a transfer that requires compensation, especially where the contracts have been negotiated at arm's length and there is no statutory right of compensation.

A major concern highlighted by Keijzer and Dijckmeester (2009) that arises is that the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft does not take the nature of an MNE into account, because, from an MNE's point of view, it may not be possible or realistic to assume that each legal entity's alternatives will be hypothesised accordingly to satisfy the assumption that every possible structure has been analysed. Another point that is important to keep in mind is that each MNE and its legal entities are free to organise their business operations as they see fit and should be taxed accordingly. An MNE is not obliged to adopt a system seen as 'the best fit option' from a tax administration's perspective.

With regard to the renegotiation of contracts or the termination of the contract, Vrind (2009) states that there may be an instance when a less favourable contract is better than no contract at all. In such a situation an independent party would probably also enter into such a transaction. The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft should mention such a possibility to ensure completeness.

The valuation of intangibles and the good faith of the initial valuation may raise some issues. As discussed in section 4.2.2.3, the valuation of intangibles must be performed with information reasonably available at the time of the restructuring and arrived at in good faith. Demade (2009) is of the opinion that this may lead to confusion because the valuation of intangibles is subject to judgement and therefore the actual value may be different to the value determined. A tax administration should be very careful before qualifying any valuation as being made in bad faith. More guidance or clarity should be given to ensure more certainty for taxpayers in this regard.

The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) discusses the issue of compensation as a result of a restructuring. Demade (2009) states that even though it is addressed in the draft it is still vague and needs to be clarified. The issue is that the discussion about the profit and loss potential is interrelated with the asset or right that is transferred. The arm's length principle does not require actual compensation for the profit potential as such, but the right or assets transferred do require compensation under the arm's length principle. Further, the examples given in the draft do not conclude on the issue and this issue appears to be open to a subjective interpretation. The "consensus on this significant issue is not obvious and the balance seems to be in favour of a required compensation in case of any restructuring transferring a profit/loss potential" (Demade, 2009:6).

As discussed previously, the issue of conversion of risk should be determined with the aid of contracts and other written documents. Less emphasis is placed on the substance of the actual transaction itself. When considering the compensation of the restructured entities, the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) suggests examining the substance of a transaction rather than the legal contracts. It emphasises the need to consider the actual conduct of the entity and base the compensation on the substance of the arrangement and the conduct of the related parties. Demade (2009) is of the opinion that even though this is in line with the OECD Guidelines, this may be confusing when related to the conversion of risk because there is no consensus in this regard on how to deal with a restructuring. Both points are very important. The legal agreements, as well as the substance of a transaction, should be taken into account. However, some limit should be placed on the substance over form approach as the taxpayer should not lose its protection from written contracts by having tax administrations ignoring them and claiming that the substance of a transaction is different to its form.

The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) discusses the role of the terms of a related party contract. However Hannes (2009:17) states that, tax administrations "should be strongly discouraged from <u>assuming or speculating</u> about what contractual terms and conditions, such as the number of years of a contract's term, 'would have been reasonable' for independent parties to agree upon, particularly on the basis of hindsight." [Author's emphasis] Instead, the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft should follow the OECD

Guidelines and emphasise that a contract entered into between related parties should be implemented consistently with its terms and adhered to. It should be enough to accept the transaction from a tax administration's view point as long as the actual compensation within the contract is at arm's length.

The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008:35) mentions that "an implicit longer term contract should be implied". This position may give tax administrations potential authority to remake a contract. The Tax Executives Institute, Inc. (Alicandri, 2009:6) recommends that the statement should be eliminated as it stands in contrast with the OECD Guidelines where tax administrations do not "have an implied right to impute a contract duration longer than that agreed to by the parties."

According to the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) business restructurings involve either a transfer of functions, assets and/or risk jointly or separately. The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft is very vague on how the term "functions" and its transfer should be dealt with. Deloitte (Neuenschwander, 2009:6) understands that compensation may only be required for an actual transfer of risks, rights, or assets or something of value. Functions, however, are not discussed. Deloitte believes that "functions are not transferred – rather, one function ceases and another one starts somewhere else."

5.3.3 Comments on the application of the arm's length principle after the restructuring

The issue regarding an increased tax compliance burden also relates to the application of the arm's length principle after the restructuring. The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) requires a comparability analysis of each party's characteristics to be performed for both pre-restructuring and post-restructuring arrangements as well as the actual transaction undertaken. This puts an additional tax compliance burden on the taxpayer.

Another point mentioned by Demade (2009) regarding the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft is that a restructured entity is not necessarily in the same position as a newly structured entity, which may make it very difficult or impossible to find comparables. It was explained in the draft that a restructured entity always retains some valuable intangible in the converted entity. This could be true in

certain cases, but should not be taken as true for every case.

Emphasis is placed by the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) on whether the comparison of post-restructuring profits compared to its pre-restructuring profits can be used with the help of a comparability analysis as a sanity check to determine if the post-restructuring profits are at arm's length. The problem is that many different external factors can influence the level of profits before and after the restructuring that had nothing to do with the restructuring itself. Demade (2009) is of the opinion that it is important to acknowledge that a comparison may be distorted and therefore no adjustment by any tax administrations should be made on this basis. One may be able to use the comparison as a sanity check, as long as a deep review of factors including internal and primarily external factors have been examined, that may influence the post-restructuring profit.

