

THE POSSIBLE INTRODUCTION OF ADVANCE PRICING
AGREEMENTS IN SOUTH AFRICAN INCOME TAX LEGISLATION

by

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DECLARATION

This treatise is an original piece of work which is made available for photocopying,
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SUMMARY

This treatise analyses the suitability of the Advance Pricing Agreements (APA) for the South African Transfer Pricing legislation. The transfer pricing legislation places emphasis on the arm's length principle. Determining an arm's length price is problematic and as a result some countries have resorted to APA's to establish an arm's length price up-front, and thus avoid reviews and subsequent audits. The treatise first focuses on the transfer pricing provisions and other relevant applicable sections of the Act from the South African point of view, and it then examines the current status quo, i.e. the review processes used by the South African Revenue Services (SARS) as detailed in the Organisation of Economic Co-operation and Developments (OECD) Guidelines and the SARS Practice Note.

Since negotiated tax treaties form part of the South Africa law, the impact of these treaties are discussed in Chapter 4.

The treatise discusses in detail an APA from the OECD's point of view. It examines the objectives of an APA; the benefit and the shortcomings of using an APA. It then examines the APA request processes from a Canadian perspective and the administration of the APA from an USA perspective.

The treatise examines South African trading partners using APA in transfer pricing matters, with reference to the effects and the challenges such countries face.

The treatise concludes by looking at the benefits provided by use of an APA by South African major trading partners. The effect and the use of such APA will have in South Africa is also discussed and how it should be modelled; the present status quo with regard to personnel at SARS; and the possible impact the introduction and implementation will have in South Africa.

KEY WORDS

Transfer pricing

Taxation

International transaction

Advance pricing agreements

Multinational entities

Tax authorities

Double Tax Agreement

Double taxation

Organisation for Economic Co-operation and Development

CHAPTER 1

INTRODUCTION AND OVERVIEW

1.1. Introduction

The current South African income tax legislation relating to transfer pricing requires enterprises that are engaged in international dealings, particularly with related parties, to transact at an arm's length price or face the adjustment to their taxable income as set out in section 31 of the Income Tax Act. This has been a difficult issue for these enterprises for they are required to demonstrate that they are transferring goods and/or services at a price which reflects the behavior of independent parties.

Management of multinational entities may knowingly manipulate prices with the object of shifting profit from a jurisdiction with a high tax rate to that with a low tax rate, thus increasing profits which will be eventually distributed to shareholders. Such actions erode the tax base and may thus hinder the ability of a country to sustain vital projects. Although the Income Tax Act has enacted provisions, as indicated above, that discourage the use of prices that are not reflective of the conduct of independent parties, it is sometimes difficult for tax authorities to challenge such actions due to lack of sufficient resources and other reasons.

Transfer pricing is by its nature a complex and contentious issue, and is caused by the existence of related multinational entities in more than one tax jurisdiction. The term transfer pricing is used to refer to any arrangement in which goods or services are transferred at a disguised price as a means of effectively transferring income or an

expense from one person to another.¹ This transfer of prices is done with a principal object of easing the tax burden. At the core of transfer pricing anti-avoidance legislation is the arm's length principle. The arm's length principle functions on the basis of taxing each enterprise within a multinational group separately as if the transaction between them were independent transactions at arm's length.²

Enterprises are faced with the dilemma of determining an arm's length price where one may simply not exist, leaving them in the doubtful position of not knowing whether the requirements of the legislation have been complied with.³

Matters of transfer pricing are intricate and, while there is no universal remedy for the concern of both the enterprises and the tax authorities, there is an approach which may be beneficial – a response to transfer pricing dispute: an advance pricing agreements (APA's). APA's are acknowledged to strategically reduce risk in the area of transfer pricing.

¹ Keith Huxham & Phillip Haupt on *Notes on South African Income Tax: 2008* in 16.7.1

² Lynette Olivier & Michael Honiball on *International Tax: A South African Perspective 2005* in page 405

³ Dr Kerry Sadiq on *Journal of Australian Taxation*

The concept of APA is documented by Samir Gandhi as follows:⁴

‘APA’s are arrangements that determines in advance of controlled transactions, an appropriate set of criteria for determination of the transfer price for those transactions over a fixed period of time.’

The opportunities provided by the APA procedure affords the tax authorities and taxpayers to consult in a non-adversarial spirit and environment, facilitate principled and practical negotiations, resolve transfer pricing issues expeditiously and prospectively.⁵

APA programmes have increasingly been adopted by many countries. Its application varies from country to country, but generally follows the guidelines laid down by the OECD. South Africa is not a member of the OECD, but applies the guidelines in its approach to transfer pricing issues.

All major South African trading partners are members of the OECD. The United States of America (USA) was the first country to introduce an APA Program due to a growing dissatisfaction by the Internal Revenue Service (IRS). Canada followed suite, probably because the USA is its largest trading partner. Australia also has an APA Program which has been embraced positively by the Australian Tax Office (ATO),

⁴ Advance pricing agreements for reducing transfer pricing dispute: Economic Time Delhi: September 2009.

⁵ Samir Gandhi: Advance pricing agreements for reducing transfer price disputes: Economic Times Delhi; September, 29, 2009

especially in recent years.⁶ Other major trading countries that have an APA program include the UK and the Peoples Republic of China (China).

The introduction and implementation of the APA by South Africa trading partners has shown that it is an arrangement worth having, it has contributed to the raising of compliance in other areas of tax, raising revenue coffers and resulting in cost saving.

1.2. Research objective

The objective of this treatise is to research the possibility of the introduction of APA's into the South African domestic income tax legislation. This will be done by examining the current transfer pricing legislation, rules and documentation required of taxpayers, and the effect of the relevant articles of Double Tax Agreements (DTA's).

An evaluation in detail of APA's and how they have been implemented in other jurisdiction will be considered. Also to be considered is the APA's processes and its administration. From this, a conclusion will be drawn for a suggested model for South Africa.

1.3. Research Method

The treatise is desktop based. Text books, journal articles on transfer pricing and APA were evaluated. Relevant sections of the legislature and various papers and articles by local authors and that of other countries were considered.

⁶ International Tax Review: Australia aims to allay APA fears

1.4. Treatise outline

The treatise comprises nine chapters. Following this introductory chapter, chapter 2 explores the current transfer pricing legislation and also focuses on the documentation that is necessary and relevant from the SARS point of view.

Chapter 3 focuses on the current review processes. The SARS's Practice Note 7 forms an integral part of the discussion. Chapter 4 examines the articles of the DTA and the effect this will have on the APA program. Chapter 5 concentrates on the concept and the idea of an APA. Also discussed are the effects; the advantages and disadvantages an APA program may have. To ensure that the APA yields the intended results, the processes and its administration should be unproblematic and cost effective, this is discussed in chapter 6 which focuses on the APA process as adopted by the Canadian Tax Authority due to its simplicity; and Chapter 7 focuses on the administration of an APA program as adopted by the US.

Chapter 8 analyzes SA major trading partners who are using APA in their tax systems. The observed findings from countries mentioned above are robust with respect to introduction, implementation and experience.

Finally, chapter 9 will conclude the treatise by discussing the findings, the implications of these findings and then make recommendations thereof.

CHAPTER 2

TRANSFER PRICING PROVISIONS AND DOCUMENTATION GUIDELINES

This chapter examines the South African transfer pricing provisions. It briefly discusses the historical overview of transfer pricing in South Africa, followed by the discussion on the current provisions of the Act and a brief discussion of the amendments to section 31; the brief discussion on the status of SARS's Practice Note 7 and the role of DTA's. The chapter also discusses the documentation guidelines that are necessary and required from SARS' point of view.

2.1. TRANSFER PRICING

2.1.2. Introduction

Since the advent of democracy in 1994, South Africa has experience a significant increase in cross-border trade, with wide-ranging changes in volume and complexities. A significant number of these transactions are carried on between members of multinational entities. Due to tax rates being dissimilar, the prices multinational entities use to transfer goods and/or services may have a direct bearing on the profit that should be taxed in a particular country, consequently eroding the tax base of a particular country – with dire consequences.

In the past, from a South African perspective, exchange controls have provided some protection against this distortion and regulated the manner in which goods and/or

services are priced. The Katz Commission's report⁷ recommended that the transfer pricing and thin capitalization rules be introduced into the tax system. Section 31 of the Act was thus enacted in 1995, and it coincides with the continuing program of the liberalization of the exchange controls.

Section 31 is an anti-avoidance measure that is used to address tax avoidance schemes involving the manipulation of prices for goods and/or service under cross border transactions between connected persons. In conformity with international models in many developed countries, it is the intention of the legislature that such transfer pricing provisions may also be applied to counter the abusive practice of thin capitalisation.⁸

2.1.3. Transfer pricing provisions

The transfer pricing provisions are aimed at entities wishing to shift profits from one country to the other with the purpose of paying no tax at all or paying less tax. In essence, the transfer pricing provisions stipulate multinationals to transact at an arm's length price.

Basically, the provision states that if the price set for the supply of goods or services between connected persons is not at arm's length, i.e. the price is either less or greater than the price that would have been set if that supply or acquisition of goods or service had occurred between independent parties dealing on an arm's length basis, then the Commissioner may adjust the consideration, for tax purposes, and use the amount so calculated, in the determination of the taxable income of either of the

⁷ First and Second Interim Reports of the Inquiry into certain aspect of the Tax Structure of SA (1995)

⁸ De Koker on Silke on South African Income Tax on page 17-89 paragraph 1

parties to the transaction. The above is enacted into the Act in Section 31(2) and which prior to its amendments provides as follows:

- Where any supply of goods or service has been affected –

(a) between -

(i) (aa) a resident; and

(bb) any other person who is not a resident;

(ii) (aa) a person who is not a resident; and

(bb) a permanent establishment in the Republic of any other person who is not a resident, or

(iii) (aa) a person who is a resident; and

(bb) a permanent establishment outside the Republic of any other person who is a resident

(b) between those persons who are connected persons in relation to one another;

and

(c) at a price which is either –

(i) 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)

(ii) greater than the arm's length price,

the Commissioner may, for the purpose of this Act in relation to either the acquiror or supplier, in the determination of the taxable income of either the acquiror or supplier,

adjust the consideration in respect of the transaction to reflect an arm's length price for the goods or services.'

Due to loopholes and considerable abuse of the current provision, the legislature decided to amend section 31, with the promulgation of the Taxation Laws Amendment Act No. 7 of 2010. The amended section will come into operation on 1 October 2011, and will apply in respect of the years of assessment commencing on or after that date.

Notwithstanding the amendment to section 31, the amended provision still requires international transactions to be based on the arm's length principle. The notable difference between the current provision and the amended provision is that the current provision refers to "any supply of goods and services..." while the amended provision refers to "any transaction operation, scheme, agreement or understanding has been directly or indirectly entered into..."⁹ The amended provision is broadly worded and includes in its ambit 'anything' done by connected persons. The main purpose is to curtail the undue tax benefit resulting from dealings by connected parties.

