REPUBLIC OF SOUTH AFRICA

SOUTH AFRICAN REVENUE SERVICE

PRACTICE NOTE NO. 7 DATE: 6 August 1999

SECTION 31 OF THE INCOME TAX ACT, 1962 (the Act) : DETERMINATION OF THE TAXABLE INCOME OF CERTAIN PERSONS FROM INTERNATIONAL TRANSACTIONS : TRANSFER PRICING

ISSUED BY THE
COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE

Acknowledgement

The kind assistance of the Policy Advice Division of the Inland Revenue Department in New Zealand, in permitting the use of material published by the Department, is gratefully appreciated.

CONTENTS

1. Definitions and Terminology

1.1 The concepts below are defined in section 1 and section 31 of the Act:

1.1.1 Goods;

1.1.2 Services;

1.1.3 International agreement;

The concept of "managed or controlled" is used a number of times in the definition and the scope thereof is intended to be wider than the term "managed and controlled", as used in other sections of the Act.

In order to determine the place where an entity is managed or controlled, regard will be had to the business activities of the entity and business activities of connected persons, as well as the degree of autonomy under which the entity operates.

SARS's view is that the control of an entity is to be found at the meeting place of the persons who exercise authority over and control direction of the entity's business operations. A company is generally controlled by its directors. However, situations may be encountered where control is effectively exercised by the directors of a company's holding company or ultimate holding company. The question of where the shareholders may reside or meet in annual general meeting (in the case of a company) is therefore irrelevant.

The place where directors and other persons performing the same functions (in the case of entities other than companies) usually exercise their functions and direct the affairs of the entity, is an indication of where an entity is controlled. In most cases this will be the place where the entity's head office is located.

The place where an entity is managed is usually the place where the day-to-day running of the business activities takes place.

From the above it is evident that the place from which an entity is controlled is not necessarily the place from which it is managed.

1.1.4 Connected person.

A "connected person" is defined in relation to each of the following categories of persons.

1.1.4.1 In relation to a natural person:

(i) any relative *of such person (including by adoption), i.e. children and parents, grandchildren, grandparents, brothers and sisters, great-grandchildren, great-grandparents, uncles and aunts, nephews and nieces, the person's spouse and any person who is a relative of the spouse, the spouse of any of the above-mentioned relatives*; and

(ii) any trust of which such natural person or any relative or spouse referred to above is a beneficiary. *A beneficiary means any person named, in the will, trust deed or letter of wishes, as a beneficiary or as a person upon whom the trustee or the trust has a power to confer a benefit from the trust.*

1.1.4.2 In relation to a trust:

(i) any beneficiary of such trust, *i.e. any person named as a beneficiary in the trust deed or letter of wishes, or any other person in favour of whom the trustee of the trust exercises the trustee's discretion*; and

(ii) any connected person in relation to such beneficiary*, for example any of the beneficiary's relatives and any trust of which a relative may be a beneficiary. A trust and connected persons in relation to the beneficiaries of the trust, are connected persons.*

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

All persons who are connected persons in relation to a trust are connected persons in relation to each other.

1.1.4.4 In relation to a member of any partnership:

(i) any other member *of such partnership*; and
(ii) any connected person in relation to any member of such partnership*, for example any of that member's relatives and any trust in which a relative may be a beneficiary.*

1.1.4.5 In relation to a company:

(i) its holding company, as defined in section 1 of the Companies Act, 1973 (Act No. 61 of 1973)(the Companies Act);
(ii) its subsidiary, as defined in section 1 of the Companies Act;

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

(iii) any other company, where both such companies are subsidiaries (as defined) of the same holding company;
(iv) any person, other than a company as defined in section 1 of the Companies Act, who individually or jointly with any connected person in relation to such person, holds (directly or indirectly) at least 20 per cent of the company's equity share capital or voting rights*. The person so contemplated, could be a natural person, trust, close corporation or any entity which is not a company for purposes of the Companies Act;*
(v) any other company, if at least 20 per cent of the equity share capital of such company is held by such other company, and no shareholder holds the majority voting rights of such company. *This will be the case where companies B and C each hold 50 per cent of the equity share capital of company A; both companies, B and C, will be connected persons in relation to company A*.
(vi) any other company, if such other company is managed or controlled by—
  (aa) any person (A) who or which is a connected person in relation to such company; or
  (bb) any person who or which is a connected person in relation to A.

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

In this context, references to a company in the definition are not limited to a company, as defined in section 1 of the Act. Company also refers to entities which are companies or corporations according to the ordinary meaning of the word. For example, a company incorporated under the law of any country other than the Republic, which does not carry on business in the Republic and which is not a shareholder of a South African company could also be a connected person, for the

purposes of the application of the connected person provisions.

1.1.4.6 In relation to a company which is a close corporation:
- (i) any member *of such close corporation*;
- (ii) any relative of such member, or any trust which is a connected person in relation to such member; and
- (iii) any other close corporation or company which is a connected person in relation to any member or relative or trust contemplated in (i) and (ii) above.

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

1.2 For purposes of this Practice Note, the words below are defined as follows:

1.2.1 **Controlled transaction**: A transaction in terms of which the ownership or control relationship is able to influence the transfer price set. In relation to section 31, a controlled transaction will be any transaction between connected persons, as defined in section 1 of the Act.

1.2.2 **Uncontrolled transaction:** A transaction which is concluded at arm's length between enterprises that are not connected persons in relation to each other. This could, for example, include transactions at arm's length between a member of a multinational and an unconnected person. Uncontrolled transactions form the benchmark against which a multinational's transfer pricing is appraised in determining whether its prices are arm's length.

1.2.3 **Multinational**: The term multinational is used to refer to any group of connected persons with members or business activities in more than one country. The term "members" refers to constituent parts (including natural persons) of that multinational, each having a separate legal existence.

1.2.4 **OECD Guidelines**: The Organisation for Economic Co-operation and Development (OECD) Report on Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, published in July 1995 and supplemented with additional chapters and revisions to the contents thereof.

1.2.5 **Transfer prices**: Transfer prices are the prices at which an entity transfers goods and services to connected persons.

2. Introduction

2.1 The term transfer pricing describes the process by which entities set the prices at which they transfer goods or services between each other.

2.2 The transfer prices adopted by a multinational have a direct bearing on the proportional profit it derives in each country in which it operates. If a non-market value (inadequate or excessive consideration) is paid for the transfer of goods or services between the members of a multinational, the income calculated for each of those members will be inconsistent with their relative economic contributions. This distortion will impact on the tax revenues of the relevant tax jurisdictions in which they operate.

2.3 For example, if a member of a multinational sells to a connected person resident in a specific country at a price which exceeds the market price, the profit which the multinational earns in that country is reduced. Similarly if the member of a multinational sells to a connected person resident in a country at a reduced price, the profit the multinational earns in that country is increased.

2.4 Since South Africa's re-emergence in the international market, there has been a marked expansion of international trade and commerce, with wide-ranging changes in volume and complexity. An increasing proportion of this international activity is carried on between members of multinationals. As the globalisation of business activity continues to accelerate, protecting the

South African tax base is vital to South Africa's wealth and development.

2.5 Exchange controls have historically provided some protection against the more significant manipulation of transfer prices to transfer profits to lower tax jurisdictions. In anticipation of the relaxation of exchange controls and the envisaged adverse effect on the South African tax base, section 31 was introduced into the Act in 1995.

2.6 Section 31 enables the Commissioner to adjust the consideration in respect of a supply or acquisition of goods or services in terms of an international agreement between connected persons. The Commissioner may adjust the consideration, for tax purposes, if the actual price is either less or greater than the price that would have been set if the supply or acquisition of goods or services had occurred between independent parties on an arm's length basis. The Commissioner may use the amount so determined, in the determination of the taxable income of either of the parties to the transaction.

2.7 The section, therefore, provides a mechanism by which the Commissioner adopts the internationally accepted "arm's length principle" for taxation purposes as the basis for ensuring that the South African fiscus receives its fair share of tax. This is achieved by adjusting the consideration in the determination of taxable income based on the conditions which would have existed between unconnected persons under comparable circumstances.

2.8 The objective of this practice note is to provide taxpayers with guidelines about the procedures to be followed in the determination of arm's length prices, taking into account the South African business environment. It also sets out the Commissioner's views on documentation and other practical issues that are relevant in setting and reviewing transfer pricing in international agreements.

3. The Commissioner's Approach to the Practice Note

3.1 This Practice Note has been drafted as a practical guide and is not intended to be a prescriptive or an exhaustive discussion of every transfer pricing issue that might arise. Each case will be decided on its own merits, taking into account the taxpayer's business strategies and commercial judgment.

3.2 Status of the OECD Guidelines

3.2.1 Because of the international importance of the OECD Guidelines, this Practice Note is based on, *inter alia*, those guidelines. Although South Africa is not a member country of the OECD, the OECD Guidelines are acknowledged as an important, influential document that reflects unanimous agreement amongst the member countries, reached after an extensive process of consultation with industry and tax practitioners in many countries. The OECD Guidelines are also followed by many countries which are not OECD members and are therefore becoming a globally accepted standard.

3.2.2 The OECD has issued a report entitled "Harmful Tax Competition – An emerging global issue". In this report, the failure to adhere to international transfer pricing principles is identified as a contributing factor to the proliferation of harmful preferential tax regimes. A tax authority's view on appropriate arm's length prices, if they impact on how an enterprise conducts its cross-border activity, can directly affect the competitive position of that enterprise. Following the OECD Guidelines will thus promote tax equality and reduce the possibility of South Africa contributing to the establishment of a harmful preferential tax regime.

3.2.3 The OECD Guidelines should be followed in the absence of specific guidance in terms of this Practice Note, the provisions of section 31 or the tax treaties entered into by South Africa.