PricewaterhouseCoopers (Andrus et al., 2009:9) believes that the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft:

> should not state or imply that a transfer between members of the same multinational enterprise of the opportunity to engage in certain business functions is itself a taxable event. Unless such business opportunities are accompanied by intangible assets that give the owner the ability to exclude others from carrying on similar business activities, a business opportunity is not a unique asset and should not need to be paid for.

With regard to location savings, the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) should explicitly state that location savings should be evaluated in terms of specific facts and circumstances relevant to each transaction and it should not be based on a general rule.

> It has been KPMG's experience that tax authorities in high wage cost countries tend to assume that the buyer of products made in low cost areas should be able to capture all or most of location savings while the tax authorities in low wage cost countries assume that their local manufacturers should be able to realize high profits because of their low costs. As a practical matter, the answer is likely to turn on the functions, capabilities and circumstances of the specific legal entities involved. If the legal entity in the low wage country has significant capabilities that cannot be readily replicated by alternative suppliers in the same or other low wage countries, it may be able to sell at prices that reflect a higher

> cost base than it has and therefore realize substantial profits. Conversely, if the local entity has very limited capabilities and is closely supervised by the legal entity that is buying its product, it may be unlikely to receive anything more than a low routine profit. Finally, it is important to realize that in many cases the "location savings" may be passed onto the third party customers of the taxpayers, and that they may therefore not lead to higher profits for any of the specific subsidiaries (Chandler, 2009:25).

5.3.4 Comments on the recognition of the actual transaction performed

Keijzer and Dijckmeester (2009) continue the discussion that an MNE may set up its organisation and structure as it sees fit, and state that it also applies to recognition of the actual transaction performed. A tax administration should not just ignore a method applied because the tax administration does not like the method. However this does not mean that artificial structures should not be questioned, but the tax administration should rather adopt an open approach to analysing the MNE approach.

The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008:55) speaks about the non-recognition of a transaction due to the restructuring of the transaction not "behaving in a commercially rational manner". Crüger (2009) and Dunahoo et al (2009) are of the opinion that this commercially rational manner test may lead to confusion and may be very difficult to enforce due to two reasons. Firstly, when looking at the commercial rationality, the whole environment of the restructured entity should be taken into account, which may be very difficult. Secondly there are many different business models within an MNE and it may be difficult to find comparables for the restructured transaction that are reliable.

Ernst & Young's (2009:2) response is very similar and states the problem with non-recognition of a transaction as follows.

> Our own view is that tax administrations should only be able to disregard a business restructuring if there is no commercial rationale for it from a group perspective. Other cases can be dealt with through conventional transfer pricing adjustments where appropriate. Unless powerful safeguards are applied, we [Ernst & Young] fear that the number of cases in which recourse is had to these provisions, even if only to put pressure on the taxpayer to settle, will increase further.

The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) recognises the difficulty of defining commercially rational clearly and does not provide a definition. However, Andrus et al. (2009:4) lists the following principles that should apply:

- The totality of the circumstances and not individual elements of a transaction must be considered.
- The fact that comparably structured transactions among unrelated parties cannot be identified is not a sufficient reason to disregard a transaction on the ground that it is not 'commercially rational.'
- Where real functions, assets and risks are transferred, the fact that the restructuring is undertaken to achieve tax savings does not cause the transaction to fail the 'commercial rationality' test.

Even though the commercial rationality standards were described and an attempt made to explain them in the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft, there is no consensus and no clear definition by the OECD participants. Andrus et al. (2009:4) believe that this unclear definition may give rise to controversy and may be difficult to resolve. This problem has been heightened "by public comments of some individual tax authorities following publication of the Discussion Draft to the effect that their countries would routinely seek to disregard transactions where the arrangements themselves are not" arm's length. More clarity and guidance is required with regard to disregarding an actual transaction, to ensure it is dealt with consistently and in terms with the OECD Guidelines.

To put this into perspective, a tax administration should not be able to disregard a restructuring which was prompted by *bona fide* business purposes. As mentioned by PricewaterhouseCoopers (Andrus et al., 2009:4), tax administrations should certainly not "be allowed to do so based merely on a subjective declaration that similar transactions would not be engaged in by unrelated parties." The *bona fide* restructuring transaction taking place should be evaluated to ensure that it complies with the arm's length principle at each individual entity level. This is very important. The assertion made by the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008:57) that "transaction[s] must be arm's length at the level of each individual taxpayer, taking account of its rights and other assets, expected benefits from the restructuring arrangement, and realistically available options" should not be seen as a basis to disregard the MNE group's authenticity. In the view of PricewaterhouseCoopers (2009), the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft should be rewritten in such a way

that it analyses whether each individual party to the whole restructuring has been appropriately compensated for the actual transfer of assets, risks or functions, and whether that transfer is in accordance with the arm's length principle.