2.1.4. Thin Capitalisation

Thin capitalisation is regarded as a category of transfer pricing, and is contained in section 31(3) of the Act. Thin capitalisation is a term used to refer to businesses that have received a loan from a foreign investor which is disproportionately large in relation to the equity of the company.¹⁰ Due to the loan granted, the local entity will incur interest on such a loan and claim it as a deduction, while the foreign investor

⁹ Taxation Law Amendments Act No. 7, 2010

¹⁰ K Huxham & P Haupt on Notes on South African Income Tax, paragraph 16.72

may be tax-free in South Africa on that interest. Multinationals prefer this method instead of investing in equity which produces dividends that are not tax deductible. Thin capitalisation rules are, therefore, aimed at companies that are heavily geared with foreign investment.

The thin capitalisation provision, therefore, limit the deductibility of interest on excessive debt funding, thereby protecting the erosion of the South African tax base. In terms of the thin capitalisation rules as contained in section 31(3), the Commissioner may disallow the interest relating to the excessive loan, or which does not reflect an arm's length rate.

The Taxation Laws Amendment Act No 7 of 2010 also brings in new wording to the thin capitalisation rules. The thin capitalisation rules has been extended and merged with transfer pricing rules¹¹. Subsection 3 of the transfer pricing provision also refers to “any transaction, operation, scheme, agreement, or understanding that has been directly or indirectly entered into or affected...” The legislature hopes that with this amendment, it will bring most activities in the tax net, and thus boost revenue.

The major feature of section 31 of the Act as expressed is that it plays a significant role in curtailing price manipulation. Any adjustment made in terms of section 31 may be subject to the provision of section 64C of the Act, which stipulates that certain amounts distributed to a recipient, if that recipient is a non-resident shareholder and a party to cross border transactions, by a company are deemed to be a dividend declared by the company. Section 64C(3)(e) deems any amount adjusted or disallowed in terms

¹¹ Draft Explanatory Memorandum - Taxation Law Amendment Bill 2010.

of section 31 to have been distributed to a recipient by the company. The adjustment will therefore be subject to Secondary Tax on Companies.

2.1.5. Other measures

There are some other measures available to SARS other than section 31, i.e., section 11(a) of the Act and Article 9 of the relevant DTA. In terms of section 11(a) of the Act, the expenditure that is extravagant or excessive is disallowed as a deduction.¹² Our courts have been lax to provide guidance on the yardstick to be used to determine whether the expenditure is grossly excessive, except to say that in certain circumstances a court is not entitled to consider the open market price (*Tobacco Father v COT* 17 SATC 395).¹³ This thus renders section 11(a) less effective.

The DTA's are generally based on the OECD Model Tax Convention. The primary purpose of the DTA is the avoidance of double taxation, but for transfer pricing purposes, the aim is to determine the arm's length price as standard for the adjustment of transfer prices by tax authorities.

Similar to section 31, SARS also applies Practice Note 7, which also refers to an arm's length price. The Practice Note is based on the OECD transfer pricing guidelines.¹⁴ These guidelines should be followed in the absence of specific regulations in the Practice Note, despite the fact that South Africa is not a member of the OECD.

¹² Income Tax Case 569 13 SATC 447

¹³ L Olivier and M. Honiball on International Tax: A South African Perspective 2008 at page 486 par 4

¹⁴ Practice Note 7, paragraph 3.2.2

A question that often arises is the legal standing of Practice Note 7. It is an acknowledged fact that SARS' Practice Notes or Interpretation Notes are not the law,¹⁵ and consequently cannot override the provision of the Income Tax Act when properly interpreted. However, in the case of transfer pricing, SARS' Practice Note 7 sets out the situations where the Commissioner will consider the price to be an arm's length price, based on internationally accepted principles. The concern of the many is why depend in the Practice Note since it is not law – should not perhaps its standing be questioned. It is submitted that, though not law in the strict sense of the term, normally it is assumed that Practise Note 7, due to its meticulous nature, would carry more weight in a court of law as compared to other Practice Notes. The reason perhaps is that there are many different international principles which could be used to determine a particular arm's length price.¹⁶

The Practice Note's main aim is to present guidelines with regard to the *modus operandi* to be followed in deciding on the price to be used to transfer goods and services.¹⁷

In discharging the burden of proof it is clearly in the taxpayer's best interest to: (1) develop an appropriate transfer pricing policy (2) determine the arm's length price, as required by section 31; and (3) voluntarily produce documentation to evidence their analysis. Section 82 of the Act places the burden of proof regarding exemption, non-liability for tax, deduction or set-offs on the taxpayer.

¹⁵ Income Tax Case 1675 (62) SATC 219

¹⁶ L. Olivier & M. Honiball on International Tax: A South African Perspective 2008 page 492 par 5

¹⁷ Practice Note 7 paragraph 2.8

2.2. DOCUMENTATION GUIDELINES

2.2.1. Introduction

Entities involved in cross border activities should keep in their possession accurate documentation to show that the prices set reflects the behavior of independent parties dealing at arm's length. Although the disclosure requirement in respect of transfer pricing is not legislated, it is incumbent on the entity involved to satisfy the tax authorities, when called upon to produce and prove, that prices set to transfer goods and services are within the arm's length range.

The disclosure requirements in respect of transfer pricing and access to such information should therefore be similar to the disclosure and documentation provisions which are contained in section 74, 74A, 74B, 74C and 75 of the Act. In addition, section 69 of the Act also enables the Commissioner to request any person to furnish the information he may require.

It is, thus, in the taxpayer's best interest to document and show that transfer prices that are at arm's length have been determined. Adequate documentation is the best way to show that transfer prices are consistent with the arm's length principle, as required by section 31 of the Act.¹⁸

A taxpayer electing not to prepare documentation in respect of transfer pricing is at risk on two counts. Firstly it is more probable that the Commissioner will examine transfer pricing in detail if the taxpayer has not prepared proper documentation. Secondly, if the Commissioner, as a result of this examination, substitutes an

¹⁸ Practice Note 7 to the Income Tax Act No 58 of 1962, par 10.2.1

alternative arm's length amount for the one adopted by the taxpayer, the lack of adequate documentation will make it difficult for the taxpayer to rebut that substitution, either directly to the Commissioner or in Court.

There are no specifics in the Act indicating the kind of documentation that needs to be prepared by the taxpayer, because appropriate documentation depends on each taxpayer's facts and circumstances.¹⁹

It is accepted that as long as the taxpayer can demonstrate on paper the processes that have been followed in their analysis of determining the arm's length price and show that the chosen transfer prices are considered to be consistent with the arm's length principle.²⁰

Unlike independent parties, to evidence compliance, members of multinational companies are required to demonstrate that the prices they have used in their transactions comply with the arm's length principle.²¹

One should bear in mind that transfer pricing documentation is not something multinationals want to compile, as it is costly, complicated and consumes considerable manpower. Be that as it may, the tax authorities will, of course, need confirmation in the form of proper documentation to assess whether transfer prices have been set correctly.²²

¹⁹ Paragraph 10.3.2 of Practice Note 7

²⁰ Paragraph 10.3.4 of Practice Note 7

²¹ Paragraph 10.35 of Practice Note 7

²² Rijkele Betten: International Transfer Pricing Journal – January/February 2009

2.2.2. Conclusion

The intricacies of transfer pricing can be seen by the rules involved, immense guidelines provided and various measures available. All this serves to ensure that the tax base is not eroded in favour of other tax jurisdictions and that proper documentation is in place to support the prices set. The crux of transfer pricing is the arm's length principle, however, neither the Act nor Practice Note 7 provides a clear indication of how to determine the arm's length price.

Multinational entities should ensure that they transfer goods and/or services at an arm's length price and should also ascertain that their transfer pricing documents are readily available upon request by the tax administrator. Failure to transfer goods and service at an arm's length and failure to produce documents as requested may lead to unintended consequences. Various applicable sections of the Act may be imposed as discussed above and in addition section 75; 76 and section 104 of the Act.

The documentation submitted in respect of transfer pricing may be subject to SARS review processes. This is done to ensure that satisfactory disclosure has been made. The transfer pricing review processes are discussed in the following chapter.

CHAPTER 3

THE CURRENT REVIEW PROCESS

3.1. Introduction

The current review processes adopted by SARS to re-examine transfer pricing issues is extracted from Practice Note 7 which also incorporates the OECD Guidelines.²³ The Practice Note 7 has been developed as a guide and is not intended to be prescriptive or an exhaustive discussion on every issue in transfer pricing. Each and every transfer pricing matter/case will be decided on its facts and circumstances. As mentioned in chapter 1, that South Africa is not a member country of the OECD, but does follow the OECD Guidelines due to their significance in global trade matters.

3.2. Review processes

The review and audit of transfer pricing generally follow a certain model different to an ordinary tax audit. It is therefore important that proper documentation is available, clearly outlining how the selected prices have been set. This document is called the transfer pricing policy document. The SARS may or may not review or audit the document depending on certain circumstances.

The review process looks at the nature and extent of a taxpayer's cross border transactions with related parties. The SARS will conduct a review of the relevant global and local industry, and also of the tested taxpayer and its related group companies. Thereafter global group structure is examined, followed by a functional

²³ L Olivier & M. Honiball on International Tax: A South African Perspective 2008 page 493.par 3

analysis and risk analysis of a taxpayer under review or audit. Thereafter the most appropriate method for determining an arm's length price is selected based on the specific functions and risks relevant to the taxpayer's circumstances. Quantitative screening is then undertaken to determine relevant comparables for a pricing analysis, including a record of the research process, and a determination of the relevant comparable pricing range.²⁴

The purpose of the functional analysis is to identify the functions performed by each member of the multinational group and to assess the relative importance of each function to the overall operations of the group.²⁵

Other essentials in the analysis is the 'substance over form doctrine' and transactions that are deceptive. The doctrine of substance over form looks at the real nature of the transaction rather than its form, and deceptive transactions will be disregarded to the extent that the transaction lacks any bona fide business purpose²⁶.

It is vital to note that SARS will need to satisfy itself as to the existence of and the true nature of the transaction, hence a functional analysis is performed. The following are the possible risks associated with undertaking a functional analysis.

- Risk of change in cost, price or stock;
- Risk relating to success or failure of research and development;
- Financial risks, including change in the foreign exchange and interest rates;
- Risk of lending and payment terms;

²⁴ L Olivier & M Honiball on International Tax: A South African Perspective 2008 page 493 par 4

²⁵ L Olivier & M Honiball on International Tax: A South African Perspective 2008 page 493 par 5

²⁶ J. Bettinger on Tax structure and planning international business transaction and domestic transaction: 2008

- Risk for manufacturing liability; and
- Business risks related to ownership of assets or facilities.

Practice Note 7 further indicates that the procedure adopted should be documented, stating the grounds why the selected methodology was considered and other methodologies rejected.²⁷

The functional analysis performed will, to a certain degree resolve the allocation of risk between concerned parties to the transaction, and also the circumstance each party would expect in their arm's length dealings.²⁸

3.3. Characteristic of a functional analysis

The SARS' view on the role and characteristics of the functional analysis requires that an assessment of the multinational's operations and group structure be part of the analysis. Even though not specifically indicated in Annexure A of Practice Note 7, but when read with Annexure B which outlines the four step approach, it would appear that most of the functional analysis needs to be documented by the taxpayer. The information that is relevant to the functional analysis is found in Annexure A.²⁹ Hence it is paramount that taxpayers involved in cross border trade documents their dealing in a manner that will be easy for review and/or audit.