4. Section 31 of the Act

4.1 Section 31 was introduced into the Act with effect from 19 July 1995 to counter transfer pricing practices which may have adverse tax implications for the South African fiscus. This section consists of a combination of transfer pricing and thin capitalisation provisions. The measures to combat transfer pricing schemes are in essence contained in section 31(1) and (2). The provisions of section 31(3) are more specifically aimed at countering thin capitalisation schemes.

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

4.3 The Commissioner may exercise his discretion in the following circumstances in relation to cross border transactions:

4.3.1 Where the acquirer of the goods or services is a connected person in relation to the supplier of those goods or services (including the supply of goods and services to or by a permanent establishment which either such acquirer or supplier has in South Africa or which either such acquirer or supplier has outside South Africa); and

4.3.2 the goods or services are supplied at a price other (greater or less) than the arm's length price.

4.4 Although the Act grants the Commissioner the power to adjust the consideration in respect of a transaction, the reality is that numerous transactions in respect of the same goods or services are entered into between the connected persons. In practice the Commissioner will exercise his discretion in respect of all transactions entered into in respect of a product or service during any period. Such period could be a year or number of years of assessment.

4.5 In terms of section 3(4) of the Act, the Commissioner's decision is subject to objection and appeal.

5. Financial Transactions

5.1 The definition of services, as contained in Section 31, includes financial transactions and would thus apply to non-arm's length interest, discounts and other payments for the use of money.

5.2 The consideration for the use of funds obtained from, or made available to, a connected person may be unacceptable to the Commissioner for reasons other than a high debt : fixed capital ratio or a high rate of interest envisaged in SARS Practice Note 2. For example, the amount of the loan or terms of the agreement may not reflect what would have been agreed if the persons had been unconnected and dealing entirely at arm's length. The Commissioner may, therefore, apply the provisions of section 31 to adjust or ignore such non-arm's length transactions for tax purposes.

5.3 The guidelines set out in this Practice Note will apply to all types of financial transactions between connected persons in terms of international agreements.

6. Tax Treaties

6.1 Article 7 of the OECD "Model Tax Convention on Income and on Capital" provides *inter alia* for the attribution of profits to a permanent establishment of an enterprise. Furthermore, Article 9 of the OECD Model Tax Convention stipulates that the arm's length principle must be applied to commercial and financial relations between associated companies residing in the contracting states. These principles are embodied in each of South Africa's tax treaties. Tax treaties cannot impose tax liability, they merely allocate existing tax liabilities between countries.

6.2 The "business profits" and "associated enterprises" articles in the tax treaties do not indicate priorities as to the methods to be used to determine the attribution of profits or an arm's length price. Therefore, the Commissioner holds the view that the treaties do not restrict or limit the application of Section 31 of the Act, regardless of the method selected to determine an arm's length consideration. The Commissioner also takes the view that no inconsistency exists between domestic law and the tax treaties, as both embody the arm's length principle.

6.3 Paragraph 2 of Article 9 of the OECD Model Tax Convention provides that a contracting state must make an appropriate adjustment to the amount of tax it levies on profits, if the other contracting state has made an adjustment to the profits of a related enterprise. Furthermore, the competent authorities of the contracting states may consult each other over the transfer pricing adjustments. Although South Africa's treaties generally incorporate such adjusting mechanisms, the wording of the relevant article in the treaties may not oblige South Africa to make a corresponding adjustment in all cases.

6.4 Although the provisions of section 31 of the Act are applicable to persons, which are separate legal entities, the contents of this Practice Note will also apply to determine the arm's length consideration for income tax purposes of cross-border transactions conducted by-

- a person with a connected person;
- a person's head office with a branch of such person; or
- a person's branch with another branch of such person,

in the application of the tax treaties entered into by South Africa.

7. The Arm's Length Principle

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

7.2 Paragraph 1 of Article 9 of the OECD Model Tax Convention deals with the arm's length principle as follows:

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

7.3 The problem to be resolved is how a multinational should determine what price would have arisen if transactions between its members were subject to market forces. The solution advanced by the arm's length principle is that a comparable transaction between independent parties (an uncontrolled transaction) should be used as a benchmark against which to appraise the multinational's prices (the controlled transaction). Any difference between the two transactions can then be identified and adjusted. An arm's length price that will reflect the economic contributions made by the parties to the transaction can be determined for the controlled transaction.

7.4 South Africa has adopted the arm's length principle, which is the international norm. The Commissioner is of the opinion that application of this internationally accepted principle will minimise the potential for double taxation.

7.5 Other than tax considerations, factors such as governmental regulations (for example price or exchange controls) may distort the prices charged between connected persons. These factors are recognised by the OECD Guidelines and the Commissioner. This Practice Note intends to provide broad guidelines about the business and economic concepts which serve to indicate what information, data and other evidence would support a contention that a transaction has occurred at arm's length.

7.6 The determination of an arm's length consideration is not an exact science but requires judgment on the part of both the taxpayer and the Commissioner. Accordingly, taxpayers and the Commissioner need to approach each case, having due regard for the unique business and market realities applicable to each individual case.

7.7 An arm's length price does not necessarily constitute a single price, but a range of prices and the facts of each case will determine where, within that range, a specific arm's length price will lie. See also paragraph 11.4 in this regard.

8. Principles of Comparability

8.1 Introduction

8.1.1 Comparability is fundamental to the application of the arm's length principle. The preferred arm's length methods are based on the concept of comparing the prices/margins achieved by connected persons in their dealings to those achieved by independent entities for the same or similar dealings. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be highly comparable.

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

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

8.1.4 The objective of comparability is to always seek the highest practical degree of comparability, recognising though that there will be unique situations and cases involving unique intangibles where it is not practicable to apply methods based on a high degree of direct comparability.

8.1.5 The practicable standard of comparability will be determined by the amount of data on which comparisons with uncontrolled situations and dealings in a particular case can be based. Comparisons with controlled dealings by other taxpayers cannot be regarded as arm's length comparisons.

8.1.6 The assessment of comparability can be affected, *inter alia*, by:

a) the characteristics of goods and services;
b) the relative importance of functions performed;
c) the terms and conditions of relevant agreements;
d) the relative risk assumed by the taxpayer, connected enterprises and any independent party where such party is considered as a possible comparable;
e) economic and market conditions; and
f) business strategies.

8.2 Characteristics of the property or services

8.2.1 Differences in the specific characteristics of property or services account, at least in part, for differences in their value in the open market. The OECD Guidelines, at paragraph 1.19, mention a non-exhaustive list of features that may be relevant in comparing two products:

Tangible property:	Intangible property:	Services:
Physical features	Form of the transaction	Nature of services
Quality and reliability	Type of property	Extent of services
Availability	Duration of protection	
Volume of supply	Degree of protection	
	Anticipated benefits from use	

8.2.2 The significance of the actual characteristics of a product or services being transferred in determining an arm's length price depends on the method applied in determining an arm's length price. For example, in applying the Comparable Uncontrolled Price (CUP) method, the actual characteristics of the goods or services are critical. On the other hand, when the Transactional Net Margin method is applied, the characteristics of the goods or services transferred are not nearly as important as the functions and risks undertaken by the relevant entities. Refer to paragraph 9 for a discussion on the various transfer pricing methods.

8.3 Functions undertaken

8.3.1 The compensation for the transfer of property or services between two independent enterprises will usually reflect the functions that each enterprise performs, taking into account the risks assumed and the assets used. In determining whether two transactions are comparable, the functions and risks undertaken by the independent parties should be compared to those undertaken by the connected persons.

8.3.2 Economic theory predicts that when various functions are performed by a group of independent enterprises, the enterprise that provides most of the effort and, more particularly, the rare or unique functions, and assumes the most risk should earn a greater portion of the profit. For example, a subsidiary may be responsible for the entire assembly of a product. If the trademark, know-how and the selling effort rest with the parent and the subsidiary is only acting as a contract manufacturer, the subsidiary should be entitled to a relatively smaller portion of the profit (representing a fair return on the functions it performs).

8.3.3 Most of the recommended transfer pricing methods (Cost Plus, Resale Price, Transactional Net Margin and Profit Split methods) focus on functions performed, risks assumed and assets utilised rather than on the goods or services being transferred. When applying one of these methods in a transfer pricing analysis, the comparability of functions performed by the member of the multinational and the independent entity or entities to which it is compared is very important. In contrast thereto the CUP method is based on a direct comparison of the price charged for goods or services and the characteristics of the goods or services are therefore significant.

8.3.4 A practical way of evaluating functional comparability is to prepare a functional analysis. A functional analysis is a method of finding and organising facts about a business' functions, assets (including intangible property) and risks. It aims to determine how these are divided between the parties involved in the transaction under review.

8.3.5 Functional analysis serves, therefore, to identify the economically significant activities (functions performed, assets employed and risks assumed) that are undertaken by the member of a multinational, and for which it should expect to be rewarded. This identifies the nature and characteristics of the connected party dealings that have to be priced.

8.3.6 Functional analysis also serves to help appraise the validity of an independent firm, as a benchmark for appraising the behaviour of a member of a multinational. Consider, for example, an independent firm and a member of a multinational that both sell toasters. The independent firm sells at the retail level with a liability for claims under warranty. By contrast, the member of the multinational sells at the wholesale level with no liability for defects. In this case, the independent firm's functions are quite different from those of the member of the multinational and would not ordinarily be used as a comparable. The member of the multinational should, instead, attempt to locate a comparable independent firm operating at the same level of the market, performing similar functions and assuming similar risks.

8.3.7 A functional analysis will help to highlight where such significant functional differences may exist. However, it must be noted that functional analysis is not a pricing method in its own right. Rather, it is a tool assisting in the selection of a transfer pricing method and the proper determination of an arm's length price.