The current proposal by the OECD raises some points that need additional clarification with regard to the recognition of a transaction between related parties. The United States Council for International Business (Walker, 2009:9) lists these issues as follows:

- How much business and economic substance is required to have a restructuring accepted?
- Should Article 9 of the Model Tax Treaty permit tax authorities to challenge the restructuring itself?
- Do domestic anti-abuse rules apply…?

PricewaterhouseCoopers (Andrus et al., 2009:4) believes that "[n]on-arm's-length behavior should, as far as possible, be dealt with on the basis of pricing adjustments, rather than by re-characterizing all or part of the actual transactions undertaken." This is in line with the Transfer Pricing Guidelines, which view a re-characterisation of a transaction or part thereof as a last resort, especially as it may result in double taxation.

5.4 Summary of the main concerns

The major concerns raised on the arm's length principle, Article 9 of the OECD Model Tax Convention and business restructurings are summarised in the table below:

Area of concern	Concern raised	Suggested changes
Arm's length principle		
	The arm's length principle does not account for economies of scale.	No change to the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft has been proposed.
	The arm's length principle results in a static approach that fails to bring together functions, assets and risks, especially with regard to MNE.	No change to the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft has been proposed.
Article 9 of the OECD Model Tax Convention		
	The OECD Model Tax Convention may be out-dated as it only takes two parties for a transaction into account.	Article 9 of the OECD Model Tax Convention should be updated to include more than two parties for transactions.
Business restructuring in general		
	Consensus between OECD Member countries may be lacking which may lead to double taxation; this has been addressed with the new OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft but some terms need further clarification.	Clarify the relevant terms and ensure tax administrations and taxpayers alike understand all the terms.
	No tax administration should be able to dictate how an MNE should run its business.	Clarify that tax administrations should only be able to adjust an MNE's taxable income in a worst case scenario.
	The treatment of intellectual property is not clear enough.	Further discussions or examples should be given in the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft.

	There may be an increased administrative burden through the review of contracts which may also result in an increased form over substance approach, which is not in accordance with the OECD Guidelines.	The norm is to look at the substance over its form.
	Tax administrations should not be able to re-characterise taxpayer's business restructurings except for very limited cases.	It should be clarified that the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft does not give tax administrations the ability to simply re-characterise transactions.
Conversion of risk		
	The determination for the allocation and control of risk.	It should be determined who has the control over the risk and who has the financial capacity to bear the risk, in order to determine if the allocation of risks is at arm's length. However this is not as easy as it sounds.
	If there are no contracts in place between the related parties it seems as the tax administrations may speculate about how, in practice, independent parties would have dealt with the same issue.	Tax administrations should respect a taxpayer's allocation of risks unless they can prove with empirical evidence that independent parties in similar circumstances do not share risks in the same manner. Therefore Tax administrations should not be able to second guess contracts and behaviours of related parties.
	The use of financial statements to assess whether a risk is economically significant.	The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft should acknowledge that financial statements may be a good reference point but should not be overestimated. It may be more appropriate to do a functional analysis for each party involved in the restructuring to identify functions, risks and assets, characterising the types of risks transferred which then could be quantified through a financial risk model.

	In order to determine if a related party has control over a risk it should be determined if that party has the actual financial capacity to cover such a risk.	Further guidance should be given in the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft.
	The term goodwill is used rather loosely.	The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft should clearly state or define what it means with "goodwill" as the term has widely varying interpretations.
Actual restructuring and the arm's length compensation		
	Related parties should evaluate and document other possible options available to them to strengthen their case that the business restructuring is at arm's length. This may severely hamper an MNE's business process and place a heavy burden on the taxpayer.	The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft should consider providing a safe haven for MNE restructurings when the restructuring is considered to have commercial rationality. Further it should be clarified that not having adequate documentation in place to prove an analysis of other options realistically available does not imply that a transaction is not at arm's length. Another suggestion is that the tax administration should carry the burden of proof to determine that business restructurings were not at arm's length.
	The compensation for profit and loss potential is interrelated with the asset or right that is transferred. Even though this has been discussed by the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft it is still vague and open to subjective interpretation.	Further guidance and clarification should be given.

	The term "functions" and its transfer within a business restructuring should be dealt with in more detail.	The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft should clarify and define "functions" and how it proposes to deal with one function ceasing and another starting as functions are not restructured but rather ended and/or started.
Application of the arm's length principle after the restructuring		
	There is an increase in tax compliance burden due to the requirement of a comparability analysis of each party's characteristics to be performed for both pre-restructuring and post-restructuring arrangements and the actual transaction undertaken.	No change to the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft has been proposed.
	It may be difficult to find comparables for the newly restructured entity. Further guidance is needed for such instances.	No change to the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft has been proposed.
	Location savings should be evaluated in terms of specific facts and circumstances relevant to each transaction and it should not be based on a general rule.	The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft should acknowledge that more than just a general rule is needed for location savings and related business restructurings.
	As previously discussed the transferred profit or loss potential needs further guidance. It is important that the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft acknowledges that a comparison between before and after profit or loss potential may be distorted through external factors. Tax administrations should not just be able to make adjustments on a general basis without taking external factors into account.	The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft should acknowledge that profit and loss potentials are not a straight forward comparison but further guidance and clarification is needed.