²⁷ L Olivier & M Honiball on International Tax: South African Perspective 2008 page 493 par 3

²⁸ Paragraph 7.4 of Annexure A to Practice Note 7

²⁹ L Olivier & M. Honiball on International Tax: A South African Perspective 2008.page 493 par 5

3.4. The four step approach

The four step approach, as contained in Practice Note 7, was designed by the Australian Tax Office.³⁰

The steps are as follows:

1. Cross border dealings between connected parties in the context of the business should be understood by both the taxpayer and the Commissioner.
2. The selected pricing methodology and the resulting application for calculation of the arm's length price should be made and documented.
3. The selected method can therefore be applied to the preliminary functional analysis prepared.
4. Lastly, the taxpayer concerned will be required to show how the method to determine an arm's length price was established.

The four step approach is renowned for compiling the transfer pricing report for South Africa, but would not be a viable approach in compiling a global transfer pricing report.³¹

3.5. Methods for determining an arm's length price

It is worth mentioning that there is no specific method for determining the arm's length price. The Practice Note 7 acknowledges that, neither section 31 nor any tax treaty entered into recommends any particular methodology for the purpose of determining an arm's length consideration.³² The Practice Note itself, therefore,

³⁰ L Olivier & M Honiball on International Tax: A South African Perspective 2008 page 494 par 2

³¹ L Olivier & M Honiball on International Tax: A South African Perspective 2008, page 494 par 4

³² L Olivier & M Honiball on International Tax: A South African Perspective 2008 page 494 par 4

permits the application of any of the principle methods referred to in the OECD Guidelines.³³

The Practice Note does not favour nor preferred any method to determine the arm's length price, and as such, the taxpayer can use the following recognised methods to determine the arm's length.

- The comparable uncontrolled price method
- The resale price method
- The cost plus method
- The transactional net margin method
- The profit split method.

For any of the above method to be applied precisely, it will depend on the particular situation and the extent of the reliable data.³⁴

3.6. Principle of comparability

The principle of comparability is vital to the application of the arm's length principle. To be comparable, simply means that none of the variations, if any, between the circumstances being compared could significantly influence the condition being assessed in the method, or that reasonably accurate adjustments can be made to eliminate the effect of any such variations.³⁵ The arm's length principle utilizes the conduct of independent parties as a guide. With the principle of comparability, taxpayers are advised to always seek the highest practical degree of comparability, while still recognising their distinct situation.³⁶

³³ Paragraph 9.2.2 of Practice Note 7

³⁴ L Olivier & M Honiball on International Tax: A South African Perspective 2008 page 494 par 5

³⁵ <http://www.ftomasek.com/pn0499.html>: SARS Practice Note 7: Transfer Pricing

³⁶ Paragraph 8.1.4 of Practice Note 7

Many factors can play a role in the assessment of comparability, such as the characteristic of the relevant goods and services, the relative importance of functions performed, the economic circumstances and the business strategy.³⁷

The data that is similar may have to be attuned so that it corresponds to the taxpayer's situation and the risk profile. Further, comparability must be judged by the methodology that requires the fewest and most reliable adjustment.³⁸ Due to lack of freely available financial information concerning private companies in South Africa, SARS has indicated in practice that it will accept the use of foreign financial database, as long as all the comparables are adjusted for the South African market.

3.7. Conclusion

Practice Note 7 clearly specifies the views of the Commissioner on documents and other pertinent issues. It also indicates that the OECD Guidelines on transfer pricing issues should be used to complement additional information requirements.

As indicated in chapter 2 that Practice Note 7 is not law, clarity is thus needed as to whether it is capable of protecting taxpayers in the event that SARS needs to dispute the transfer prices used by the taxpayer with the aid of the Practice Note 7. Greater intervention is therefore needed in this regard, although there is sufficient case law dealing with the issue of legitimate expectation presented by the use of SARS' interpretation of the legislation.

³⁷ Paragraph 8.1.6 of Practice Note 7

³⁸ Paragraph 9.3.2 of Practice Note 7

Owing to the complexities of transfer pricing, and despite efforts provided to clarify issues related thereto, there is always a possibility that tax authorities and multinationals will form different opinions as to the determination of the arm's length price resulting the raising of an additional assessment with substantial penalties and interest.

The transfer pricing review and the audit process itself can become dreary, lengthy and may involve a significant amount of money on both sides. It is on rare occasions that you will find that proper documents are available since most reviews and audits are conducted after two or more years, and the information that relates to a particular year has been archived already.

In addition, to the difficulties encountered in transfer pricing review processes and/or audit, it is also imperative that SARS delivers on its promised target as set by the Treasury Department. It has been stated that any deficit in tax collection will negatively impact on the economy.

There may be circumstances forcing the adjustments of the taxpayer's income or expenses by the Commissioner in terms of Section 31 of the Act. The consequential taxation thereof, in particular transfer pricing adjustments, may need the application of the relevant DTA to avoid double taxation. DTA's, also referred to as tax treaties, are designed to reduce the hurdles of cross-border trade, provide tax relief, play a pivotal role in facilitating tax administration and thus indirectly enhance trade and investments.

South Africa has entered into taxation agreements with a significant number of countries to promote co-operation regarding tax matters. Such exposure is relevant and should be seen as an alignment with the world best economies. The following chapter will analyse relevant articles of the DTA, and briefly discuss its inter-action with section 31 of the Act.

CHAPTER 4

DOUBLE TAX AGREEMENTS

4.1. Introduction

The function of DTA's in international tax matters is undoubtedly significant.³⁹

Almost all DTAs are drawn from the OECD Model Tax Convention (MTC). South Africa has only observer status which was awarded in 2004, and all of its tax treaties are based on the OECD MTC.

Tax treaties are designed to prevent fiscal evasion, promote co-operation on the sharing of tax information and alleviate double taxation. Transfer pricing issues, in particular transfer pricing adjustments, can result in double taxation.

Events that lead to double taxation are:

- Juridical double taxation: Occurs when the enterprise is subject to tax on the same income by two different tax jurisdictions, and neither granting relief for tax imposed by the other.

- Economic double taxation: Occurs when two different enterprises in different tax jurisdiction are taxed on the same income, and neither jurisdiction granting relief for the tax imposed.

³⁹ L Olivier & M Honibal on International Tax: A South African Perspective 2008 page 7 par 1

It should also be noted that where a treaty does not provide for the relief of economic double taxation, the taxpayer has to seek relief under the domestic legislation⁴⁰. This is done in terms of section 6 *quat* of the Income Tax Act.

The role played by the tax treaty is that it classifies income and then allocates the right to tax the income either to the country of residence or to the country of source or situs.⁴¹

In terms of section 108 read with section 232 of the Constitution of South Africa (the Constitution), a tax treaty becomes part of the South African tax law. On a clear analysis of section 233 of the Constitution an opinion exists that the DTA's may override domestic law, to the extent that it is inconsistent with it. But it remains to be seen how the DTA can override domestic law, particularly section 31, given the fact that both the DTA and section 31 are concerned with the arm's length principle.

By incorporating international law into our domestic law, it implies that both have equal status under the South African law, and therefore, the treaty should not limit the application of domestic law; section 31 of the Act in particular.⁴²

As a consequence, South Africa is in compliance with Article 9 of the OECD MTC, which determines the tax liability of each group company separately on an arm's length basis.⁴³ Article 9 of the OECD model is a taxing as well as a burden-alleviating mechanism.

⁴⁰L Olivier & M Honiball on International Tax: A South African Perspective 2008 page 13 par 5

⁴¹L Olivier & M Honiball on International Tax: A South African Perspective 2005 page 14 par 2

⁴² Practice Note 7, paragraph 6.2.

⁴³ L Olivier & M Honiball on International Tax: A South African Perspective 2005 page 406 par 2

4.2. Article 9 of the OECD MTC

A solid assertion regarding the arm's length principle is found in Par 1 of Article 9 of the OECD MTC.⁴⁴

Article 9 provides as follows:

“When conditions are made or imposed between two associated enterprises in their commercial or financial relation which differ from those which would be made between independent enterprise, then any profits which would, but for those conditions, have accrued to one of the enterprises, but by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly”

In essence the article thus dictates that the profits of an enterprise will be adjusted if they do not conform to the arm's length principle because transacting parties are not treating themselves as independent parties as a result of the special relationship between them. This adjustment may, then, give rise to economic double taxation.

In situations like these, relief should be sought under paragraph 2 of Article 9, even though it does not provide a specific method by which an adjustment is to be made. It is up to the OECD member countries to use diverse methods in providing relief and thus ease the burden.

⁴⁴ Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration page I-3 par 1

Most treaties dictate that parties should try to resolve any dispute arising from the interpretation or application of the relevant treaty, and further allows for direct communication between the competent authorities of both contracting parties.⁴⁵

In the event of double taxation arising, the enterprise concerned may present its case to the competent authority in which it is a resident or national for possibilities of rectifying the situation. Such a request for assistance is found under Article 25 of the OECD MTC.

4.3. Article 25 of the OECD MTC

A significant number of tax treaties and most tax systems provide a means of resolving disputes amongst the tax administrators and the taxpayers. The OECD MTC introduces a communal agreement procedure for resolving difficulties arising out of the application of the Convention in the broadest sense of the term.⁴⁶ This process which is not covered by domestic law, and is invoked whenever there is a dispute regarding international transactions is called Mutual Agreement Procedure (MAP). MAP is covered in Article 25 of the OECD MTC.

Paragraph 1 and 2 of Article 25 indicates that the competent authorities shall endeavour by mutual agreement to resolve the situation of taxpayers subjected to taxation not in accordance with the provision of the convention.

⁴⁵ Resolving Multilateral Tax Treaty Dispute: (In)competent Authorities in the 21st Century

⁴⁶ Commentary on Article 25 concerning the mutual agreement procedure – par 1

Paragraph 3 of Article 25 indicates that the competent authorities of the two States may get together to resolve by mutual agreement problems relating to the interpretation or application of the Convention and, furthermore, to consult together for the elimination of double taxation in cases not provided for in the Convention.

Article 25, in essence, provides a mechanism that enables competent authorities to consult with each other with the view to resolving, in the context of transfer pricing, not only problems of juridical double taxation but also those of economic double taxation.

The MAP procedure is invoked by the action of one or both of the contracting states and the risk of taxation will lead to double taxation. The OECD MTC commentary indicates that the MAP processes is in addition to and not as an alternative to the remedies available in domestic courts.⁴⁷ Thus, taxpayers that feel aggrieved by the application of Article 9 can invoke in addition to MAP, any other legal form that is available in the country concerned.

However, the problem with MAP is that it is invoked only after adjustments have been made, and yet there is still no assurance that the matter will be resolved. There are also no time lines involved; the matter can drag for a very long time.

⁴⁷ www.nishithdesai.com/indiataxlaws/dtaa-rd.asp.

4.4. Conclusion

Although the MAP is intended to deal with issues of double taxation and transfer pricing, but by not providing assurance that it will resolve such issues, it becomes a serious flaw in the tax system, and such a flaw can place a severe burden on both the taxpayer and the tax authority. In certain circumstances the MAP mechanism can fail to reach an equitable solution, and there appears to be no other alternative available to remedy the situation.

In the South African context, there is no ruling in respect of international transactions; advance ruling are only available in terms of section 76I of the Act, and such rulings only applies to domestic transactions.