8.3.8 Functional analysis is discussed in detail in Annexure A. The extent to which functional analysis should be performed depends on the transactions at issue. For more involved transactions a functional analysis should address all of the following:

a) An overview of the organisation, the overall structure and nature of the business undertaken by a member of a multinational.
b) General commercial and industry conditions affecting the member of the multinational, an explanation of the current business environment and its predicted changes.
c) Direct consideration of the transaction under review, the nature and terms of the transaction, economic conditions and property involved in the transaction, how the product or service that is the subject of the controlled transaction in question flows between the connected parties.

d) Actual contractual terms of the transaction, because this may provide evidence about the form in which the responsibilities, risks and benefits have been assigned among those members.
e) The functions undertaken by the relevant members of the multinational.
f) The relative contributions of various functions: The number of functions performed by a particular member of a multinational is not decisive in determining whether that member should derive the greater share of the profit. It is the relative importance of each function that is relevant.
g) An appraisal of risk. In the open market, this assumption of increased risk will be compensated for by an increase in the expected return. The risks assumed should therefore be taken into account in the functional analysis.
h) It must also be considered whether a purported allocation of risk is consistent with the economic substance of the transaction. In this regard, the parties' conduct should generally be taken as the best evidence concerning the true allocation of risk. The functions undertaken by an entity will, to some extent, determine the allocation of risks.

8.4 Economic circumstances

8.4.1 Arm's length prices may vary across different markets, even for transactions involving the same product or service. To achieve comparability, it is important to ensure that the markets in which the parties operate are comparable. Any differences must either not have a material effect on price, or be differences for which appropriate adjustments can be made.

8.4.2 The OECD Guidelines at paragraph 1.30, identify a number of factors relevant for comparing markets, including:

a) geographic location of the market;
b) size of markets;
c) extent of competition in the markets;
d) availability of substitute goods and services;
e) transport costs;
f) the level of the market (retail or wholesale).

8.4.3 These factors may have particular relevance in the South African situation. Because South Africa is a small country, it may be difficult to obtain comparables from the South African market. Refer to paragraph 11.2 for a discussion of this problem.

8.5 Business strategies

8.5.1 Business strategies are also relevant in determining comparability for transfer pricing purposes. Business strategies are a legitimate aspect of arm's length operations. The arm's length principle, therefore, acknowledges those strategies. Business strategies would take into account many aspects of an enterprise, such as innovation and new product development, degree of diversification, risk aversion and other factors which have bearing upon the daily conduct of business.

8.5.2 Business strategies could also include market penetration schemes. A taxpayer seeking to penetrate a new market or to expand (or defend) its market share might temporarily charge a lower price for its product than the price for otherwise comparable products in that market. Alternatively, it might temporarily incur higher costs (perhaps because of start-up costs or increased marketing efforts) and hence achieve lower profit levels than other taxpayers operating in the same market.

8.5.3 The important issue is how one should appraise whether a business strategy that temporarily decreases profits in return for higher long-term profits is consistent with the arm's length principle. The relevant question here is whether a party operating at arm's length would have been prepared to sacrifice profitability for a similar period under such economic circumstances and competitive conditions.

8.5.4 The Commissioner may consider a number of factors in evaluating a taxpayer's claim of following a strategy that temporarily reduces profits in return for higher long-term profits, for example, whether:

a) the conduct of the parties is consistent with the professed business strategy;
b) the nature of the relationship between the parties to the controlled transaction justifies that the taxpayer bears the costs of the business strategy;
c) there is a plausible expectation that the business strategy will produce a return sufficient to justify its costs, within a period of time that would be acceptable in an arm's length arrangement.

9. Acceptable Methods for Determining an Arm's Length Price

9.1 Introduction

9.1.1 Neither Section 31 nor the tax treaties entered into by South Africa prescribe any particular methodology for the purpose of ascertaining an arm's length consideration. Given that there is no prescribed legislative preference, the Commissioner would generally seek to use the methods that have been set out below.

9.1.2 The most appropriate method in a given case will depend on the facts and circumstances of the case and the extent and reliability of data on which to base a comparability analysis. It should always be the intention to select the method that produces the highest degree of comparability.

9.1.3 The choice of the most appropriate method should therefore be based on a practical weighting of the evidence, having regard to:

a) the nature of the activities being examined,
b) the availability, quality and reliability of the data,
c) the nature and extent of any assumptions, and
d) the degree of comparability that exists between the controlled and uncontrolled transactions where the difference would affect conditions in the arm's length dealings being examined.

9.1.4 In cases where there are no comparables or there is insufficient information to determine an arm's length outcome, the method to be used should be a method that produces a reasonable estimate of an arm's length outcome. Such estimate must be based on the facts in hand.

9.1.5 The application of the principles set out in this Practice Note may require the exercise of judgment. After the identification of an independent benchmark or benchmarks against which the pricing of a multinational is to be compared, it needs to be established to what extent the functions of the members of a multinational are similar to or differ from those of the independent benchmark(s). An element of judgment is required to determine the extent to which these similarities or differences have a material effect on the transfer price adopted by the multinational.

9.1.6 As a general rule, the most reliable method will be the one that requires fewer and more reliable adjustments to be made. Taxpayers will not be required to undertake an intricate analysis of all the methodologies, but should have a sound basis for using the selected methodology. This could entail providing reasons why secondary methods are not appropriate.

9.1.7 This section of the Practice Note considers the principles underlying each of the various transfer pricing methods. An understanding of these principles is useful for identifying the limitations of each method and applying the methods in practice.

9.2 The principle methods referred to in the OECD Guidelines

9.2.1 Several transfer pricing methods have been developed in international practice for determining and appraising a taxpayer's transfer prices. These methods are based on measuring a multinational's pricing strategies against a benchmark of the pricing behaviour of independent entities in uncontrolled transactions.

9.2.2 The standard transfer pricing methods recognised by the OECD Guidelines, are:

a) the comparable uncontrolled price method (CUP method);
b) the resale price method (RP method);
c) the cost plus method (CP method);
d) the transactional net margin method (TNMM); and
e) the profit split method.

9.2.3 The CUP, RP and CP methods are known as the traditional transaction methods and the TNMM and profit split method are referred to as transactional profit methods.

9.2.4 The Commissioner endorses the CUP, RP, CP, TNMM and profit split methods as acceptable transfer pricing methods, the most appropriate of these depending on the particular situation and the extent of reliable data to enable its proper application.

9.3 The hierarchy of methods

9.3.1 Section 31 does not impose a hierarchy for the transfer pricing methods. However, there is in effect a hierarchy, in that certain methods may provide a more reliable result than others, depending on the quality of available data and the taxpayer's circumstances.

9.3.2 The Commissioner acknowledges that the suitability and reliability of a method will depend on the facts and circumstances of each case. The most reliable method will be the one that requires fewer and more reliable adjustments.

9.3.3 It is essential to have an understanding of the commercial and economic reality underlying any particular transaction before beginning with a search for, and close examination of comparable transactions between unrelated enterprises in an application of the traditional arm's length methods.

9.3.4 As a general rule, the traditional transaction methods are preferred. Of these methods the CUP method is preferred, as it looks directly to the product or service transferred and is relatively insensitive to the specific functions which are performed by the entities being compared.

9.3.5 The RP and CP methods look at valuing the functions performed. Because these methods examine gross margins, operating expenses are excluded and therefore the impact of relative cost structures should not be material.

9.3.6 In practice, the traditional methods may not be able to be applied, because of information constraints, particularly the lack of comparable uncontrolled transactions or published data on gross margins. Hence it may be necessary to resort to the transactional profits methods.

9.3.7 Of the transactional profits methods, the TNMM is reasonably objective because comparables are applied. Essentially, this is either the RP or CP with varying levels of operating expenses incorporated into the calculations.

9.3.8 In theory the TNMM is inferior to the RP or CP methods where sufficient information is available to apply all three methods, because comparing operating expenses requires a similar structure of business to be truly reliable. This presents a more difficult threshold than functional comparability.

9.3.9 Where a taxpayer has considered a number of methods, it may be appropriate to document the reasons for discarding some of those methods. The availability of data is likely to be very important in a taxpayer's choice of method. South Africa is a small market and under certain circumstances this means reliable comparables may be difficult for taxpayers to locate. Approaches to address this problem are set out in paragraphs 11.2, 11.3 and 12.5 of this Practice Note.

9.4 The CUP method

9.4.1 Description

In applying the CUP method, a direct comparison is drawn between the price charged for a specific product in a controlled transaction and the price charged for a closely comparable product in an uncontrolled transaction, in comparable circumstances. It therefore primarily focuses on the goods being transferred or service being rendered, but also takes into account broader business functions and economic circumstances.

Differences between the two prices may indicate the existence of non-arm's length conditions and that the price in the controlled transaction may need to be substituted for the price in the uncontrolled transaction.

9.4.2 Application

The CUP method is the most direct and reliable way to apply the arm's length principle where it is possible to locate comparable uncontrolled transactions. A comparable uncontrolled price can be determined by reference to similar products or services transferred under similar circumstances by the taxpayer to an independent party (internal comparable) or by reference to similar products or services transferred under similar circumstances by one independent party to another (external comparable).

The two transactions being compared will only be truly comparable if there are no differences between the two transactions that will have a material effect on the price, or if reasonably accurate adjustments can be made to eliminate the effect of differences that may materially affect the price.

It is important to keep in mind that two transactions will not be comparable merely because the product or service transferred is comparable. Regard should also be had to the effect on price of broader business functions and economic circumstances other than just the product comparability.