Recognition of the actual transaction performed		
	The test applied to determine if a transaction is commercially rational may lead to confusion and may be difficult to enforce due to two reasons. Firstly the whole environment must be taken into account and secondly it may be difficult to find comparables.	The OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft should further define and clarify how tax administrations should deal with "no commercial rationale". Further safe guards may be needed to protect taxpayers.

5.5 Advance pricing agreements and mutual agreement procedures

PricewaterhouseCoopers (2008:49) write as follows:

> With fiscal deficits at record levels in major countries, governments face tremendous pressure to enforce tax laws and maximize their tax revenue. Governments are cooperating internationally to exchange information about taxpayers, and multinational corporations (MNCs) are subject to simultaneous tax audits. Tax conflicts relating to the development and use of technology and marketing intangibles also exists between developed and emerging countries. As a result, MNCs are facing a daunting array of rules concerning documentation of transactions, disclosure of financial information, transparency of tax issues, analyses of tax reserves, and reasoned conclusions regarding tax exposures. These global forces are leading to a dramatic increase in tax audits, disputes and tax adjustments around the world. At the same time, there are significant competitive pressures on MNCs to operate efficiently and to produce a competitive global effective tax rate.
>
> The world needs efficient mechanisms to enhance and secure international economic relationships, thereby leading to more certainty in an uncertain environment. The importance of abolishing double taxation is obvious in this context. Advance pricing agreements (APAs), mutual agreement procedures (MAPs) between competent authorities, and arbitration procedures serve this goal.

Advance pricing agreements are defined by the OECD (2001:G-1) as:

> [a]n arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An advance pricing arrangement may be unilateral involving one tax administration and a taxpayer or multilateral involving the agreement of

two or more tax administrations.

KPMG (2008:7) believes it is worthwhile to consider entering into an advance pricing agreement if one or more of the following outcomes may be generated:

- create an opportunity to realize an important objective, such as removing uncertainty or achieving a given TP [transfer pricing] result
- allow the taxpayer to switch from decision-makers who seem to be entrenched in an unfavourable position to a more open-minded APA [advance pricing agreement] team
- change the timeframe being assessed, and thus the facts used in negotiations with the tax authorities
- allow several years to be covered in one negotiation
- establish a favourable precedent for other transactions.

From the above it can be concluded that an advance pricing agreement is established to give the taxpayer assurance with regard to the cost that may be incurred by him for future transactions entered into.

Even though SARS does not enter into advance pricing agreements with its taxpayers at present, KPMG (2008) is of the opinion that they should be considered. There are about forty countries that currently have advance pricing agreements with their taxpayers and those countries that do not have any legislation for advance pricing agreements, such as South Africa, may be willing to use their mutual agreement procedure to resolve any advance pricing agreements that may be brought to the table by other tax administrations.

A mutual agreement procedure is defined by the OECD (2001:G-6) as:

> [a] means through which tax administrations consult to resolve disputes regarding the application of double tax conventions. This procedure, described and authorized by Article 25 of the OECD Model Tax Convention, can be used to eliminate double taxation that could arise from a transfer pricing adjustment.

KPMG (2008) states that an advance pricing agreement enables a taxpayer to manage transfer pricing uncertainties and audit risks proactively. In some cases it has been argued that an advance pricing agreement between the effected tax administrations may be a solution to the wide controversy that has arisen due to business restructurings.

The basic procedure for an advance pricing agreement as explained by KPMG (2008) starts with the taxpayer's proposal to the relevant tax authorities dealing with the pricing method and structures for the relevant intra-group, cross-border transactions. The proposal must also include a description of circumstances that may affect the transfer price, such as a functional analysis with the key value drivers for the transaction and the parties thereto or data relating to economic situations and what would happen if these change. Following the submission of the proposal, the relevant tax administration will review the proposal. Once everything has been reviewed by the tax administration the taxpayer and the relevant tax administration will start negotiations regarding the prices to be charged for the related cross-border transactions. The negotiation, depending on how many countries are involved, may be between more than one tax administration and the taxpayer. Once an agreement between the parties has been reached the advance pricing agreement is executed.

Further, KPMG (2008) highlights that problems with the negotiation process may arise where the proposal submitted is partially or wholly unacceptable. This may happen where the taxpayer believes his proposal is at arm's length, but one or more tax administrations believe a wrong method is used which may result in a wrong price.

As previously discussed, business restructurings may require a substantial amount of documentation and many aspects are very vague with regard to the actual disclosure of business restructurings even where the OECD Guidelines are followed. The main reason for this is that the OECD Guidelines are just that, guidelines. These guidelines can be interpreted differently by different taxpayers and tax administrations. In many instances there are clear-cut rules, but these guidelines are not legislated. In countries such as South Africa there is no case law to give guidance that may be upheld in court.