Most countries have in their tax systems mechanisms for settling disputes well in advance. Such systems allow taxpayers to prepare transfer pricing documents to be lodged well in advance. In such circumstances, the taxpayer and the tax authority meet cordially to resolve transfer pricing issues before the taxpayer renders the returns of income. Such process is only available if there is an Advance Pricing Agreement Programme (APA). The APA thus allows transfer pricing issues to be thwarted early before the returns of income is lodged. The concept of APA is discussed in the following chapter.

CHAPTER 5

ADVANCE PRICING AGREEMENTS

5.1. Introduction

Tax authorities and taxpayers alike have been irked by the difficulties caused by transfer pricing, and in particular where there are considerable problems in establishing the manner by which the arm's length principle should be applied and the resultant implications of double taxation. Adding to this problem also is the burdensome process of compiling transfer pricing documents and the review process undertaken by the revenue authority.

The conundrum with the present approach is that it keeps both the taxpayer and tax authority in limbo until a review process is undertaken; and if not undertaken, no one is certain as to the method used to determine the arm's length price. So the system that will allow both parties to attend to matters well in advance and to agree to transfer prices is essential and should be considered.

The concept of an APA came about as a result of all these difficulties. The majority of the OECD member countries have chosen the APA approach in resolving their transfer pricing issues, and all follow the OECD transfer pricing guidelines as laid therein.⁴⁸

⁴⁸ OECD: Transfer Pricing Guidelines for Multinational Enterprise and Tax Administration

5.2. The purpose of APA

An APA is meant to resolve definite or potential transfer pricing differences in an ethical, accommodating approach, and may be used as a substitute to the conventional review process.⁴⁹ In view of the fact that it is initiated by the taxpayer, the purpose is to give the taxpayer the prospect of entering into an agreement with the tax authority with the view of predicting a tax liability with certainty, thus eradicating all those costs associated with the preparation of the transfer pricing policy documents, costs associated with the review process and costs associated with audit and consequent litigation costs.

5.3. Definition

The OECD transfer pricing guidelines defines an APA as an arrangement that establishes, in advance of controlled transactions, a suitable set of criteria (e.g. methods, comparables and appropriate adjustments thereto, critical assumptions as to the future events) for the determination of the transfer pricing for those transactions over a fixed period of time.⁵⁰ Rohan Phatarphekar and Hardev Singh⁵¹ defined the APA in simpler terms as *‘an advance ruling sought and agreed between the taxpayer and the tax authorities that agrees to the pricing of goods or service between related parties. Such ruling would be binding on the taxpayer and the tax authorities.’*

5.4. Concept of APA

An APA has been hailed as a remarkable alternative. It is important in that it is precise in stipulating the taxpayer’s transfer pricing over a period of time, for example,

⁴⁹ M. Frank on Announcement Report Concerning Advance Pricing Agreements.

⁵⁰ OECD: Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration at 4.124

⁵¹ R. Phatarphekar & H. Singh on Advance Pricing Agreements: Hindu Business Line issued 05/10/2009

whether only the transfer pricing methodology or more particular result can be fixed in a particular case. However, care must be taken if the APA goes beyond the methods adopted, and the critical assumptions, since more precise conclusions rely on predictions about future events.⁵²

An APA should be distinguished from a private ruling in that it is an agreement between the taxpayer and the tax authority about a treatment of the transfer prices, while a ruling is a written expression of an opinion by the tax authority.⁵³

Predictions that are consistently used in an APA depends on the nature of the forecast and the critical assumptions on which the forecast is based. For example, it would not be sensible to affirm that the arm's length short-term borrowing rate for a certain corporation on intra-group borrowings will remain at six percent during the entire coming three years,⁵⁴ but would be more probable to forecast that the rate will be the London Interbank Offered Rate (LIBOR) plus a fixed percentage.⁵⁵

LIBOR is the most active interest rate market in the world. It is the interest rate at which banks offer to lend money to one another in the wholesale market in London. Due to London's position as a global financial centre, LIBOR applies not only to pound Sterling, but also to major currencies such as the Canadian Dollar, the US Dollar and the Japanese Yen. The prediction would become even more reliable if an appropriate critical assumptions were added regarding the company's credit rating (e.g. the addition to LIBOR will change if the credit rating changes)

⁵² OECD: Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations at 4.125.

⁵³ Dr, K Sadiq: Journal of Australian Taxation: The taxing effect of APA arrangement program A review of APAs and their impact on stakeholders.

⁵⁴ OECD: Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations at 4.126

⁵⁵ OECD: Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations at 4.126

Various techniques can be used in settling for the precise method in an APA. Revenue authorities should be acquainted with notion that forecast of complete future profit experience seems least conceivable. The possibility of using profit ratios of independent enterprises as comparables exists, however volatile and hard to predict they seem. Hence the use of suitable critical assumptions and use of ranges may boost the trustworthiness of forecasts, as well of past information in the industry in question can also be a guide.⁵⁶

5.5. The Process

An APA process is formally initiated by a taxpayer and requires negotiations between the taxpayer, one or more associated enterprises, and one or more tax authorities. The APA process, therefore, supplement the conventional administrative, judicial, and treaty mechanisms for deciding transfer pricing problems. They may be most helpful when conventional mechanism to assign income of related-party business within a multinational group are ineffective or are not easy to apply.⁵⁷ The details regarding the APA processes is explained in Chapter 6 of this treatise.

⁵⁶ OECD: Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations at 4.128

⁵⁷ OECD: Transfer Pricing Guidelines for Multinational Enterprise and Tax Administration at 4.124,

5.6. Objectives of APA.

The purpose of the APA programme is to make things easier for both the taxpayer and the tax authority, to create certainty in tax issue, and the process, therefore, should be able to facilitate just that. Markus Brem listed the following as the main objectives of the APA:⁵⁸

- ‘The APA procedure should assist in resolving transfer pricing issues as quickly as possible, to use the resources of the taxpayer and the tax administrator more efficiently, and to provide a measure of certainty for the taxpayer.
- An APA should be the process that is administered in an amicable, efficient and practical manner; that needs the corporation of both the taxpayer and the revenue authority. It is meant to replace conventional methods of resolving transfer pricing issues.
- The APA plays a role in eradicating the possibility of double taxation.’

5.7. Forms of APA’s

5.7.1. Bilateral arrangements

A bilateral APA is an agreement between an entity, the tax authority and one or more foreign tax authorities. Basically the bilateral APA is an agreement where two or more countries agree on the pricing methodology to be used. It provides a guarantee that the method used in transfer pricing issues will be accepted by tax authorities of

⁵⁸ M. Brem on Globalisation, Multinationals and Tax Base Allocation: Advance Pricing Agreements as a shift in International Tax- WP. No. 2005-12-01

both countries and thus ensures that the arrangement will be able to reduce the risk of double taxation, is impartial to all tax authorities and taxpayers involved and also provides greater certainty to the taxpayer concerned.⁵⁹

In some countries domestic provisions do not permit the tax authority to enter into binding agreements directly with the taxpayer, in such cases APA's can be concluded with the competent authority of a treaty partner only under the mutual agreement procedures.

In a bilateral APA, the cooperation of the associated enterprise is fundamental to a successful APA negotiation. For example, the associated enterprise normally would be expected to provide the tax authorities with the methodology that they consider most reasonable under the particular facts and circumstances. The information that supports the fairness of the proposal should be submitted, which will include data relating to the industry, markets and countries covered by the arrangements. In addition, the associated enterprise may identify uncontrolled prices that are comparable or similar to the associated enterprise's business in terms of the economic activities performed and the transfer pricing conditions, e.g. economic costs and risks incurred, etc, and perform a functional analysis.⁶⁰

Normally multinational entities are allowed to partake in the process of obtaining an APA, by presenting the case to and negotiating with the tax authority concerned, by providing the required information, and reaching an agreement on the transfer pricing

⁵⁹ OECD: Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators on paragraph 4.131.

⁶⁰ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations on paragraph 4.134

issues. From the associated enterprises' perspective, this ability to participate in an APA program may be seen as an advantage over the conventional mutual agreement procedure.

At the end of the APA process, the tax authority should provide confirmation to the multinational entities in their respective jurisdiction that no transfer pricing adjustment will be made as long as the taxpayer follows the terms of the arrangements.

There should also be a stipulation in a bilateral APA that provides for possible revision or cancellation of the agreement for future years when the business operations change significantly, or any issue that may significantly affect the reliability of the methodologies used in a manner that independent enterprises would consider important for transfer prices purposes.

5.7.2. Unilateral arrangements

A unilateral agreement is where the tax authority and the taxpayer in its jurisdiction institute an agreement not including the participation of the other interested tax authority.⁶¹ With regard to the unilateral APA's, the tax liability of the associated enterprise in another tax jurisdiction may be affected, i.e. possibilities of double taxation may result in respect of transfer pricing issues attended to by the use of a unilateral APA.

⁶¹ OECD: Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations at 4.130

But where unilateral APA's have been agreed to, the tax authority of the other country should be notified about the arrangements so as to be able to consider whether a bilateral arrangement may be permitted.

5.8. Benefits of APA

There are tremendous benefits provided by the use of APA to a wide range of entities due to the fact that they deal with real time issues, including highly integrated operations and novel situations. Declarations of triumph have been noticed from taxpayers who benefited from the APA programme. The taxpayer who partakes in an APA programme will benefit in the following way:⁶² resolution of uncertainty in transfer pricing issues, prevention of double taxation, avoidance of probable audit, ability to deal with real time issues, amicable cooperative atmosphere.

5.8.1. Benefits to taxpayers

- And as articulated in the OECD Transfer Pricing Guidelines an APA programme assists in diminishing uncertainty as it predicts the future tax treatment of cross border transactions over time.⁶³ The aspect is regarded as the foremost benefit provided by the use of APA's.
- Unlike the unilateral APA, the bilateral APA serves as a means of avoiding double taxation. A bilateral or multilateral APA, to a large extent, will lessen the impending juridical or economic double tax.⁶⁴ In a bilateral or multilateral

⁶² Dr, K Sadiq: Journal of Australian Taxation: The taxing effect of APA arrangement program A review of APAs and their impact on stakeholders.

⁶³ OECD: Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations on Chapter 4 fig (iii)

⁶⁴ S. Gandhi: Economic Times Delhi: Sep 29, 2009: Advance pricing for reducing transfer price dispute.

APA, the interested taxpayer approaches the tax authorities before transacting with a related party, to negotiate a mutually acceptable transfer price. After the information has been submitted, in response thereof, the tax authorities commit to a transfer price that makes it certain that the taxpayer will not be subject to double tax.⁶⁵

- An APA programme presents opportunities, for both the tax authority and taxpayer, to discuss and work together in a favourable spirit and environment. It create a process that can smooth out differences of opinion that can arise, in a cooperative environment rather than across the audit table.⁶⁶ It is certainly a big advantage in that a confrontational attitude is avoided and more information can flow effortlessly, as compared to the traditional approach where information is not expected to flow smoothly.
- An APA may thwart expensive and time consuming assessments and proceedings of major transfer pricing issues for taxpayers. It basically acts as a means of circumventing costly hassles with the tax authority, especially where there is no data in respect of third-party's activities.⁶⁷
- An APA programme reduces compliance costs and a possibility of an audit. Taxpayers are, therefore, in a position to concentrate on important business aspect rather than worrying over transfer prices and the tax authority's view.