Listed below are examples of where adjustments may be necessary when comparable products or services are transferred between independent parties or the taxpayer and an independent third party:

a) terms of a transactions may differ (for example, credit terms)
b) volumes transferred may differ significantly e.g. sell 10 tonnes to an independent party vs. 1000 tonnes to a connected person
c) sell FOB to a connected person and at CIF to an independent party

Certain adjustments could be very difficult to effect, such as differences in-

a) the quality of the products
b) geographic markets
c) market levels
d) amount and type of intangible property involved

9.4.3 Practical problems

a) It is usually very difficult to find a transaction between independent enterprises which is sufficiently similar to a controlled transaction, without differences which have a material effect on price.
b) Where differences exist between the controlled and uncontrolled transactions, or between the enterprises undertaking those transactions, it may be difficult or impossible to determine reasonably accurate adjustments to eliminate the effect on price.

9.4.4 Example

A South African enterprise, A, manufactures crocodile leather shoes and travel bags. The shoes are sold to a French subsidiary, B, which sells the shoes to unconnected exclusive boutiques. The credit terms to B are 90 days. A also sells the shoes to two independent distributors in France, C and D. The credit terms to the independent parties are 30 days. C sells the shoes directly to end-users and D sells the shoes to expensive shoe shops in Oxford and Bond Street in London. A also sells the travel bags to an independent distributor in France.

Possible CUP's:

The travel bags sold to the independent distributor in France will not constitute a CUP because the product is not similar to shoes and the price is not comparable.

The shoes sold to C would also not qualify as a CUP because the level of the market is different. B is at a higher level in the distribution chain than C and it is unlikely to be possible to quantify this difference and make reliable adjustments.

The shoes sold to D may be a valid CUP if the Paris and London markets are comparable. It will, however, be necessary to adjust the price for the difference in credit terms.

9.5 The Resale Price method

9.5.1 Description

The resale price method is based on the price at which a product, which has been purchased from a connected enterprise, is resold to an independent enterprise. The resale price is then reduced by an appropriate gross margin, to cover the reseller's selling and other operating costs, and to provide an appropriate profit, depending on functions performed, assets used and risks assumed by the reseller. The balance may be regarded as the arm's length price before other adjustments in respect of, for example, customs duties.

9.5.2 Application

The resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the entity obtains on items purchased and sold in comparable uncontrolled transactions, as well as by reference to the resale price margin obtained by one independent party selling to another.

Functional comparability is very important and it is essential that the functions performed by the independent entity are comparable to the functions performed by the member of the multinational selling to an independent enterprise. There should be no differences, which have a material effect on the price, for which reasonably accurate adjustments cannot be made.

In applying the resale price method, fewer adjustments are normally required for product comparability than under the CUP method. Minor product differences are less likely to have an effect on profit margins than on prices, as profit margins for similar functions tend to be equal, but prices for different products will be equal only to the extent that products are substitutes for one another. For example, a distributor performs the same function to sell toasters and blenders and is therefore likely to require the same profit margin, but blenders are not comparable in price to toasters.

Although broader product differences can be allowed in the resale price method, product similarity may still be important when applying this method, for example when high value intangibles are involved. All the other factors affecting comparability will have to be considered when applying the resale price method.

The resale price method focuses only on the external sale price to third parties and the gross margin required to reward the function performed by the reseller. These factors are not overly sensitive to differences between the cost structure of a member of a multinational and an independent firm. Thus, if the member of the multinational operates a more efficient distributorship than the independent firm, this will result in a higher net profit percentage when the resale price method is used, and will not influence the gross profit percentage.

The resale price method is most appropriate where the reseller does not add substantially to the value of the product or does not posses valuable marketing intangibles.

9.5.3 Practical problems

a) The biggest problem is to determine an arm's length resale price gross margin. It is usually very difficult to find a transaction between independent enterprises that is similar to a controlled transaction and where differences do not have a material effect on the margin.
b) Accounting policies also play an important role and appropriate adjustments should be made to ensure that the same types of costs are included for the comparison. The items of cost taken into account to arrive at a gross margin may differ from company to company.
c) The application of this method sometimes requires access to segregated product data. Whilst this information may be available in respect of the controlled party being examined, it will usually not be available in respect of uncontrolled entities used as benchmarks.

9.5.4 Example

A South African company, manufactures pasta at its factory in Cape Town. Subsidiaries in Italy and Greece distribute the pasta in their relevant markets after packaging the pasta. The packaging is not a very complicated process since the pasta is shipped from South Africa in units of 500g wrapped in plastic. These individual packets are merely packaged in cardboard boxes by the subsidiaries.

Application of the resale price method:

A search on independent comparable distributors showed that these independent distributors obtain a gross profit margin of 37 per cent to 40 per cent. The only difference is that these distributors are not involved in packaging the pasta.

The effect of the additional packaging function on the gross profit margin earned by the subsidiaries should be evaluated. If material, an adjustment should be made. If not material, the subsidiaries would also be expected to earn a gross margin of between 37 per cent and 40 per cent.

9.6 The Cost Plus method

9.6.1 Description

The cost plus method requires estimation of an arm's length consideration, by adding an appropriate mark-up to the costs incurred by the supplier of goods or services in a controlled transaction. This mark-up should provide for an appropriate profit to the supplier, in the light of the functions performed, assets used and risks assumed.

9.6.2 Application

This method is best suited to situations where:

a) services are provided,
b) semi-finished goods are sold between connected parties,
c) connected persons have concluded joint facility agreements or long-term buy-and-supply arrangements

The mark-up should ideally be determined with reference to the mark-up earned by the same supplier in uncontrolled transactions. If this is not possible, the mark-up should be determined by using the mark-up earned in comparable transactions by an independent supplier performing comparable functions, bearing similar risks and employing similar assets to those of the taxpayer.

An uncontrolled transaction is comparable to a controlled transaction for purposes of the cost plus method if one of two conditions is met:

a) none of the differences between the transactions being compared or between the enterprises undertaking those transactions materially affect the cost plus mark up in the open market; or
b) reasonably accurate adjustments can be made to eliminate the material effects of such differences.

Fewer adjustments are needed for product comparability than under the CUP and the same comparability principles as discussed under the resale price method will apply to the cost plus method.

9.6.3 Practical problems

a) The application of the cost plus method presents certain difficulties. In particular, the determination of costs, as some companies are more effective than others and will incur lower costs.
b) In addition there may be circumstances where there is no discernible link between the level of costs incurred and a market price.
c) Accounting policies also play an important role and appropriate adjustments should be made to ensure that the same types of costs are included for the comparison. The types of cost included in cost to arrive at a gross margin may differ from company to company.
d) The application of this method sometimes requires access to segregated product data. Whilst this information may be available in respect of the controlled party being examined, it will usually not be available in respect of the uncontrolled entities used as benchmarks.

9.6.4 Example

B, a South African holding company, is responsible for the development of all the software and the purchase of computer hardware to be used by its subsidiaries in Namibia and Botswana. It was clear from the beginning that there was a market for this kind of service in Africa. B also provides this service to other customers throughout Africa. The software and hardware required by each customer are unique and differ from the software developed and hardware supplied to the subsidiaries, but the functions and processes to provide these services are comparable.

Application of the cost plus method

An analysis of the income and costs in respect of the services provided to the independent customers, indicates that costs are recovered and gross profit of between 22 per cent and 25 per cent is achieved.

B should therefore charge its subsidiaries at cost plus between 22 per cent and 25 per cent for the performance of the information technology function.

9.7 Transactional Net Margin method (TNMM)

9.7.1 Description

The TNMM examines the net profit margin that a taxpayer realises from a controlled transaction, relative to an appropriate base, for example cost, sales or assets. This ratio is referred to as a profit level indicator. The profit level indicator of the tested party is compared to the profit level indicator(s) of comparable independent parties.

9.7.2 Application

Although the TNMM is classified as a transactional profit method, it is more closely aligned to the CP and RP methods than to the profit split method. As with the CP and RP methods, the TNMM focuses on the functions performed by an enterprise. The difference is that the TNMM compares net profit rather than gross profit.

The TNMM is, however, considered less reliable than the traditional transaction methods. This is because the net margins which are used in the TNMM are very sensitive to the relative cost structures of the entities being compared, as they include operating expenses in their calculations.

For example, if a multinational operates a more efficient distributorship than the independent firm, the application of the TNMM would result in a lower net profit being determined for the distributorship than if the RP method were used. Thus, unless an adjustment could be made to reflect the relative efficiency of the firms being compared, use of the TNMM would not provide a reliable result.

In order to maximise the reliability of the TNMM, the member of the multinational and the independent firm being compared would need to be structurally similar. In practice, firms are structurally unique and comparisons of indicators between firms will tend to be less reliable than comparisons made at the gross margin level. For this reason the TNMM, along with the profit split method are considered to be methods of last resort in international practice.

This observation does not preclude the TNMM from being used. It must be recognised that reliable information on gross margins may be difficult, if not impossible, to obtain. Thus information constraints may dictate the TNMM as the only practical approach in many cases.

The connected party (tested party) whose profit level will be compared to the profit level of the independent parties, will usually be the party for which reliable data on the most closely comparable transactions can be identified. It is also usually the enterprise that is the least complex and that does not own valuable intangible property.

9.7.3 Practical problems

a) The net margin of a taxpayer can be affected by factors that do not necessarily have an influence on price or gross margins, thereby reducing the reliance that can be placed on the results in applying the TNMM.
b) Information about the taxpayer, required to apply the TNMM may not be available at the time of determining an arm's length price. It may, for example, not be possible to determine the net margin that will result from the controlled transaction.
c) Information on the uncontrolled transaction may not be available.
d) As with the CP and RP methods, the TNMM is a one-sided analysis, as it does not consider the effect of the determined price on the other party to the transaction. However, because operating expenses affect the calculations, the result for the TNMM is likely to be less reliable than that determined under the other methods. It is important, therefore, to check that the profit resulting from applying the TNMM is consistent with what one may expect, based on first principles.
e) It is often difficult to determine a transfer price once an appropriate margin has been determined.