Taking the above into account, an advance pricing agreement between the relevant parties to a related cross-border restructuring and the tax administrations may lead to more certainty and therefore may be seen as a possible solution to the problem that business restructurings face.

5.6 Triangular transfer pricing cases

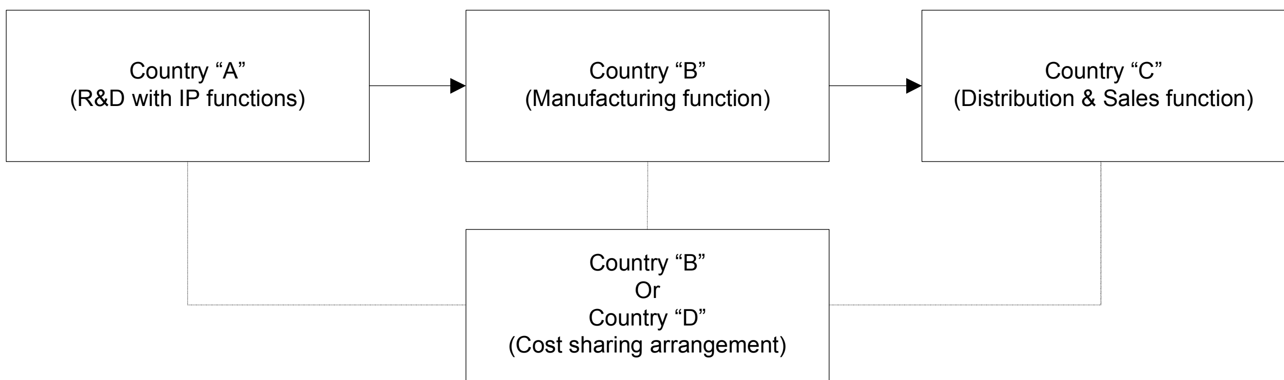
In the present day economy, with an ever-increasing number of MNEs and their desire to centralise departments to decrease costs and increase synergies within the MNE, transactions flowing between related parties involve, more frequently, three or more countries.

PricewaterhouseCoopers (2008:41) explains the emergence of triangular transfer pricing cases as follows:

> Initially, transfer pricing cases generally arose from the transfer of tangible or intangible property between two related companies in two tax jurisdictions. In those cases, the assessments made by the tax authorities in each jurisdiction at times created bilateral disputes. The difficulties and complexities involved with resolving those cases are well documented. Now, however, we are seeing a new development in transfer pricing cases that is adding a layer of complexity and raising challenging – and as yet unanswered – questions. We are observing an increasing number of situations whereby multinational entities are involved in transaction flows that give rise to transfer pricing disputes in more than two countries, otherwise known as a 'triangular case.' These new multilateral cases generate many difficult procedural and substantive issues and increase the difficulties of reaching a global agreement among all countries involved.

To get a better understanding the following examples indicate certain circumstances that a typical MNE may face.

The simplest example would include three legs to a cross border related transaction or two cross border transactions that are interlinked between different related parties. For example, in the auto manufacturing business the car manufacturer has its intellectual property and related research and development in country "A". A licence for this intellectual property is provided to country "B" where the manufacturing takes place. Once the products are manufactured they are sent to country "C" for sale and distribution. Historically there would have only been a bilateral dispute, a dispute between both country "A" and country "B" or both countries "B" and "C", as shown in the diagram below (PricewaterhouseCoopers (2008) – amended).



However, in the modern transfer pricing environment, the effect of a transfer pricing adjustment in one country will usually affect the other countries, hence a triangular case.

Even if the example is made more complex, for example by introducing a cost-sharing arrangement within the group in another related party in either the same country (i.e. country "B") or a separate country (i.e. country "D") the outcome is similar.

The problem with a triangular case, in the view of PricewaterhouseCoopers (2008), is that each tax administration wants its fair share of the profits achieved in the whole value-added chain of the transaction. The main issue with the profit allocation is how to divide the profits between the different tax administrations. Because transfer pricing legislation is emerging in most tax administrations, more legs are being added to the transaction and each tax administration wants its share of the global tax revenue.

PricewaterhouseCoopers (2008) also states that certain products which require complex research and development phases in multiple countries in order to be saleable may pose a challenge. The difficulty that arises is to calculate exactly how much the research and development added to the value-chain within each country and both MNE and tax administrations may believe that the actual value added may be different.

The OECD convention does not yet deal with such issues. It may be possible to use certain definitions provided by the OECD but that is not wholly satisfactory as a solution to the problem at hand. When considering the example above, the main issue identified by PricewaterhouseCoopers (2008) is that even though each country may have a tax treaty with other countries, such treaties do not address a relationship between three or more countries. This means there is a litigation issue on how to resolve conflicts arising between three or more countries. Is there a certain order to be followed when looking at the

countries? For example should a manufacturer be examined first before following the value-chain or should the arbitration start from the selling price of a commodity? A more creative approach may be necessary to ensure that the issue is dealt with in a timely and cost–efficient manner.