⁶⁵ De Waegenaere, A Sansing, et tal: Using bilateral APA agreements to resolve transfer pricing disputes.

⁶⁶ International tax review, March 1999: Australia aims to allay APA fears

⁶⁷ N. Boidman: Tax Executive – July 1, 2001: Details of APA arrangements programme.

5.8.2. Benefit to the tax authorities

- As soon as an agreement has been reached, less resources may be required for subsequent examination of the taxpayer's return, because more information is known about that taxpayer.
- The tax authority will be in a position to divert other transfer pricing personnel and other important staff members where they are mostly needed. The existence of an APA, therefore, positively affects the amount of resources devoted to compliance.
- An APA presents an opportunity in that work that would otherwise have to be collected via the audit process is available now,⁶⁸ and can be used to other forums, reviews or audits.
- Much stands to be gained due to the accommodating manner under which an APA can be negotiated. It may help tax authorities to gain insight into intricate international transactions, and thus improve awareness and insight of such transactions.
- A successful APA programme presents an opportunity for tax authorities to concentrate on other complex areas of tax. The cooperative compliance model is envisaged by any tax authority. Therefore, continuous development is necessary if such compliance is to be achieved. An environment that is self regulatory allows for greater investments and economic growth.

⁶⁸ J. Harden & T. Biggart: Strategic finance, Oct, 2004: Advance pricing agreements: A chance for certainty amidst chaos.

5.9. Shortcomings relating to APA's

Besides the irresistible benefits the APA provides, it can also present some challenges. The following are some disadvantages relating to an APA.

- Unilateral APA's may present considerable inconveniences for tax authorities and taxpayers alike.⁶⁹ With regard to tax authorities, an APA may put a strain on transfer pricing resources.⁷⁰ The envisaged balance between enforcement and compliance may be severely affected as the APA programme tends to need highly skilled resources and other specialist staff.
- These demands may not coincide with the resource (human and financial) planning of the tax authority, thereby making it difficult to process efficiently both the APA programme and other equally important work. Renewing an APA, however, is likely to be less time-consuming than the process of initiating one.
- The eventual result is that scarcity of the resources may hinder the number of request that can be attended to by both the tax authority and the taxpayer. In certain circumstances it may mean only large companies will receive preference.
- From the point of view of the associated enterprise concerned, one problem is the possible effect on the behaviour of the associated enterprises. If the

⁶⁹ OECD: Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations on Chapter 4

⁷⁰ Joint Transfer Pricing Forum: Commission of the European Countries, Brussels February 26, 2007

taxpayer accepts an arrangement that over-allocates income to the country making the APA in order to avoid lengthy and expensive transfer pricing enquiries or excessive penalties, the administrative burden shifts from the country providing the APA to other tax jurisdictions. Taxpayers may therefore be less interested in the APA programme for these reasons.

- Bilateral or multilateral APA's take too long to complete and as such create inefficiencies and significantly augment the cost of the APA programme.⁷¹ In most cases, however, only large companies can afford to use the APA Programme since it will require the expertise of independent consultant and such expertise are normally expensive. Therefore, an APA program can be seen as only catering for the large multinationals.
- Unlike the bilateral APA, a unilateral APA may not offer a corresponding adjustment. There may be difficulties also with regard to a bilateral APA in that the tax authority of one of the countries involved may disagree with the APA's conclusions.
- An APA programme may be inflexible, and such inflexibility may be a problem due to changing markets conditions without sufficient critical assumptions, which may negatively affect the arm's length circumstance.⁷²
- Only a certain number of associated enterprises within an MNE group may be interested in an APA. Harmony is thus not achieved as these companies often

⁷¹ D. Korb, H. Hicks & M. Frank on Comments regarding the APA program, Feb17, 2005

⁷² OECD: Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations on Chapter 4

transact with each other. Also an APA program may be of interest only to taxpayers with a good compliance history, and in particular very large companies and those that have been frequently harassed by the tax authorities in respect of their transfer pricing activities.

- An APA programme may pose a serious risk to audit resources and expertise as this will be diverted to taxpayers requesting APA's. Thus, the investigation of less compliant taxpayers may be compromised.
- The request for an APA programme does not protect the taxpayer from usual assessments/audits of the other tax issues including transfer pricing activities, and other related financial matters. In the mean time the taxpayer concerned may still need to comply in good faith with all the terms and conditions of the APA,

i.e. ensuring that correct methodologies were used and critical assumptions underlying the APA are valid.⁷³
- The APA processes may become unnecessarily burdensome for the taxpayer due to the bulk of information that may be needed. Should the request become arduous, it may hinder further request from related companies, thus jeopardise the whole process.

⁷³ OECD: Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations on Chapter 4

- Domestic rules against disclosure should be applied. Trade secrets and other sensitive information and documentation submitted to revenue authority in the course of an APA proceeding should remain confidential. The confidentiality clause applies to both unilateral and bilateral APA's.⁷⁴ Some companies, however, may not want to disclose the information that can be available to competitors and used by the latter for their benefits,⁷⁵ despite the confidentiality provision that is available.

5.10. Conclusion

The issue of double taxation, determining an arm's length price, accompanied by all the review processes, preparation of documents, lengthy litigation processes, use of limited skilled recourses and time constrains has not been easy for both the taxpayer, and the tax authority. It is a painstaking experience that needs to be attended too quickly and with vigor.

Having discussed the benefits provided by the use of APA, it thus stands without reasoning that they far surpass the shortcomings. The pitfalls to transfer pricing issues as mentioned can be avoided by the use of the APA. The APA can provide a winning solution to both parties.

There is an approach that is followed when an interested taxpayer wishes to request an APA. Such an approach is like a standard procedure that is adopted to ensure that all

⁷⁴ ⁷⁴ OECD: Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations on Chapter 4

⁷⁵ J. Harden & T. Biggart: Strategic finance, Oct, 2004: Advance pricing agreements: A chance for certainty amidst chaos

information requested is made available and all the structures are utilised for the benefit of both the taxpayer and the tax authority. The process of requesting an APA is important to both parties and is discussed in the following chapter.

CHAPTER 6

THE APA PROCESS

6.1. Introduction

The first country to introduce the APA programme was the USA, and other countries had to follow. Application of the APA process differs from country to country, but they all follow the general principles detailed below. The APA process should be voluntary, that is, interested taxpayer should approach the Tax Authority.

6.2. General principle

It should be noted that the request for an APA follows the procedure below and is applied by countries discussed in Chapter 8. For simplicity sake, Canada's Custom and Revenue Agency (CCRA) procedure⁷⁶ will be discussed as they have the straightforward procedure as compared with the USA, even though they are generally the same.

6.3. Pre-filing meeting

An interested taxpayer may initiate the programme by contacting the tax authority to discuss the suitability of the APA. In Canada, the taxpayer may request a pre-filing meeting (PFM) with the tax authority to discuss informally the suitability of an APA. The PFM meeting(s) should be held within 180 days after the end of the first taxation year that is to be covered by the APA. The PFM meetings are attended by the taxpayer, his representatives and the tax authority officials to explore the suitability of

⁷⁶ Information Circular 94-4R: International Transfer Pricing: Advance Pricing Arrangements

an APA, and to informally discuss the APA process and the matters set out in the circular. An APA request information should be submitted at least two weeks before the PFM. The taxpayer's representative attending the PFM with the taxpayer must submit a written endorsement throughout the APA process.⁷⁷

The rationale behind the PFM is to provide the taxpayer and the tax authority an opportunity to detail down what the content of the APA should be like.

6.4. Processing an APA Request.

6.4.1. Accepting an APA request

The APA request documentation should be complete in all respect as it will allow the APA team to narrow its focus without delay to the core issue and avoid delays caused by the need to supplement the original APA request.

The choice in respect of the nature of the APA rests with the taxpayer. He may request bilateral or unilateral APA. The CCRA considers request for bilateral/multilateral and unilateral APAs. The CCRA will send an acceptance letter to the taxpayer within 45 days after receiving an APA request. The letter set out the fee to be paid, and other terms and conditions under which the APA request will be pursued.⁷⁸

Most countries prefers to enter into a bilateral or multilateral, but its entirely up to the taxpayer. The CCRA also favour bilateral or multilateral APA. Any taxpayer

⁷⁷ Information Circular 94-4R: International Transfer Pricing: Advance Pricing Arrangements, Part II

⁷⁸ Information Circular 94-4R: International Transfer Pricing: Advance Pricing Arrangements, PART III, paragraph 21.

requesting a unilateral APA should indicate in writing why a bilateral or multilateral is not an option. Under the APA provisions in Canada, the CCRA will inform any treaty partner, if the unilateral APA request is to be actioned. If the competent authority later needs to resolve potential double taxation arising from applying a unilateral APA, the provisions of Part VI will apply.⁷⁹

6.4.2. Declining an APA request.

In certain circumstances an APA request may be declined. The CCRA may in certain situation exercise its discretion and decline to consider an APA request, and reasons for declining the request should be provided.⁸⁰

6.4.3. Withdrawing an APA request.

The taxpayer may at any time during the request process withdraw an APA. Should the APA be withdrawn, any previous undertaking and understanding relating to the APA request will be of no further use and effect. Any prior undertaking and understanding unfolding to the taxpayer's APA request will be of no further force and effect.⁸¹

⁷⁹ Information Circular 94-4R: International Transfer Pricing: Advance Pricing Arrangements, Part III, paragraph 22

⁸⁰ Information Circular 94-4R: International Transfer Pricing: Advance Pricing Arrangements, Part III, paragraph 23 and 24

⁸¹ Information Circular 94-4R: International Transfer Pricing: Advance Pricing Arrangements, Part III, paragraph 25 and 26.

6.4.4. User charge

Some countries do not charge a fee for an APA request, but in Canada, the CCRA will request a fee (user charge) for every APA request, and such a fee will be mentioned in the acceptance letter and should be payable upon reply by the taxpayer.⁸²

6.4.5. Case assignment

Generally APA request and its processing is handled by the dedicated transfer pricing personnel. In Canada, a multidisciplinary team will be assigned to a case as soon as the required fee is paid. The leader of the team will then contact the taxpayer concern within a reasonable period of time, normally within 30 days, to discuss the APA submission.⁸³

6.5. Content of the APA submission

6.5.1. General

The information pertained in the APA submission should be complete in all material respect. The taxpayer should make sure that all the information necessary to decide on the proposed APA submission is presented. The case leader will then contact the taxpayer to discuss the time plan, and if it's a bilateral APA, the competent authority in the other tax jurisdiction.⁸⁴ The taxpayer will also be requested to provide three copies of the APA submission.

⁸² Information Circular 94-4R: International Transfer Pricing: Advance Pricing Arrangements, Part III, paragraph 27 and 28

⁸³ Information Circular 94-4R: International Transfer Pricing: Advance Pricing Arrangements, Part III, paragraph 29 and 30

⁸⁴ Information Circular 94-4R: International Transfer Pricing: Advance Pricing Arrangements, Part IV, paragraph 31 and 32

6.5.2. Items for inclusions in an APA submission

The APA submission must include detailed information about the taxpayer and about the non-resident involved in the proposed APA. The particulars of the case will determine the information the taxpayer need to submit.