9.7.4 Example

CCP is a manufacturer of dehydrated food. Its products are distributed by subsidiaries throughout Europe. CCP does not sell to independent distributors at all and no comparables could be located that would allow the application of the CUP, cost plus or resale price methods. The profit split method is not applicable and the only remaining method is thus the TNMM.

Research on comparable independent companies resulted in the determination of an arm's length range of 15 per cent to 18 per cent. This percentage is determined by expressing operating profit as a percentage of turnover. After adjustments were made for differences between CCP and the comparable independent companies, in respect of stock holding and debtors days outstanding, the range of arm's length margins is 17,5 per cent to 19 per cent.

The transfer price for the sale of the dehydrated food from CCP to its subsidiaries should thus be set at a level that will result in operating profit as a percentage of turnover of between 17,5 per cent and 19 per cent.

9.8 The Profit Split method

9.8.1 Description

The first step in the profit split method is to identify the combined profit to be split between the connected parties in a controlled transaction. In general, combined operating profit is used, ensuring that both income and expenses of the multinational are attributed to the relevant connected person consistently.

That profit is then split between the parties according to an economically valid basis approximating the division of profits that would have been anticipated and reflected in an agreement made at arm's length.

9.8.2 Application

The profit split method is usually applied where transactions are so interrelated that they cannot be evaluated separately. Under similar circumstances, independent enterprises may decide to set up a form of partnership and agree to some form of profit split.

Two alternative approaches to the profit split method are outlined in the OECD Guidelines. Under both approaches, the first step is to determine the combined profit attributable to the parties to the transaction. The combined profit is then allocated as follows:

- Under the residual profit split approach, each of the parties to the transaction is assigned a portion of profit according to the basic functions that it performs. The residual profit or loss is then allocated between the parties on the basis of their relative economic contribution in respect of the amount to be allocated.
- Under the contribution analysis approach, it is generally the combined operating profit (profit before interest and tax) that is divided between the parties on the basis of the relative contribution of each party to that combined gross profit.

However, paragraph 3.15 of the OECD Guidelines notes that these approaches are not necessarily exhaustive or mutually exclusive. There may be alternative ways to split a profit to achieve a reliable arm's length result.

As is explained in paragraph 3.17 of the OECD Guidelines it may, in some circumstances, be appropriate to split gross profits (as opposed to operating profits) between the connected parties and then deduct the operating expenses incurred by or attributable to each relevant enterprise. The example used in paragraph 3.17 of the OECD Guidelines is the case of a multinational that engages in highly integrated world-wide trading operations involving various types of property. It may be possible to determine the enterprises in which expenses are incurred or attributed, but not to accurately determine the particular trading activities to which those expenses relate. In such case it may be appropriate to split the gross profit from each trading activity and then deduct from the resulting overall gross profit the operating expenses incurred by or attributable to each enterprise.

The allocation of gross profit should be consistent with the location of activities and risks. Care must be taken to ensure that the expenses incurred by or attributable to each enterprise are consistent with the activities performed and risks assumed by the relevant entities.

a) Residual Profit Split Analysis

The residual profit split approach first provides both the parties to the transaction with a basic return, based on what independent firms would obtain for performing similar functions and undertaking similar risks. Applying other transfer pricing methods, such as a cost plus method or a resale price method, could also achieve this.

The residual profit remaining after the first stage division would be allocated among the parties, in accordance with the way in which this residual would have been divided between independent enterprises. Facts and circumstances that could influence the profit allocation in the second stage include the parties' contributions of intangible property and relative bargaining positions.

This requires a judgment about what factors contribute to the residual profit, and their relative contribution. For example, it may be determined that the process development and the marketing are the only relevant contributors to the residual profit and that each contributes 50 per cent to that profit. A 50:50 split of the residual profit between the manufacturer and the retailer would then be justified.

There is no definitive guide on how the relative contribution of the parties should be measured. It is quite likely that the transaction between the parties will be unique, so there will be no external benchmark against which to test the reliability of the assessment of relative contributions. In practice, the assessment of relative contribution may, of necessity, need to be a somewhat subjective measure, based on the facts and circumstances of each case.

b) Contribution analysis

Multinationals are organisationally different from comparable domestic enterprises. Large integrated multinationals may have the benefit of cost savings attributable to the scale of their operations, otherwise known as economies of scale. Such savings are not necessarily available to independent enterprises. For example, the administration costs incurred by a multinational which both manufactures and retails toasters are likely to be less than the aggregated costs faced by two separate firms, one of which manufactures toasters, and the other of which retails them. In the absence of intangibles, the price determined under the cost plus method would then be higher than the price determined under the resale price method. This means that there would be a negative residual if the residual profit split approach were to be used.

Economies of scale is not an aspect which can readily be evaluated in a traditional arm's length analysis. However, it is an important factor that needs to be addressed when determining whether a multinational's transfer prices are consistent with the arm's length principle.

One approach to this problem may be to use the contribution analysis approach. Under this approach, the combined gross profit of the two parties to a transaction is allocated between them, on the basis of their relative contribution to that profit. This differs from the residual profit split approach, in that basic returns are not allocated to each of the parties to the transaction before the profit split is made.

9.8.3 Practical problems

a) The application of the profit split method relies on access to world-wide group data, which may be difficult to obtain.
b) The allocation of profits is subjective.
c) This method may result in a less reliable measure of the arm's length price than an analysis under one of the other methods.

9.8.4 Example

A, a South African manufacturer of mining equipment, acquired B, a company located in Namibia. B has an established distribution network in Namibia and the rest of Africa and has good contacts at mines in the region. A would not have been able to sell its product without involving B's contacts. Before the acquisition of the B, A and the company considered entering into a joint venture agreement and were negotiating a profit split of 40 per cent for A and 60 per cent for B.

Application of the profit split method

There are no comparables which would allow the application of the CUP, resale price or cost plus methods. Based on the negotiations before the acquisition of B by A, it was decided to apply the profit split method to arrive at arm's length prices. Because of the importance of B's contacts and distribution network, and the other factors taken into account during the negotiation phase, it was decided that the transfer price at which the product should be sold to the B should be set at a level that will result in a 40 : 60 profit split if the relevant factors remain unchanged.

10. Documentation

10.1 The Act

10.1.1 Sections 74, 74A, 74B, 74C, 74D and 75 of the Act deal comprehensively with the information and documents of the taxpayer and the access of SARS to such information and documents, as well as the supporting documentation required when submitting returns. These provisions are also applicable to transfer pricing investigations. In addition, section 69 of the Act also enables the Commissioner to require any person to furnish the information he may require.

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

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

10.1.4 The purpose of this section of the Practice Note is to cover the broad issues relating to the types and extent of documentation which taxpayers are advised to keep, to be able to demonstrate how their methods and prices satisfy the arm's length principle.

10.2 The need for documentation

10.2.1 Although there is no explicit statutory requirement to prepare and maintain transfer pricing documentation, it is in the taxpayer's best interest to document how transfer prices have been determined, since adequate documentation is the best way to demonstrate that transfer prices are consistent with the arm's length principle, as required by section 31.

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

10.2.3 Also, if taxpayers have not maintained appropriate records, the process of checking compliance with the arm's length principle becomes far more difficult and the Commissioner's officials are forced to rely on less evidence on which to apply a method, thus requiring a greater degree of judgment.

10.2.4 In addition there are practical reasons why taxpayers would be well advised to keep contemporaneous (at or close to the time the transaction occurs) documentation. The income tax return for companies (IT 14) requires taxpayers to supply certain specific information regarding transactions entered into between connected persons. It is not possible for a taxpayer to comply with these requirements if the taxpayer has not addressed the question of whether its dealings comply with the arm's length principle.

10.2.5 Thus, if a taxpayer can demonstrate that it has developed a sound transfer pricing policy in terms of which transfer prices are determined in accordance with the arm's length principle by documenting the policies and procedures for determining those prices, the Commissioner is more likely to conclude that its transfer pricing practices are acceptable and the risk of possible adjustments will be diminished.

10.2.6 On the other hand, preparing documentation is time-consuming and expensive. It will therefore not be expected of taxpayers to go to such lengths that the compliance costs related to the preparation of documentation are disproportionate to the nature, scope and complexity of the international agreements entered into by taxpayers with connected persons.

10.3 Documentation guidelines

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

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

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

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

10.3.5 The arm's length principle imposes requirements on connected parties that independent parties dealing at arm's length would not have. For example, independent firms are not required to justify the price of their transactions for tax purposes, but members of multinationals are required to justify the price adopted in their controlled transactions, to evidence compliance with the arm's length principle. Taxpayers may therefore have to prepare or refer to written materials which they would not otherwise prepare or refer to, such as documents from foreign connected persons.

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

a) identification of transactions in terms of international agreements entered into with connected persons and the extent of any other commercial or financial relations with connected persons which fall within the scope of Section 31;
b) copies of the international agreements entered into with connected persons;
c) a description of the nature and terms (including prices) of all the relevant

transactions (including a series of transactions and any relevant off-setting transactions);

d) the method that has been used to arrive at the nature and terms of the relevant transactions (including the functional analysis undertaken and an appraisal of potential comparables);
e) the reasons why the choice of method was considered to be the most appropriate to the relevant transactions and to the particular circumstances;
f) an explanation of the process used to select and apply the method used to establish the transfer prices and why it is considered to provide a result that is consistent with the arm's length principle;
g) information relied on in arriving at the arm's length terms such as commercial agreements with third parties, financial information, budgets, forecasts etc.
h) details of any special circumstances that have influenced the price set by the taxpayer.