There is one international body, namely the European Union Joint Transfer Pricing Forum that has actually addressed the issue of triangular cases. PricewaterhouseCoopers (2008:47) argues that “a number of pragmatic solutions could prevent the need to alter the Arbitration Convention to accommodate the possibility of triangular cases. These suggested solutions include an additional MAP between the additionally affected countries, extending the workings of existing bilateral treaties to third parties, or even an extension of the Arbitration Convention to a third state.”

The problems of triangular cases are likely to increase over the coming years, due to the expected increase in global trade and the mounting economic pressures from the relevant tax administrations. A practical solution is needed in order to give MNEs certainty in their dealings and to avoid heavy burdens of uncertainty or even double taxation in certain instances. International cooperation is needed from both the taxpayer and tax administrations alike, in order to realise these goals (PricewaterhouseCoopers: 2008).

5.7 Global best practice in avoiding transfer pricing audits and disputes

PricewaterhouseCoopers (2008) states that transfer pricing audits and disputes may be protracted and expensive. In addition to the costs they also involve management time of both the taxpayer and tax administration. Certain MNEs will have more frequent transfer pricing audits and disputes, with the relevant transfer pricing policy being questioned by the tax administration. Such transfer pricing audits and disputes may impose significant costs and penalties. An MNE should be even more alarmed if there are recurring transfer pricing audits and disputes, as this may indicate a deeper malaise within the MNE.

In order to avoid transfer pricing audits and disputes the MNE should take proactive steps and work together with the tax administration rather than just sitting back and waiting for the tax administration to start asking questions and finding problems. These proactive steps include but are not limited to those listed below.

5.7.1 Start from the outset

The first step to show a tax administration that the MNE is acting in a *bona fide* manner is to establish a transfer pricing study or policy setting document. This study or document is analysed and should focus on proper planning to comply with local legislation and regulations in order to avoid disputes. The most common approach to achieve this is to document the study or policy in such a way as to identify all relevant transfer pricing issues that the related cross-border transaction may attract. PricewaterhouseCoopers (2008:20) states that: “This should include not only a review of various ’hot’ issues in the specific countries concerned, but also other developments around the world. We live in an increasingly connected global tax environment, and governments are increasingly identifying certain issues and examining those issues in their tax environment.” For example, it is vital to stay up to date with the definition of permanent establishments in double tax agreements between tax administrations, as the smallest change in the definition may have effect on how to deal with a transaction from a tax perspective.

In order to have a transfer pricing study or policy setting document that is complete and sufficient to address all the issues that a tax administration may want to audit or dispute, PricewaterhouseCoopers (2008) is of the opinion that it should contain:

- corporate structure and transaction flows for each particular business activity;
- identification of the particular transfer pricing methods associated with the above, explaining how the identified method suits each transaction best;
- overall transfer pricing framework and strategy (i.e. how the transactions are dealt with, how functions are remunerated and who bears the risks); and
- the transfer pricing protocol when executing business strategies and transactions.

It is important to keep in mind that all material related cross-border transactions need to be addressed in this transfer pricing study or policy setting document, using the simplest approach possible to deal with the issues at hand.

PricewaterhouseCoopers (2008:20) highlights the following,

> issues relating to moving intellectual property from one jurisdiction to another will need to be addressed with greater particularity. Having established the fundamental approach, the strategy process can then engage the right stakeholders at headquarters and in the local jurisdictions.

5.7.2 Building concrete foundations

PricewaterhouseCoopers (2008) is of the opinion that, in order to document a solid transfer pricing study or policy setting document, the project will usually involve senior stakeholders in order to define the functions of the material transactions and the whole project is usually driven by the corporate tax department. As each transaction is different in its function it is important to have operational staff who can explain the main value drivers of each transaction. This may include certain intellectual property specialists.

When an MNE is planning to restructure a cross-border related transaction, transfer pricing is an important element of that plan. An MNE may conclude that certain costs can be saved by establishing a cost centre, due to economies of scale. PricewaterhouseCoopers (2008) acknowledges that in the planning stages it is important to discuss and visualise what the issues may be from a tax administration perspective and to document the relevant steps to ensure business restructurings will be at arm's length.

The next step is to implement the actual plan effectively to ensure that the planned structure, transaction flow and pricing are implemented as planned. With the implementation it is important to establish the corporate entities with the required intercompany agreements in order to prove to tax administrations that the actual transfer pricing policy is adhered to. PricewaterhouseCoopers (2008:22) believes that the reason for this is that "[c]ommercial documentation precedes the establishment of the transfer pricing documents that support the various methodologies chosen for pricing, services rendered, and functions performed. The corporate documents in question should describe in detail the commercial agreements that establish the functions and risks of the respective corporate entities, ensuring the proper debt-equity ratios and intercompany agreements are in place."

Lastly, once the above is completed, the required transfer pricing policies are drafted to complete and support the financial results, including the flow of the documented transactions and the costs related to the relevant functions and methods used. An important aspect of this is to ensure that the transfer pricing documentation actually reflects the reality of the corporate documentation. PricewaterhouseCoopers (2008:23) describes this as follows. If transfer pricing documents and agreements do not "accurately reflect the underlying corporate structures and relationships or the type of relationships that unrelated parties would enter into" there may be larger issues at hand which a tax administration may question and take advantage of the mismatch.