The following are items for inclusion:⁸⁵

- Comprehensive discussion of the taxpayer’s proposed TPM
- The details of the Independent expert used/if any
- Details regarding the set of critical assumptions under which a proposed TPM would operate.
- Proposal of to the initial term for an APA, giving appropriate consideration to the industry and transactions involved.
- Declaration statement

6.6. Critical assumptions

Each and every APA should have critical assumptions upon which their respective TPM’s depend. Critical assumption is any facts (whether or not within the control of the taxpayer) related to the taxpayer, a third party, an industry, or business and economic conditions, the continued existence of which is material to the taxpayer’s proposed TPM. Failure to meet a critical assumption may render an APA inappropriate or unworkable

If critical assumptions have not yet been met, the APA may be revised by agreement of the parties. If such an agreement cannot be achieved, the APA is cancelled.

⁸⁵ Information Circular 94-4R: International Transfer Pricing: Advance Pricing Arrangements, Part IV, paragraph 43 – 56.

6.7. Case work and resolutions

6.7.1. Review, analysis and evaluation

As soon as the case has been allocated to the team, it will be reviewed according to plan as agreed with the taxpayer. More information may be requested depending on what is in the submission.⁸⁶

All parties involved, i.e., the taxpayer and the assigned team need to discuss the essential facts and circumstances pertaining to the APA. The information will be reviewed and analysed and the team will inform the taxpayer of their position, normally within 12 month after receiving an APA request.⁸⁷

6.7.2. Negotiations and agreement

Neither the taxpayer nor the non-resident entity will be directly involved in the competent authority negotiations, however, the taxpayer or the non resident entity may be available to respond to questions the authorities may have during the negotiations.

The CCRA will ensure that it complete the unilateral APA according to the case plan agreed with the taxpayer. With regard to bilateral APA, they take longer to complete and it's difficult to agree to a time plan.⁸⁸

⁸⁶ Information Circular 94-4R: International Transfer Pricing: Advance Pricing Arrangements, PART V, paragraph 58 and 60

⁸⁷ Information Circular 94-4R: International Transfer Pricing: Advance Pricing Arrangements, Part V, paragraph 61

⁸⁸ Information Circular 94-4R: International Transfer Pricing: Advance Pricing Arrangements, Part V, paragraph 65 - 67

6.8. Competent Authority Consideration

The unilateral APA's are the main cause of double taxation, unlike the bilateral APA which has as its main purpose the avoidance of double tax.⁸⁹

The reciprocal exchange of information will commence forthwith should the CCRA agree to pursue a bilateral or multilateral APA with the competent authority of one or of more treaty partners.⁹⁰

Should double taxation transpire after a unilateral APA has been initiated, the CCRA may, together with the relevant competent authority or treaty partner, under the mutual agreement procedure, diverge from the terms and conditions of the APA and try to resolve the issue. Should both parties agree to transactions covered and the issue of double taxation is resolved, the new terms will prevail instead of the initially agreed unilateral APA.⁹¹

6.9. Legal effect of the APA's

Like any another agreement entered into, an APA is also a binding agreement between the taxpayer and the CCRA (tax authority). If the taxpayer complies with the terms and conditions of the APA, the tax authority will not contest the application of the TPM to the subject matter of the APA.⁹²

⁸⁹ Information Circular 94-4R: International Transfer Pricing: Advance Pricing Arrangements, Part VI, paragraph 69

⁹⁰ Information Circular 94-4R: International Transfer Pricing: Advance Pricing Arrangements, Part VI, paragraph 70

⁹¹ Information Circular 94-4R: International Transfer Pricing: Advance Pricing Arrangements, Part VI, paragraph 72

⁹² Information Circular 94-4R: International Transfer Pricing: Advance Pricing Arrangements, Part VII, paragraph 74.

6.10. Use, disclosure, and protection of information

All the taxpayer's information at the disposal of the tax administrator should be protected and not disclosed in terms of the relevant provision legislating disclosure. This also applies to Revenue Canada. The confidentiality provisions of the Act limit the CCRA's right and powers to use and disclose information submitted in connection with an APA request or submission. The confidentiality provision therefore applies.⁹³

6.11. Conclusion

The process (APA procedures) to resolve transfer pricing issues is an attractive, appropriate and a welcoming initiative. Assurance in taxation matters is an important goal, and accordingly it makes sense to carefully think about the hardships experienced by taxpayers and pursue an APA program, notwithstanding the time and costs constrain involved; it is a valuable initiative to attempt it. However, the concluded APA programme will be subject to review and/or administration by tax authorities, but on a lesser scale than without an APA. The administration of an APA is discussed in the following chapter.

⁹³ Information Circular 94-4R: International Transfer Pricing: Advance Pricing Arrangements, Part VIII, paragraph 75 and 76

CHAPTER 7

ADMINISTERING AN APA

7.1. Introduction

Most countries have adopted the approach of the USA in administering their APA's as the USA is the first country to introduce and implement the APA Program. The general principles below were enacted from the Internal Revenue Service Procedure.⁹⁴ There is a very thin line between this procedure and those of countries mentioned in this treatise. So concentration will be on the IRS procedures. The important items will be discussed.

7.2. Annual report

The taxpayer must submit completed annual reports for all the years covered by the APA programme, detailing its operation for the year and indicating compliance with the terms and conditions of the APA. Any material information that is essential and any information pertaining to the adjustment made or to be made must also be submitted.⁹⁵

As soon as the APA request has been submitted, the APA Programme office will contact the taxpayer regarding an annual report if it is necessary to clarify or complete the information submitted in the annual report. The taxpayer must supply the additional information by the date specified.

⁹⁴ Internal Revenue Procedure published January 9, 2006.

⁹⁵ Internal Revenue Procedure published January 9, 2006, section 11, paragraph 1

If the information submitted is incomplete or incorrect, or the TPMs have been incorrectly applied, the taxpayer should amend such information within 45 days (USA) after becoming aware of the need to amend the report. The time may be extended for a good cause.

7.3. Examination and record retention

The review of the taxpayer's annual returns for the years covered by the APA programme will not be intense. Only a limited assessment of the documents will be done. The tax administrator will only need the taxpayer to ascertain the following:⁹⁶

- Compliance with the APA's terms and conditions;
- Validity and accuracy of the annual report's material representations;
- Correctness of the supporting data and computation used to apply the TPM;
- Satisfaction of the critical assumption; and
- Consistent application of TPM

There should be consultation within the APA programme office with regards to the above requirements. If there is non-compliance with any of the above, the APA Director may decide to apply the terms of the APA, or revise, cancel or revoke.⁹⁷

After the review of the information submitted, it will then depend whether an audit is necessary. Should an audit be carried out and adjustments proposed thereafter, the taxpayer's result as determined under the TPM may not affect the validity of the APA. It is entirely up to the taxpayer to agree or reject the proposed adjustments. If the

⁹⁶ Internal Revenue Procedure published January 9, 2006, section 11, paragraph 2

⁹⁷ Internal Revenue Procedure published January 9, 2006, section 11, paragraph 3

taxpayer decides to reject such adjustments, he may contest them through normal administrative and judicial procedure.⁹⁸

The taxpayer must maintain books and records sufficient to enable the audit division to examine whether the taxpayer has complied with the APA. The taxpayer's compliance with this paragraph fulfils the record-keeping requirements laid down by statute.

7.4. Revising, revoking or cancelling the APA

An APA is also subject to revision only if both parties agree. If both agree, then the revised APA will indicate its effective date.⁹⁹ With regard to the bilateral or multilateral APA, the foreign competent authority must be contacted and consent be obtained. Should the foreign competent authority reject the revised terms, the APA Director and the taxpayer may agree to apply the existing terms of the APA or apply the revised terms or cancel an APA as of an agreed date.¹⁰⁰

An APA may be revoked because of fraud detected or malfeasance, or due to mistakes as to the material facts, or failure to state material facts or due to lack of good faith in complying with the terms and conditions of the APA.¹⁰¹

In certain circumstances, despite the above, both the taxpayer and the tax authority may revise the APA or else cancel the APA in the event of failure of critical assumption, or material change in governing case law, statute, or treaty.¹⁰²

⁹⁸ Internal Revenue Procedure published January 9, 2006, section 11, paragraph 4

⁹⁹ Internal Revenue Procedure published January 9, 2006, section 11, paragraph 1

¹⁰⁰ Internal Revenue Procedure published January 9, 2006, section 11, paragraph 2

¹⁰¹ Internal Revenue Procedure published January 9, 2006, section 11, paragraph 1

The process of requesting a renewal of an APA is the same as that of initial APA request. Interested taxpayers are encouraged to furnish information for renewal APA request well before the expiration of the existing APA term.¹⁰³

7.5. Conclusion

An APA process is a remarkable initiative that ensures that both parties know exactly what transpires before attending to the technical details. For an APA submission to be considered it should include reputable transfer pricing methodologies. This does not mean however that the taxpayer's way of determining the methodologies are incorrect or lack repute. A vital aspect, it should be noted, is a conclusion that will bring happiness to both parties.

The frequent change in global economic activities necessitates that South Africa pay a special attention to the conduct of its major trading partners, especially in the field of taxation. All countries discussed in the treatise, which happen to be South Africa's major trading partners, make use of an APA programme. Such countries will be discussed in the treatise. The USA, recently surpassed by China, was South Africa's largest trading partners. Large companies of the United Kingdom have a significant stake in the South African economy. South Africa's tax system is developed along the Australian way. The simplest APA process happens to be that of Canada, the second country to make use of the APA.

¹⁰² Internal Revenue Procedure published January 9, 2006, section 11, paragraph 3

¹⁰³ Internal Revenue Procedure published January 9, 2006, section 12, paragraph 1

The following chapter will discuss the APA programme of these countries as they are important to South Africa.

CHAPTER 8

COUNTRIES

8.1. Introduction

Most countries that have introduced the APA programme have noted its success in the USA and then developed their APA procedures modelled after the USA's APA Programme. The processes are generally the same and what differs most is the composition of the APA team; user charge (some countries do not charge a fee in executing an APA) and the location of the APA Programme.

As noted above the general principles for most countries are the same, only information of note has been illustrated in each of the countries mentioned.

8.2. United States of America

8.2.1. Background

The USA was the first country to introduce an APA programme in 1991 owing to a growing dissatisfaction by the IRS with regard to transfer pricing issues.

8.2.2. Application

In the USA, the APA Programme is processed and administered by the dedicated team, led by the Team Leader. The APA Programme is independent from the IRS Examination Department and the US's Competent Authority.

8.2.3. User charge

Interested taxpayers wishing to file an APA request need to pay a certain amount for their application to be processed.

8.2.4. Notable comments regarding APA

The US tax authority requested a task team to review their APA and its impact on revenue and human resources. The notable comments below are worth mentioning.¹⁰⁴

- ‘Resource constrains in personnel and travel funds have made it difficult for the APA Programme to operate as well as it could. Recommendation made that the APA be fully staffed to meet its timelines goals, and travel funds be made available whenever they are required. Since APA's are fact intensive and contain issues that are difficult to resolve, the programme require the dedication of knowledgeable and talented staff.
- Time span to complete a bilateral APA is two to four times as long to complete a unilateral APA. The length of time creates inefficiencies and substantially increases the costs. Recommendation made to hold both countries' competent authorities to case plans and fixed time frames to resolve a bilateral APA.