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

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

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

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

10.3.10 In the event that contemporaneous documentation does not exist, companies should review their pricing policies against the guidelines set out in this Practice Note and satisfy themselves that they accord with the arm's length principle and that dealings with connected persons have been carried out on that basis. It is recommended that documentation be prepared in respect of transactions entered into from July 1995. For future transactions documents should be prepared not later than the date of submission of a tax return affected by these transactions.

11. Practical Considerations

11.1 Introduction

11.1.1 The fixing of transfer prices is a complex process. Many factors will have an impact on an arm's length transfer price. The purpose of this Practice Note is to highlight some of the practical issues that may arise in fixing arm's length prices for the transfer of goods or services between connected persons in terms of transactions as envisaged in section 31 of the Act.

11.2 The availability of information

11.2.1 In the light of the difficulties which may be encountered in obtaining information on uncontrolled transactions in South Africa, the Commissioner will accept the use of foreign country comparables (e.g., data from the Australian, United Kingdom and United States markets) in taxpayers' transfer pricing analyses. However, taxpayers using such comparables would be expected to assess the expected impact of geographic differences and other factors on the price.

11.2.2 For example, data may be available to indicate that the gross margin paid to distributors of a particular product in the United Kingdom is 20 per cent. This does not mean that 20 per cent will necessarily be an appropriate gross margin for South African distributors. There are a number of factors which may indicate an alternative gross margin to be more appropriate. For example:

a) Consumer preferences may result in different retail prices for a product in the two countries. This raises the question of which party to the transaction should capture any premium in price.
b) Higher transport costs may be associated with one of the markets. The relative gross margins may be affected by who bears this cost.
c) The relative competitiveness of the distribution industries in South Africa and the United Kingdom may differ. This could result in lower gross margins being paid in the more competitive market.
d) There may be differences in accounting standards that, if not adjusted for, could distort the relative margins of the parties being compared.

11.2.3 Thus, while foreign comparables may be useful, taxpayers will need to exercise caution to ensure that appropriate adjustments reflect differences between the South African and foreign markets.

11.3 Determining the party to be evaluated in a controlled transaction

11.3.1 From a South African perspective, the focus should be primarily on functions performed by the South African member, as the basis for determining and applying an appropriate pricing method.

11.3.2 However, there may be instances where, based on a taxpayer’s circumstances and the information available, it would be appropriate for the foreign party to a transaction to be evaluated in determining the most reliable measure of the arm's length price. This would be the case where the foreign party does not own intangible property, or does not perform any unique functions. For example, if the other party were a contract distributor, the obvious choice of method, based on the activities of that distributor, would seem to be the resale price method. In such instances the taxpayer will need to consider its ability to obtain reliable information about comparable transactions from which to determine an arm's length price.

11.3.3 From the Commissioner' perspective, the important point is that a pragmatic approach is required. In determining which party to a transaction should be used as the party to be evaluated, taxpayers should seek a practical solution that leads to a reliable determination of the arm's length amount.

11.3.4 However, taxpayers should be aware that the Commissioner would generally prefer using the South African party as the party to be evaluated, in appraising whether a taxpayer's transfer prices are arm's length. It is, therefore, important that if a taxpayer uses a foreign party as the party to be evaluated, the price determined is also considered in relation to the South African operations, to ensure that it results in an appropriate return for those operations.

11.4 Determination of an arm’s length range

11.4.1 As transfer pricing is not an exact science, the application of the most appropriate method or methods will often result in a range of justifiable transfer prices.

11.4.2 An arm's length range is arrived at by applying a transfer pricing method to multiple comparable data, or from applying different transfer pricing methods. Deciding on the price within a range would involve a degree of judgment.

11.4.3 A number of considerations should be taken into account when determining an arm's length range. The arm's length range would be determined using only comparable uncontrolled dealings that have been, or will be, adjusted to a level of comparability similar to the controlled dealings.

11.4.4 Where a single method is applied, it should be capable of being applied with similar accuracy and reliability to each element of data constituting the range, having regard to all the factors relevant to comparability.

11.4.5 Where there is substantial divergence between the data in the range, it is doubtful whether all the data in the range are truly arm's length outcomes. In such cases any adjustments made for material differences in comparability, as well as the method itself, should be reviewed.

11.4.6 There would be more confidence in ranges that are established by the use of different methods if those ranges, when compared, reflect common results.

11.4.7 A high level of comparability is required in order to apply a traditional transaction method (CUP, CP, and RP methods). When using these methods, an outcome that falls within a properly constructed arm's length range should be regarded as being arm's length, if the data used to construct the range is truly comparable. However, if the transaction falls outside the arm's length range, it is a matter of judgment as to where in the range the adjustment should be effected. The Commissioner concurs with the view of the OECD that the adjustment should reflect the point in the range that best accounts for the facts and circumstances of the controlled transaction. However, in the absence of persuasive evidence for the selection of a particular point in the range, the Commissioner may select the mid-point in the range.

11.4.8 When applying a method other than a traditional transaction method, arm's length ranges will be evaluated thoroughly. The approximations used in applying these other methods which rely on broader measures of comparability can result in extensive ranges, some of which may not be sufficiently accurate to permit the general statement that any point in the range may be regarded as arm's length.

11.5 Use of multiple year data

11.5.1 In order to obtain a complete understanding of the facts and circumstances surrounding the controlled transaction, it would be useful to examine data from the year under examination as well as prior years.

11.5.2 In the case of both the tested party and the uncontrolled comparables, multiple year data should be used, to take account of the effect of product and business cycles and short-term economic conditions.

11.6 Confirming transfer prices through multiple methods

11.6.1 There are conceptual links between each of the transfer pricing methods. This means that there should be a general consistency between transfer prices determined under each of the methods.

11.6.2 One of the taxpayer's key aims in transfer pricing should be to convince the Commissioner that its transfer prices are set at arm's length. To this end, a taxpayer's transfer pricing practices may be more credible if they are supported by analyses under one or more secondary methods. However, in accordance with paragraph 1.69 of the OECD Guidelines the Commissioner does not as a rule require the application of more than one method, as this could place a significant burden on taxpayers.

11.6.3 A taxpayer need not go to the same level of detail to demonstrate a price under more than one method. A brief analysis under one or more alternative methods that supports a well established and documented transfer pricing policy, determined under a primary pricing method, will add further credibility to that transfer pricing policy.

11.6.4 The decision to apply more than one method will depend on circumstances such as the availability and reliability of comparables and the taxpayer's assessment of the risk and degree of security required in its transfer pricing policies. The complexities of real life business situations may also force a taxpayer to apply more than one method, or even a mixture of methods, to determine an arm's length price. Therefore, the use of more than one method will be justified in the case of very complicated transactions.

11.7 Materiality in a practical assessment of comparability

11.7.1 The determination of an arm's length price is a practical exercise and should not deal with immaterial differences.

11.7.2 The purpose of a functional analysis is to understand the qualitative nature of the functions, assets and risks, to facilitate a comparison with other enterprises with similar functions, assets and risks. Allocating actual income to specific functions, assets and risks may lead to unnecessary complexities in analysis.

11.7.3 Instead, many factors should be assessed as part of the business risks and comparisons made based on those factors. The application of the transfer pricing methods is ultimately concerned with creating an analysis that is capable of producing a quantifiable result. Some factors that cannot be quantified may need to be addressed indirectly instead.

11.8 Interest-free loans to non-residents

Residents of the Republic making loans to non-resident individuals, trusts or companies often charge no interest on the loans and no repayment conditions are agreed upon. In exercising his discretion in terms of section 31(2) to adjust the consideration in respect of the granting of the financial assistance, the Commissioner will take into account the amount of income of the non-resident which is taxed in the Republic in terms of the provisions of section 9D, the impact of the transaction on the tax base of any of the taxes imposed under any of the Acts administered by the Commissioner, the business activities of the non-resident and the ruling interest rates in the Republic as well as the country of residence of the non-resident who/which borrowed the funds.

11.9 Losses incurred by a member of a multinational

11.9.1 If a taxpayer is incurring losses when any of the members of the multinational which has an interest in the goods provided or services rendered, are profitable, it may imply that this entity is not receiving adequate compensation from the multinational of which it is part in relation to the benefits derived by that group from its activities. The following may be legitimate reasons for incurring losses:

a) huge start-up costs
b) unfavourable economic conditions
c) inefficiencies
d) temporary strategic decisions

However, independent enterprises would not be prepared to tolerate losses that continue for an extended period of time. Since the extent to and conditions in terms of which losses will be tolerated by independent parties is the benchmark in setting and evaluating transfer prices, prices that result in losses should be compared to what comparable independent parties would accept in similar circumstances.

11.10 Recognition of actual transactions undertaken

11.10.1 As a general point of departure an examination of controlled transactions will be based on the transactions actually undertaken by the connected persons.

11.10.2 In accordance with paragraph 1.37 of the OECD Guidelines it will, in certain circumstances, be appropriate to disregard the structure of the controlled transaction entered into by a taxpayer. This will be the case where the economic substance of a transaction differs from its form. The Commissioner will, therefore, evaluate the substance of actual transactions to determine whether the transactions were structured in a way that would never have taken place between independent enterprises. An arm's length price should reflect the actual functions performed, risk assumed and assets used.

11.10.3 In terms of paragraph 1.37 above, the structure adopted by a taxpayer may also be disregarded where the form and substance of the transaction agree, but viewed in their totality, the arrangements made in relation to the transaction differ from those which would have been adopted by unconnected persons behaving in a commercially rational manner and the actual structure impedes the Commissioner from determining the appropriate transfer price.