PricewaterhouseCoopers (2008:23) gives the following example on how a tax administration may go about taking advantage of a mismatch:

> ... a mismatch in the allocation of risks between entities creates issues for tax authorities to investigate. Worse, it could provide an entrée for them to question the commerciality of the overall arrangement. A focus on the quality of the transfer pricing documentation should not detract from attention to the quality and detail of the intercompany agreements created at the outset. Investing in that documentation is a key step, but one that can be overlooked in the concern to ensure that transfer pricing documents meet the highest standards. By this stage, completing documentation should be a simple process demonstrating that the dealings and agreements are at arm's length.

5.7.3 Aligning form and substance

One major point highlighted by PricewaterhouseCoopers (2008) to keep in mind is that the form of the transfer pricing policy must reflect the substance of the actual transaction performed. If this is not the case the nature of the transaction may be questioned and can lead to transfer pricing audits and disputes. In order to ensure that form and substance are aligned the standard operational procedures may be described in the transfer pricing policy document.

PricewaterhouseCoopers (2008:23) explains that "[o]nce a structure is established and functionally operational, it is important to implement a periodic review to test the 'course of conduct.'" This includes the examination and verification of the following:

- Validate the structure to ensure it is still in line with the latest transfer pricing regulations in the relevant jurisdictions.
- Ensure that the operations and transaction flows are still in line with the transfer pricing policy as well as the relevant regulations in the different jurisdictions.

"The testing should include an analysis of financial results and the application of the selected transfer pricing methodologies to assess whether the related structures and operations are within the appropriate range" (PricewaterhouseCoopers (2008:23).

PricewaterhouseCoopers (2008) notes that even with the best planning and implementation of a recommended transfer pricing policy there may be a dispute between the tax administration and the taxpayer. This is due to the conceptual chasm between the tax administration and the taxpayer.

> For example, this presently is the case in the United States on issues relating to cost sharing. There is a significant philosophical difference between what the revenue authorities believe taxpayers should do and what taxpayers and their advisors believe is necessary and appropriate. In such cases, no amount of careful planning or implementation can bridge the divide between the two parties. But even in these instances, making sure that the steps taken are consistent with best practices should make it possible to defend a position effectively. The steps required to do this may be: first, to identify when this situation exists; then to assess the likely risks; and finally, to ensure that the arrangement, analysis and documentation either maximize the chance of acceptance by the tax authorities or minimize the likelihood of penalties (PricewaterhouseCoopers, 2008:24).

In summary, in order for a taxpayer to adhere to global best practices in avoiding transfer pricing audits and disputes, the taxpayer should have a transfer pricing study or policy setting document in place from the outset of any planned cross-border transaction. As discussed, the document should disclose certain information to tax administrations to show that the company is acting in good faith and at arm's length regarding its cross-border related transaction(s). Such information includes, but is not limited to: company background, functions performed, assets used and risks assumed by the company, an economic analysis and a conclusion on the transfer pricing method used. The document

should be updated on a regular basis and the substance of the transaction should be reflected in the transfer pricing document and related contracts to align form and substance. Even though there is no guarantee that a tax administration will not audit a company, if all the discussed steps are in place it should make it possible for the taxpayer to defend its position effectively.

5.8 Conclusion

This chapter critically analysed the OECD Guidelines and the OECD Model Tax Convention. It was established that the arm's length principle is sound in theory but there are valid arguments that it has certain flaws. Further the arm's length principle was analysed with an example which demonstrated how important it is to accurately identify the parties' characteristics which can be achieved through mapping 'similar circumstances' and that the arm's length principle in practice may not always work as demonstrated in theory.

The chapter also critically analysed business restructurings and the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft. The analysis indicated that the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft provides sound guidelines on how to approach business restructurings but there are certain points that lack consensus from the public. It is a very well written first draft but it should further analyse some of the problems discussed in this chapter and give clearer guidance. The OECD should further discuss the subjectivity of the tax administrations in relation to business restructurings. The crux of the issue regarding subjectivity is that the arm's length principle is objective and should not be subjective.

The chapter also discussed advance pricing agreements and mutual agreement procedures and the transfer pricing consequences of three or more countries involved in a cross border related party transaction. Lastly the chapter discussed global best practices in avoiding transfer pricing audits and disputes.

The final chapter provides a brief summary of the issues discussed and the conclusions arrived at in the thesis.

6 Chapter 6: Conclusion

Globalisation and the accompanying increase in MNEs has given rise to more, and more complex, transfer pricing considerations, with the attendant global tax concerns. Also driven by globalisation and the need to increase efficiency and decrease costs or increase profits through economies of scale or by taking advantage of synergies, MNEs are increasingly entering into restructuring exercises. The application of the OECD Guidelines in the context of business restructurings has exposed many deficiencies in the guidelines.

The research thesis, being cognisant of the OECD Guidelines, the Income Tax Act, international case law, the Transfer Pricing Aspects on Business Restructurings Discussion Draft and publicly available comments, addresses several important transfer pricing aspects and the anomalies that arise through internal business restructurings.