¹⁰⁴ Announcement 2004 – 2008 – Comments regarding the APA Program in the USA

- Renewal APA's request generally takes longer on average to resolve than new APA request. Recommendation made to limiting the required information to be submitted in a renewal APA and setting more ambitious timelines for renewal such that they take up to six months to complete.
- Taxpayers come into the APA Programme for certainty, and requiring an updating of the arm's length range during the APA term does not achieve that certainty and thus reduces the benefits of obtaining an APA by requiring the taxpayer to do what it would otherwise have to do for documentation purposes.'

8.3. Canada

8.3.1. Background

The Canada Customs and Revenue Agency (CCRA) also has an APA programme to help taxpayers determine appropriate TPM. The Competent Authority Service Division of the International Tax Directorate (CSAD) administers the APA program.

The Canadian APA programme is styled along that adopted by the USA and it is the second country in the world to introduce and apply APA's.

8.3.2. Application

Canada has a dedicated team consisting of highly specialist staff, same as the USA.

8.3.3. User charge

There is a user charge paid by the interested taxpayer who wishes to file an APA request. Such a user charge may be refundable depending on the stage of the APA.

8.4. Australia

8.4.1. Background

‘In the Australian context, APA’s are becoming an increasingly attractive option. The nature and size of the Australian market is such that issues of data restrictions are very real. Moreover, accounting rules do not require separate disclosure of costs of goods. As such, gross margin analysis using Australian comparable are virtually impossible, leaving aside the vexed questions of secret comparables’¹⁰⁵. Hence the Australian tax authorities decided on the introduction of an APA.

8.4.2. Application

In Australia, the Taxation Ruling TR 95/23 provides guidance on APA’s and an overview of the process. The Australian Tax Office (ATO) also published a brief guide outlining Australia’s APA programme.

Any taxpayer with related party international transactions, agreements, arrangements or interest may apply for an APA. However, the ATO reserves the right not to accept an application into the APA programme if, for example, the dealing to be covered by the APA are immaterial or merely hypothetical, or the transfer pricing methodologies

¹⁰⁵ International Tax Review – Australia aims to ally APA fears

proposed are inconsistent with Australia's transfer pricing rules and unlikely to reflect an arm's length result.

A formal APA application must incorporate the proposed terms and conditions that would govern how the TPM is applied. There is no prescribed format for an APA application, however taxpayers considering applying for an APA should contact the ATO to arrange a pre-lodgement meeting.

8.4.3. User Charge

There is no user charge applicable to taxpayers wishing to file an APA request.

8.5. United Kingdom

8.5.1. Background

Before the introduction of an APA in the United Kingdom (UK), the country used to enter into the so-called Mutual Agreement Procedure APAs which are jointly requested by the taxpayer and the other tax administration.¹⁰⁶ Now the UK has an APA programme and it is legislated under Section 85 of the Act.

8.5.2. Application

The UK Inland Revenue support applications for bilateral APA wherever this is possible in relation to cross-border transfer pricing issues. 'Such bilateral arrangements offer assurance that the method for dealing with transfer pricing issues

¹⁰⁶ intm 469010 – Transfer Pricing: Advance Pricing Agreements in UK

covered in the APA will be accepted by the tax administrators of both countries, thus avoiding potential double taxation.¹⁰⁷

No dedicated team is assigned to the APA request. The Transfer pricing specialist and delegated competent authority caseworkers from the International Tax Division, assisted by the Inspector responsible for the taxpayers' affairs, will be responsible for assessing the APA request.

The UK Inland Revenue does not regard entering into APA's on less complex matters as a sensible use of resources in the absence of significant doubt as to the manner in which the arm's length principle should be applied. It may therefore decline to accept applications that do not satisfy certain criteria's. Whenever there is a need for human resources, they get it from the Transfer Unit Team.

8.5.3. User charge

No user charge is applicable on any APA request whether unilateral or bilateral, and the roll back applies only if those years have not yet prescribed.

8.6. China

8.6.1. Background

The notion of APA in China was introduced in 1998. The process of executing an APA in China looks similar to that in the US, even though most APA's concluded so

¹⁰⁷ UK Statement of Practice 3 – 1999

far have been unilateral agreements. Very few bilateral APA's have been concluded, with Japan and USA.

8.6.2. Application

Transfer pricing in China is regulated by the State Administration of Taxation (SAT), the highest ranking organisation, though not an enforcement agency and does not conduct tax audits or directly collect tax.¹⁰⁸ The transfer pricing rules are therefore controlled by the SAT.¹⁰⁹

In China, as compared to countries mentioned in the treatise, taxpayers need to obtain an approval first from the revenue authority before they can submit an APA application.¹¹⁰

8.6.3. Rollback

Subject to the approval of the Chinese tax authority, the pricing method in an APA can be utilised to resolve similar transfer pricing issues in years before it was executed.

8.6.4. User charge

There is no user charge that needs to be paid by the taxpayer to the SAT when lodging an APA request.

¹⁰⁸ Glen DeSouza and Betty Zhu on Tax Planning International: Special Report – APA in Chin

¹⁰⁹ Fang Liu, et tal on Asian Update - Tax Planning International: Transfer pricing volume 10, number 10–

October 2009

¹¹⁰ Xinkui Fan : Asian Social Science Vol 4, No 11, 2008 – APA in China.

8.6.5. Conditions for lodging an APA request

The following conditions should be satisfied before the APA can be lodged:

- The annual related party transaction amount should exceed 40million (RMB).
- Related-party transactions should have been lodged.
- Duly prepared transfer pricing documentation should be available.

Enormous efforts have been made in promoting bilateral APA's. China's determination to improve confidence in the Chinese business environment is exhibited by SAT dedication to the APA program.¹¹¹ In China, APA's have been hailed as a success story even though most unilateral APA's have been concluded as compared to bilateral APA's.

Recently the Chinese tax authorities have been concerned that the current economic climate may impact significantly on tax revenue, and have therefore advice companies to evaluate their transfer pricing risk. The SAT has made recommendations that the following companies may consider applying for an APA programme.¹¹²

- Chinese subsidiaries of multinationals.
- Chinese subsidiaries of multinationals with the considerable cross border transactions.
- Enterprises that have been subjected to transfer pricing risks already and assessed to tax.

¹¹¹ Comments- Asian Update: China using APA to manage risk

¹¹² B. Stucken: China Practice Alert using APA to manage Transfer Pricing risks

8.7. Germany

8.7.1. Background

Germany is one of South Africa's largest trading partner, especially in the field of motor vehicle manufacturing, heavy machinery and pharmaceutical industries.

Though Germany will not be thoroughly discussed in this treatise, it is important to note that Germany does not have statutory rules for APA's. APA's are as a rule bilateral and based on Double Tax Treaties, usually containing a clause on mutual agreement procedure and joint consultation in accordance with Article 25 of the OECD MTC. The procedure to enter into advance agreements on transfer pricing related issues is contained in the Federal Ministry of Finance circular information on Bilateral or multilateral procedure under the Double Taxation Convention.

8.8. Conclusion

Despite constrains as mentioned in some countries, the APA's achievements have surpassed any deficiencies and its worth has been renowned worldwide.

In any given situation, difficulties will often arise, but as long as there is proper planning and quality coordination and organisation, nothing can stand between two parties who intend to make things work to their advantage (i.e. an agreement between the parties to resolve issues amicable). The GlaxoSmithKline case should be a lesson to both the taxpayer and the tax administrators. As previously indicated, transfer

pricing controversies can be settled without litigations provided compliance with the legislature is not compromised.¹¹³

Most OECD member countries are committed to tackling the problem of transfer pricing. An announcement by Laszlo Kovacs confirms that point. He indicated as follows:

“I am very pleased with the work carried out in cooperation with tax administrators and the private sector on transfer pricing issues. The guidelines we proposed will facilitate advance agreement between tax administrator and taxpayers and therefore increases the legal certainties for the taxpayer...I now urge member states to quickly implement in their legislation or administration rule, that the recommendation be included in the Guidelines”

In the EU Joint Forum, it was concluded that the APA programme can be an effective tool for avoiding disputes between tax administrators and taxpayers, due to its nature of agreeing in advance a mechanism for calculating the profits of companies.¹¹⁴

It is clear from the above that an APA programme is considered an important instrument in addressing transfer pricing issues. Having discussed countries employing APA's, it is therefore significant to discuss the effect the APA program will have in South Africa and then make some recommendations thereof.

¹¹³ S. Burnet & D, Pulliam: The CPA Journal, June 2008.

¹¹⁴ U. Lomas: Law & Tax news: EC Publishers Guidance on Transfer Pricing, February 27, 2007.

CHAPTER 9

CONCLUSION

9.1. Introduction

South Africa's economy is developing, and is inextricably linked to the world economies, and most particular the top 10 world largest economies. Whatever happens in those economies affects South Africa one way or the other.

The top 200 taxpayers operating in South Africa are multinational entities, and almost all these companies have subsidiaries, branches and offices world-wide and in particular in countries trading with South Africa.

The effect of the recent financial crisis accompanied by the recession has been severe for the South African economy, with fiscal deficit estimated at record level. Taxation is by far the largest revenue for the state. Therefore, creating certainty in tax issues should be a priority. One of the ways of creating such certainties, it is submitted in the introduction and implementation of an APA programme.

9.2. The notion and the effect of APA

Transfer pricing centres around the arm's length principle, and an endeavour to make the arm's length principle unbiased to both the taxpayer and the tax authority has never been an easy one, and has been very frustrating. This growing frustration is the main cause for the introduction of APA by some OECD member countries. The main

purpose of an APA is to resolve transfer pricing matter in advance and agree to specific prices or ranges.¹¹⁵

Dr Kerry Sadiq commented as follows:¹¹⁶

‘The introduction of the APA program as an administrative response to the difficulties with current tax laws has generally been viewed as a positive step towards solving the transfer pricing problem of determining the arm’s length price.’

The benefits of APA’s are comprehensibly recognised to be contributing to certainty and to reducing the ongoing compliance cost.¹¹⁷ The opportunities provided by the APA procedure are that it affords both the tax authorities and taxpayers to consult in a non-adversarial spirit and environment, facilitate principled and practical negotiations, resolve transfer pricing issues expeditiously and prospectively.¹¹⁸

The introduction of the APA programme in South Africa should also be seen as an attempt by the revenue authority to service its clients (taxpayers) better. This will be commendable. APA’s create certainty in transfer pricing issues as well as facilitating global trade since valuable time is dedicated in significant business issues.

Considering that most multinational entities operating in South Africa have business operations in countries where an APA programme is in place, they have a glimpse of the programme and consequently they may be relieved with the notion.

¹¹⁵ B. Nathan on The Effect of the APA and other USA transfer pricing initiatives in Canada and other countries.

¹¹⁶ Dr. K. Sadiq on The taxing effect of the APA program: A review of APAs and their impact on stakeholders: Journal of Australian taxation.

¹¹⁷ David Lewis on Best practice series – Advance pricing arrangements: the attractive alternative

¹¹⁸ Samir Gandhi: Advance pricing agreements for reducing transfer price disputes: Economic Times Delhi; September, 29, 2009

APA has as its purpose the avoidance of double taxation. Surely, this will increase the revenues of most companies, and this may result in direct investment in those companies, and thus benefit the country.