11.11 Evaluation of separate and combined transactions

11.11.1 Ideally, to arrive at the most precise approximation of fair market value, the arm's length principle should be applied on a transaction-by-transaction basis. However, there are often situations where separate transactions are so closely linked or continuous that they cannot be evaluated separately. The OECD Guidelines, at paragraph 1.42, cite the following examples:

a) some long-term contracts for the supply of commodities or services
b) rights to use intangible property
c) pricing a range of closely-linked products (for example in a product line) when it is impractical to determine pricing for each individual transaction
d) the licensing of manufacturing know-how and the supply of vital components to a connected manufacturer.

11.11.2 In such cases, it may be appropriate to determine the arm's length price based on some "basket of goods" or combination of transactions.

11.11.3 However, the converse may also be true. There will be cases where a multinational packages as a single transaction and establishes a single price for a number of benefits, such as licences for patents, know-how and trademarks, the provision of technical and administrative services, and the lease of production facilities. This type of arrangement is often referred to as a package deal. In these cases, it may be necessary to consider separately the component transactions of the package deal. This may occur when it is either inappropriate or not feasible to evaluate the package as a whole.

11.11.4 The OECD Guidelines note, at paragraph 1.44, that a key principle to be followed in considering whether the transfer pricing should be determined for a combination of transactions or on a package basis is that the Revenue Authority should treat the transaction between connected parties in the same way that it would treat a similar deal between independent enterprises. Taxpayers should therefore be prepared to show that any package deal or combination of transactions reflects appropriate transfer pricing. Functions actually performed and all aspects of the transaction must, however, be taken into account in substantiating the transfer price.

11.12 Intentional set-offs

11.12.1 Intentional set-offs occur when one connected enterprise provides a benefit to another that is, to some degree, balanced by another benefit received from that enterprise. Such arrangements may sometimes occur between independent enterprises and should be assessed in terms of the arm's length principle.

11.13 Arrangements common between group-companies

11.13.1 The mere fact that certain arrangements are common between members of a multinational, will not result in the arrangement being regarded as an arm's length arrangement. The arrangement will have to be tested against similar arrangements entered into by independent companies in similar circumstances.

11.13.2 A particular transaction cannot be regarded as an arm's length arrangement merely because it is an arrangement that can only be entered into between connected parties. The fact that unrelated parties would not have entered into similar arrangements will often confirm the non-arm's length nature of the transaction.

11.14 Real bargaining at the time the transaction was entered into

11.14.1 The arm's length principle is modelled on notions of comparison and predication about what independent parties dealing at arm's length either did or might reasonably be expected to have done in the taxpayer's circumstances. It is therefore relevant to consider whether any comparative analysis was done and to what extent the taxpayer relied thereon. This necessarily involves examination of the outcome of the transaction and is not confined to an examination of the process. One of the many factors to be taken into account to determine whether a transfer price is an arm's length price is to establish whether the connected persons actually entered into a bargaining process before fixing the relevant transfer prices.

11.14.2 Real bargaining between connected parties would be expected to be achieved where the conditions in which the bargaining is undertaken are similar to those that would exist between unrelated parties dealing at arm's length. Conditions for arm's length dealings are sometimes fulfilled by members of company groups where the members have a considerable amount of autonomy so that they can, and indeed often do, bargain with each other in a manner similar to that of independent entities.

11.14.3 Listed below are a few of the factors which, depending on the particular case, may lend support to arguments that conditions for real bargaining between connected parties were similar to those existing between unrelated parties dealing with each other at arm's length:

a) members of multinationals being allowed to acquire goods and services from unconnected persons where the price is lower;
b) members of multinationals being allowed to supply goods and services to unconnected persons where the price is higher;
c) each entity having its own profit and cost responsibility and "user pays" principles applying in relation to goods and services provided between the entities;
d) manager remuneration is either significantly or wholly connected to the economic performance of the individual entity and there is no scope for rewarding performance detrimental to the individual entity, but which is of overall advantage to the group; and
e) the parties prepared documentation **during the negotiation** phase similar to the documentation independent parties dealing at arm's length would have used in comparable circumstances.

11.14.4 Real bargaining between connected parties would not usually be expected to be achieved where:

a) the same directors, officers or representatives handled the negotiations on behalf of all the connected persons; or
b) one party may have directed the negotiations or determined the outcome of the dealings of the connected persons.

11.15 The use of hindsight

11.15.1 The use of hindsight is inconsistent with the arm's length principle in setting or reviewing a transfer price. At arm's length, events occurring after a taxpayer has determined its prices would not affect the determination of those prices, unless they could be reasonably predicted at the time those prices were set.

11.15.2 The Commissioner's appraisal of a taxpayer's transfer prices will, as a starting point, focus on the conditions under which the taxpayer was operating at the time the relevant transaction occurred. An examination of relative profits from a controlled transaction over a period of time will, in itself, not form the basis for a transfer pricing adjustment, but may, however, form the basis for the Commissioner to identify cases for potential investigation.

11.15.3 The appropriate use of data from periods subsequent to a transaction being examined is discussed in the OECD Guidelines at paragraph 1.51:

"Data from years following the year of the transaction may also be relevant to the analysis of transfer prices, but care must be taken by tax administrations to avoid the use of hindsight. For example, data from later years may be useful in comparing product life cycles of controlled and uncontrolled transactions, for the purpose of determining whether the uncontrolled transaction is an appropriate comparable to use in applying a particular method. Subsequent conduct by the parties will also be relevant in ascertaining the actual terms and conditions that operate between the parties."

11.15.4 Hindsight may therefore be valuable for appraising the reliability of comparables used by a taxpayer in its transfer pricing analysis. However, this does not only benefit the Commissioner. It may be that a taxpayer's transfer pricing policy is more persuasive if data of actual transactions supports the taxpayer's comparables. Hindsight is also a valuable tool in the periodic review of the continuing applicability of methods used to determine arm's length prices.

11.15.5 The availability and use of contemporaneous documentation in a taxpayer's transfer pricing analysis will also reduce the likelihood of the Commissioner using hindsight in an appraisal of the taxpayer's transfer prices.

11.16 "Safe harbours"

11.16.1 It may be argued that the difficulties in applying the arm's length principle would be alleviated by providing circumstances in which taxpayers could follow a simple set of rules under which transfer prices would be automatically accepted by the Commissioner. Such provisions would constitute safe harbours.

11.16.2 In this context, taxpayers may also erroneously be of the opinion that the adoption of an arm's length principle implies that members of groups need only cover their variable costs and make some contribution to fixed costs, or return a profit (however marginal) from their activities to avoid transfer pricing challenges from the Commissioner.

11.16.3 Various factors such as administrative simplicity, certainty and compliance relief support the use of safe harbours. However, there are various disadvantages to the setting of safe harbours. Most importantly, the introduction of safe harbours can produce results that may be inconsistent with the arm's length principle.

11.16.4 In paragraph 4.123 the OECD Guidelines warn against the use of safe harbours. The Commissioner supports this view.

11.17 The effect of government policies

11.17.1 As a general rule, government interventions such as price control, interest control and exchange control should be treated as conditions of the market in a particular country. Government policies should be taken into account in evaluating a transfer price in a particular market, to the extent that the policies affect the manner in which prices are determined by comparable independent enterprises.

11.18 Four-step approach

11.18.1 Practical transfer pricing generally involves following a process to determine arm's length transfer prices.

11.18.2 The Australian Taxation Office (Taxation Ruling 98/11, Chapter 5) has designed a four-step approach as a useful tool for taxpayers to develop the methodology and documentation needed to support the evaluation of their transfer prices. The Commissioner endorses the four-step process as a useful tool.

11.18.3 The process will be especially useful if the nature of the international dealings is fairly extensive and necessitates a thorough analysis.

11.18.4 A summary of this approach is set out in Annexure B. Taxpayers are, however, not obliged to use it in determining their transfer prices. This methodology is as follows:

a) Step 1: Understanding the cross-border dealings between connected persons in the context of the taxpayer's business and assessing the risk
b) Step 2: Selecting the appropriate transfer pricing method
c) Step 3: Applying the transfer pricing method
d) Step 4: Calculating the arm's length price in accordance with the selected method.

12. The Commissioner's Approach to Transfer Pricing Reviews, Audits and Investigations

12.1 Introduction

12.1.1 Depending on the facts applicable to each individual case, the Commissioner intends to follow the general guidelines set out in this Practice Note. The discussion below focuses on various practical issues that have not yet been addressed above:

12.2 The Commissioner' access to and use of information

12.2.1 There are various sources from which the Commissioner can obtain information. The first is from the taxpayer, by way of enquiries into its transfer pricing practices. Alternatively, information may be sought from sources external to the taxpayer, such as:

a) other taxpayers within the same or similar industry;
b) financial databases, publicly available industry information, the Internet, etc. This includes information on comparable foreign entities;
c) other jurisdictions (through the exchange of information provisions contained in tax treaties).

12.3 Use of publicly undisclosed information

12.3.1 In the context of a review of a taxpayer's voluntary compliance with the transfer pricing rules, the Commissioner's primary source for obtaining information will be from the taxpayer itself. However, it should be remembered that the Commissioner, when applying any method, may have more information available than a taxpayer has, or can through its own efforts have reasonable access to. The Commissioner does not intend as a matter of course to use publicly undisclosed information in an attempt to substitute an alternative measure of the arm's length amount. There are procedural problems in using such information, such as the likelihood that such information could not be provided to taxpayers whose transfer prices are under review or as evidence in court due to the secrecy provisions of the Act.

12.3.2 Nevertheless, the Commissioner does not rule out the possibility that publicly undisclosed information will be used in administering the transfer pricing rules.

12.4 Requesting information from foreign connected persons

12.4.1 Where a non-resident parent dictates the transfer price adopted by its South African subsidiary, the parties may not be considered to be dealing at arm's length. Where the subsidiary has limited or no documentation to demonstrate that its transfer prices comply with the arm's length principle, it may be necessary to have recourse to documentation held by non-resident connected persons, if the taxpayer's transfer prices are to be reviewed.