The aim of chapter 1 was to give a brief outline on the context and goals of the research thesis. It explained the research method and design applied to yield the anticipated results, including certain limitations to the scope of the research thesis

Chapter 2 aimed to describe all the related terms, definitions and aspects of transfer pricing with the aid of an example. To achieve its aim chapter 2 analysed the arm's length principle in detail, as it is the fundamental principle of transfer pricing. It is important to keep in mind that the arm's length principle is not an exact science but theoretically it is the best there currently is. It may not incorporate everything such as the cost savings through synergies of MNEs but it promotes international trade and investment by keeping transactions fair, unlike the global formulary apportionment. The arm's length principle gives the closest approximation to a fair transaction price between international related parties. The main methods to arrive at an arm's length range were analysed and even though there is a hierarchy of preferred methods, traditional methods over transactional methods, each case may warrant a different method to arrive at the arm's length range.

The aim of Chapter 3 was to describe the various traditional transactional methods and transactional profit methods that can be applied to approximate an arm's length price between related parties. The different methods were discussed and the hierarchy of the different models was depicted with the help of a diagram. Each method was further analysed with a practical example.

Chapter 4 presented a detailed analysis of business restructurings and the consequences, from a transfer pricing perspective. It discussed the four issues that may arise from business restructurings in functions, assets and risks, namely:

- conversion of risk;
- the actual restructuring and the arm's length compensation;
- the application of the arm's length principle after the restructuring; and
- recognition of the actual transaction performed.

Further, the chapter emphasised the point that, even though there are certain guidelines on how to deal with a business restructuring, each case needs to be determined on its own merits as no two cases are the same. At first glance, certain cases may appear to be the same but it is important that all the facts are understood correctly in order to conclude on the correct transfer pricing approach for business restructurings and the related arm's length principle.

The aim of chapter 5 was to critically discuss the arm's length principle having regard to the OECD Guidelines and the OECD Model Tax Convention. Further, the chapter's aim was to compare the theory of business restructurings as set out in the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft (2008) with how it actually is perceived by legal and audit firms to work in practice.

In chapter 5 it was established that the arm's length principle is sound in theory but there are valid arguments that it has flaws. Further the arm's length principle was analysed with an example which demonstrated how important it is to accurately identify the parties' characteristics, which can be achieved through mapping 'similar circumstances' and that the arm's length principle in practice may not always work as demonstrated in theory.

The chapter also critically analysed business restructurings and the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft. The analysis indicated that the OECD Transfer Pricing Aspects of Business Restructurings Discussion Draft provides sound guidelines on how to approach business restructurings but there are certain points that lack consensus from the public. It is a very well conceptualised first draft but it should further analyse some of the problems discussed in chapter 5 and give clearer guidance. It was found that business restructurings appear to put a strain on the creditability of the arm's length principle. The reason for this is that while the OECD Guidelines and its

Transfer Pricing Aspects of Business Restructurings Discussion Draft reflected consensus among OECD member countries across many issues, there are also differences of opinion on some crucial points. The main issue within business restructurings is that the arm's length principle compares international related party transactions to that of independent parties. Independent parties do not restructure their businesses the same way related parties may do and therefore no comparables may be available. This may lead to subjective conclusions of tax administrations and eventually it may lead to the re-characterisation of transactions which goes against the arm's length principle, which is intended to be objective.

Further the aim of chapter 5 was to discuss and analyse advance pricing agreements and mutual agreement procedures and the transfer pricing consequences of three or more countries involved in a cross-border related party transaction. Chapter 5 established that advance pricing agreements may be a possible alternative solution on how to avoid transfer pricing audits and disputes but are not always in the interest of the taxpayer. At times they may not be fair, very lengthy and not suitable if the transaction disclosed in the advance pricing agreement changes due to unforeseen circumstances. Triangular cases may also increase the taxpayer's burden because several tax administrations have to be dealt with. However, the application of the arm's length principle remains the same.

Lastly chapter 5 aimed to discuss global best practices in avoiding transfer pricing audits and disputes. The chapter provided best practice guidelines which should be followed and may be applied to business restructurings.

It is submitted that the recommended business restructurings approach of the Transfer Pricing Aspects on Business Restructurings Discussion Draft is realistic and pragmatic but some more clarity is needed especially with regard to the subjectivity of tax administrations. The biggest issue with transfer pricing, including the business restructuring aspect, is that it is not an exact science and as such there is no set way on how to determine a transfer pricing transaction. Different professional legal or audit firms approach the same international related party transaction differently and no one answer may be seen as correct by the tax administrations.

The OECD published new OECD Guidelines in July 2010 which may shed some light on the issues. Further research analysing the new OECD Guidelines that incorporate the

Transfer Pricing Aspects on Business Restructurings Discussion Draft should be performed.

It is important to note that the OECD Guidelines are just that, guidelines and each example should be looked at differently. It may be impossible to fairly value each transaction but the OECD Guidelines and the Transfer Pricing Aspects on Business Restructurings Discussion Draft appear to provide the basis for a fair balance to taxpayer and tax administration alike.

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