9.3. Effect of APA programme on transfer pricing

Having seen how cumbersome the conventional approach can be, it is therefore necessary to consider the consequence the APA programme has on the interested taxpayer, the revenue authority and ultimately the public at large. Adding to this deliberation, it would be significant also to think about the impact of the non-interested taxpayer with regard to the APA program.

It is submitted that the introduction of the APA will be good for the South African tax system. To determine this, it is necessary to focus on the benefits provided by the use of the APA and contrast them with the inconveniences experienced, with the eventual purpose of seeking to determine the viability of implementing the APA system in South Africa.

9.3.1. Certainty

An APA presents an opportunity to the taxpayer to clear regulatory queries up front and lessen intricate documentation requirements while also providing comfort on the entities' transfer pricing methodologies.¹¹⁹

Notwithstanding the certainty it provides, and depending on the terms of the particular APA, it may afford the taxpayer the choice of increasing the period covered. In contrast to arranging and preparing defensive information each year, APA means that a taxpayer can lock away this significant transfer pricing risk for up to five years.¹²⁰ When the time of an APA comes to an end, the prospect to renegotiate subsists. Due to the assurance it present, the taxpayer may be in a better position to forecast its tax liability, thereby providing a tax atmosphere that is constructive to investment, and therefore growth.

9.3.2. Avoidance of double tax

The bilateral APA provides opportunities for the avoidance of double tax. The bilateral or multilateral APA's are expected to make certain that the procedure will reduce the threat of double taxation.¹²¹ But in unusual circumstances, bilateral APA processes may hinder cooperation between tax administrators when the two countries involved have different tax regulations and the other stands to lose a significant amount of revenue.¹²²

¹¹⁹ S. Tseng on Insight – Multinational Approaches to Advance Pricing Agreements in China.

¹²⁰ David Lewis: Best practice series: Advance pricing arrangements- The attractive alternative

¹²¹ S. Gandhi on Advance pricing agreement for reducing transfer pricing dispute: Economic Times Delhi: September 29, 2009.

¹²² A. De Waegenaere, et tal on Using advance Pricing Agreements to resolve tax transfer pricing disputes.

9.3.3. Amicable environment

An APA should be seen as a substitute to the confrontational conventional method of dealing with transfer pricing issues.¹²³ The current audit approach on transfer pricing is onerous and a time wasting, and thus create an environment that is not friendly. The hostile environment presented by the traditional method of transfer pricing reviews and audit can be avoided. The atmosphere that is essential for discussions and collaboration is critical between the tax authority and the individual taxpayer in an APA programme; it is a prerequisite for closer relations on transfer pricing issues.

The consequential aim, therefore, is to resolve transfer pricing matters expeditiously, prospectively, and to utilize the resources of both parties more resourcefully.¹²⁴

9.3.4. Avoidance of possible audit

The significant amount of time is lost through timeless audits, which can be painful to both the taxpayer and the revenue authority. The accompanied compliance costs, ensuing litigations costs and other related costs that can arise can be eliminated by the use of an APA.

The APA programme certainly plays a role in avoiding unnecessary potential reviews, audits and controversial processes.¹²⁵ Ample time is thus saved as a result.

¹²³ X. Fan: Asian Social Science-Difficulties in pressing forward APA in China, Vol.4, No 11, Nov 2008

¹²⁴ M. Brem: Globalisation, Multinationals and Tax Base allocation: Advance Pricing Agreements as a shift in International Tax.

¹²⁵ A. Cranwell: Eleventh Annual International Taxation Conference on Advance Pricing Agreements – December 3, 2005.

But it will depend on whether critical assumptions have remained constant. The current review processes can cause other aspects of the financial statements and tax information to be subject to an intense review and audit which may end up having a bearing on transfer pricing issues.

9.3.5. Inexpensive

Since the use of an APA programme provides an opportunity to agree on the taxpayers' transfer pricing methodologies in advance i.e. before the taxpayer lodges the return of income, the enormous costs of preparing defensive documentation is avoided. Though it can be argued that the costs involved in preparing and securing an APA can be enormous,¹²⁶ this can be reduced substantially if transfer pricing documents are thoroughly prepared. It is also important to consider that upon renewal of the APA, the user fees and other consulting fees will be less if the taxpayer's methodologies and critical assumptions remains the same.

The GlaxoSmithKline's case, as mentioned in the previous chapter, is an ideal illustration of how the traditional review and audit processes can lead to; lengthy process, litigation costs and massive related costs.¹²⁷

¹²⁶ A. Curatola: Strategic Finance – Advance Pricing Agreements: A chance for certainty amid chaos, part 2.

¹²⁷ GlaxoSmithKline's website at <http://www.gsk.com> – CFO magazine, September 11, 2006.

9.3.6 Source of information

Documents that would otherwise have been unavailable are collected early for processing.¹²⁸ This is excellent in that such information and documentation may be used to other audits, reviews, forums for the benefits of the tax administrator.

Some companies may not want to produce information they regard as sensitive and necessary for their survival because it may land on their competitors' table for discussion. So it may happen that not all the information will be made available to the tax administrator.¹²⁹ In such instances, the confidential disclosure requirements as contained in the legislature should be tightened and vigorously enforced.

Though it can be argued that since the APA concerns only transfer pricing issues, the whole return of income is delayed,¹³⁰ the length of time and associated costs to process an APA can be reduced to cater for this mishap

9.4. Likelihood APA programme will have, if implemented

The reason why South Africa has not yet introduced the APA programme is not known, but Lynnette Olivier indicated that it's probably due to lack of administrative capacity within SARS.

Generally, problems that disturbs the free operation of the APA programme are those that have been encountered in the USA;¹³¹ being

¹²⁸ A. Curatola: Strategic Finance – Advance Pricing Agreements: A chance for certainty amid chaos, part 2

¹²⁹ A. Curatola: Strategic Finance – Advance Pricing Agreements: A chance for certainty amid chaos, part 2.

¹³⁰ J. Larson: The IRS's Push – New programs provide opportunities for resolving disagreements

- Sufficient funding of the program
- Availability of suitable qualified staff
- Consistency
- Due diligence and the nature of the APA process

In view of the fact that SARS is now aware of the problems encountered by countries using APA's and how they have been resolved, it can better implement the APA programme as the medium term resolution to transfer pricing issues and be in a position administer it with ease.

9.5. Possible impact on the economy and large scale compliance

In recent years, South Africa has experience rampant strike actions and spiralling violent crimes which are largely due to government's under-expenditure, the initial problem being the fall of the revenue collection. SARS has also started to focus on transfer pricing, a complicated area of tax that has been neglected for years. It will be very demanding for SARS to use only the conventional method on transfer pricing issues. The implementation of the APA, as part of the broader tax system, can facilitate the transfer pricing administration,¹³² and eventually boost the coffers of the State as the chief spender.

Although it is difficult to imagine the taxpayer's behaviour that is compliant in the South African context, but it is envisaged that most taxpayers will be compliant. Taxpayer who opts for an APA can be seen to be compliant and/or avoiding costs associated with the review and audit of transfer pricing documents. Due to the fact

¹³¹ K. Gideon on Re-announcement2004-2008- Comments regarding Advance pricing agreements Programme.

¹³² Dr. K. Sadiq on The taxing effects of the Advance pricing agreements program: A review of APAs and their impact on stakeholders – Journal of Australian Taxation

that an interested taxpayer has a choice to self select, whether to request an APA or not, it is hard to tell that the APA will yield the intended result. Since an APA programme is a relatively simple process, SARS will have to find mechanisms of luring taxpayer onto the programme.

9.5.1. The Non-interested taxpayer

No one seems to be certain in respect of transfer pricing due to its complexity. Certainly, not all taxpayers will avail themselves to the opportunity provided by the APA programme. So, there will be limited gains to these taxpayers as they will be subject to the traditional methods of review.¹³³ A question that may arise is; if the two previous years were subject to review and audit and the tax authority found that the taxpayer's methodologies have been satisfactory prepare; whether there will be a need for the APA programme for those taxpayers.

Thus, the revenue authority will have to understand that not all multinationals will have an interest in the APA programme.

¹³³ Dr. K. Sadiq on The taxing effects of the Advance pricing agreements program: A review of APAs and their impact on stakeholders – Journal of Australian Taxation.

9.6. Suggested model

9.6.1. Type of APA

The benefits of opting for a bilateral or multilateral APA are overwhelming, but due to factors such as budget revenue and a short supply of suitable qualified staff, it is suggested that the unilateral APA be introduced. At least for now, and it will most certainly serve as a pilot exercise.

9.6.2. Processing and administering

Simple processing procedures are suggested and should be modelled along those of Canada or along those used for private advance ruling request. They should be straightforward and easy to co-ordinate. With regard to administering an APA, the USA's approach is suggested.

9.6.3. APA personnel

'The unavailability of an APA procedure in South Africa is presumably because of a lack of administrative capacity within SARS.'¹³⁴ An APA programme provides for a sequence of events as well as time frames all of which will need ample resources. At present SARS does not have enough resources to complete as many audits as it would like to. The big four audit firms in South Africa compete with SARS for transfer pricing personnel, and SARS seems to be at the losing end. It is then up to SARS to create a pool of transfer pricing personnel by providing for a large scale intensive training or at least be prepared to recruit and maintain personnel in the field of transfer pricing.

¹³⁴ Lynette Olivier & Michael Honiball on International Tax: A South African Perspective 2005, page 416.

APA's are in particular fact intensive and contain issues that are difficult to resolve, needing the commitment of well-informed and talented staff.

Due to SARS' composition of its transfer pricing personnel, it is submitted that the UK model with regard to the structure of the APA personnel be adopted, rather than creating a new structure similar to Canada or USA were they have a dedicated APA team.

Experience from countries that have introduced the APA Programme, has shown that only large companies have interest in the programme, and that can at least leave SARS with ample human resources to concentrate its audit work on medium and small companies.

9.6.4. User fee

With regard to a user fee, it is suggested that a fee be levied on a similar basis as that of private advance tax ruling which is available in South Africa.

9.6.5. Enactment in the Act

With regard to its enactment into the Act, it is suggested that the Australian approach be adopted; i.e. it be enacted by way of advance tax ruling and the new section be promulgated and be called section 76BA with its rules under section 108, similar to the way the new objection procedure works

9.7. Budget constrain

An APA programme will place a strain on budget resources. So an increase that will cater for personnel and other logistic issues may be necessary for the proper functioning of the programme.

9.8. Conclusion

The APA programme provides a way of agreeing on the enterprise's transfer pricing methods on a going forward basis. However, it should be noted that each and every systems is without its inconveniences, as long as problems can be detected early and harnessed to the benefit of both parties (the taxpayer and the tax authority), the better. The APA programme offer unparallel benefit and the legislature will be ignoring it at its own peril.

It is evident that the means of escaping expensive hassles with the taxpayer is the introduction of an APA programme. A thoroughly completed and agreed APA will result in money now rather than after the audit which may be lengthy and costly on both sides. Any process involving two parties to succeed, both must have confidence in it, both must approach it with the intention of creating harmony and negotiate in a consistent and impartial manner.

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