12.4.2 The Commissioner acknowledges that taxpayers may face difficulties obtaining information from foreign connected persons. Such difficulties would not be encountered if taxpayers were required to produce only their own documents. However, due to the relationship between the parties the Commissioner considers it reasonable to expect taxpayers to obtain such information where necessary.

12.5 Acceptability of analyses prepared for a foreign tax administration, global pricing policies and Advance Pricing Agreements (APA's) entered into with foreign tax jurisdictions

12.5.1 In determining whether an analysis prepared for a foreign tax jurisdiction is likely to be acceptable to the Commissioner, taxpayers should consider the effect of the transfer prices on the South African operations. Whether the analysis results in the most reliable measure of the arm's length price from the perspective of the South African taxpayer, should also be taken into account.

12.5.2 Most analyses under the accepted pricing methods focus directly on only one side of a transaction (in the case of an analysis prepared for another tax jurisdiction, this is likely to be the foreign party to the transaction). In applying all but the profit split method, it is not necessary to consider the implications of the transfer price determined for the other party to the transaction.

12.5.3 The Commissioner would expect an arm's length price to result in a return for the South African operations, commensurate with its economic contribution and risks assumed.

12.5.4 If, for example, an analysis favouring the foreign jurisdiction over South Africa has been prepared (perhaps because the other jurisdiction is more aggressive than South Africa in administering its transfer pricing rules), that analysis is unlikely to be acceptable to the Commissioner. However, if the analysis represents a fair application of the arm's length principle and from the South African operations' perspective results in a return that is prima facie commensurate with that operations' economic contribution and risk assumed, that analysis is more likely to persuade the Commissioner that the transfer prices are arm's length.

12.6 Transactions with entities in low tax jurisdictions

12.6.1 Taxpayers should be aware that the Commissioner may pay closer attention to a transaction involving an entity resident in a country with lower tax rates than South Africa. The perception exists that transactions involving low tax jurisdictions are often motivated by tax, rather than strictly commercial, reasons.

12.7 General anti-avoidance provisions

12.7.1 Taxpayers should be aware that the exercising of the discretion by the Commissioner in terms of section 31 will not limit or exclude the application of the general anti-avoidance sections contained in the Act.

13. Interest and Penalties

13.1 Penalties

13.1.1 The penalty, additional tax and offence provisions applicable in the event of default or omission in the completion of the tax return or evasion of taxation are contained in sections 75, 76, and 104 of the Act and will also apply to default, evasion or omission relating to transfer pricing. The Act does not impose specific penalties in respect of non-arm's length pricing practices.

13.2 Interest

13.2.1 Sections 89 bis and 89quat of the Act provides for interest on the underpayment of tax and will also apply if the underpayment of tax results from non-compliance with section 31 of the Act.

14. Secondary Tax on Companies (STC)

14.1 Section 64C of the Act provides that certain amounts distributed to a recipient 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 of section 31 to have been distributed to a recipient by the company. The adjustment will therefore be subject to STC.

14.2 A "recipient" is defined as any:

- shareholder of the company;
- relative of such shareholder; or
- trust of which the shareholder or relative is a beneficiary.

15. Burden of Proof

15.1 In terms of section 31, the discretion to adjust the consideration in respect of a transaction rests with the Commissioner. In the discharging of its burden of proof it is clearly in a taxpayer's best interests to:

15.1.1 develop an appropriate transfer pricing policy;

15.1.2 determine the arm's length amount, as required by section 31; and

15.1.3 voluntarily produce documentation to evidence their analysis.

15.2 Section 82 of the Act places the burden of proof regarding exemptions, non-liability for tax, deductions or set-offs on the taxpayer.

16. Advance Pricing Agreements (APA's)

16.1 APA's are described in detail in the OECD Guidelines. In short, this is a process whereby the setting of transfer prices in respect of controlled transactions may be agreed with tax administrators in advance of the transactions being undertaken and reported.

16.2 Due to various factors, the APA process will not in the foreseeable future, be made available to South African taxpayers. This Practice Note will thus not deal with APA's.

17. Intangible Property

17.1 Chapter VI of the OECD Guidelines deals specifically with intangible property. The Commissioner considers the guidance provided in that chapter relevant and recommends that taxpayers follow the guidance in establishing arm's length conditions in international agreements with connected persons involving intangible property.

18. Intra-group Services

18.1 Chapter VII of the OECD Guidelines deals specifically with intra-group services. The Commissioner considers the guidance provided in that chapter relevant and recommends that taxpayers follow the guidance in establishing arm's length conditions in international agreements with connected persons involving intra-group services.

19. Cost Contribution Arrangements

19.1 Chapter VIII of the OECD Guidelines deals specifically with cost contribution arrangements. The Commissioner considers the guidance provided in that chapter relevant and recommends that taxpayers follow the guidance in establishing arm's length conditions in international agreements with connected persons involving cost contribution arrangements.

20. Effective Date

20.1 The provisions of section 31 apply only to goods and services supplied on or after 19 July 1995. This Practice Note applies in respect of such goods or services.

21. Conclusion

21.1 Taxpayers should make conscientious efforts to establish transfer prices that comply with the arm's length principle and prepare documentation to evidence that compliance.

21.2 Where such steps have been taken the Commissioner is likely to determine prima facie that the taxpayers' transfer pricing practices represent a lower tax risk and that the possibility of an in depth review of those practices is likely to be diminished accordingly. In contrast, taxpayers who give inadequate consideration to their transfer pricing practices are likely to receive greater scrutiny from the Commissioner.

21.3 The following is a summary of the broad guidelines suggested:

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

CHARACTERISTICS OF A FUNCTIONAL ANALYSIS

1 Introduction

1.1 A taxpayer's main aim in determining and documenting its transfer prices should be to convince the Commissioner that its transfer prices are arm's length. A functional analysis can serve two important purposes in this regard:

1.2 Firstly, the functional analysis should provide a quick overview of the organisation for those evaluating the transfer pricing policy of the multinational, to assist them in familiarising themselves with the general operations of the multinational. Secondly, the functional analysis should seek to identify the functions performed by each member of the multinational and assess the importance of each function to the overall operations of the multinational.

2 Outline of the Multinational's Operations

2.1 The overview of the multinational will outline the overall structure and nature of the business undertaken by a multinational. Some internal documentation, such as organisational charts, may be useful in this regard.

2.2 General commercial and industry conditions affecting the multinational may also be relevant. Such conditions could include information such as:

a) an explanation of the current business environment and its forecasted changes; and
b) how forecasted incidents influence the multinational's industry, market scale, competitive conditions, regulatory framework, technological progress and foreign exchange market.

2.3 The multinational itself is not necessarily the only source of such information. Trade associations, for example, may publish trade journals or other documents, or may have conducted studies of the market, or have access to industry experts, which may provide valuable information. Competitors and academics may also provide useful information for describing the environment in which the multinational operates.

3 Analysis of Functions of Members of the Multinational

3.1 The next step in the process would be to provide some more direct consideration to the transaction under review. Relevant information here could include:

a) the nature and terms of the transaction;
b) economic conditions and property involved in the transaction;
c) the flow among the related parties of the product or service that is the subject of the controlled transaction in question; and
d) information that might indicate whether independent firms dealing at arm's length under comparable circumstances would have entered into a similarly structured transaction.

4 Contractual Terms

4.1 The actual contractual terms of the transaction will also be relevant. The explicit contractual terms of a transaction involving members of a multinational may provide evidence about the form in which the responsibilities, risks and benefits have been assigned among those members.

4.2 For example, the contractual terms might include:

a) the form of consideration charged or paid;
b) sales or purchase volume;
c) the scope and terms of warranties provided;
d) rights to updates, revisions or modifications;
e) the duration of relevant licences, contracts or other agreements, as well as termination or renegotiation rights;
f) collateral transactions or ongoing business relationships between the buyer and the seller (including arrangements for the provision of ancillary or subsidiary services); and
g) credit and payment terms.

4.3 The contractual terms will be relevant in determining the comparability of a controlled and uncontrolled transaction. Any differences between the contractual terms of the transactions being examined would need to be adjusted in determining an arm's length price for the controlled transaction.

4.4 However, there may be a limit to the usefulness of the contractual terms. In dealings at arm's length, the divergence of interests between the parties ensures that they will ordinarily seek to hold each other to the terms of the contract. The contractual terms will be ignored or modified after the fact, generally only if it is in the interests of both parties.

4.5 The same divergence of interests may not exist for related parties. It may, therefore, be necessary to evaluate whether or not the conduct of the parties conforms to the terms of the contract. In some cases the conduct of the parties may imply that the contractual terms are a sham, or that they have been amended or superseded by a subsequent oral agreement.

4.6 Thus, even if members of a multinational enter into explicit contractual arrangements with each other, they should still examine the actual functions performed by each member as part of their transfer pricing analyses. This requires an identification of the critical functions in the multinational's operations, as well as a determination of which member (or members) is responsible for performing that function.

5 Examples of Relevant Functions

5.1 At its broadest level, a functional analysis would result in the identification of such general categories as:

a) research and development;
b) product design and engineering;
c) manufacturing, production and process engineering;
d) product construction, extraction, and assembly;
e) purchasing and materials management;
f) marketing and distribution (for example selling, inventory management, warranty administration and advertising);
g) transport and warehousing;
h) managerial, legal, accounting and finance, credit and collection, training and personnel management services.

5.2 Even so, dividing functions performed by a multinational into such broad category descriptions will, generally, not be sufficient. Activities within these categories may be divided between a number of members of the multinational. It is, therefore, also necessary to take into account more specific functions performed within these general categories.

6 Relative Contribution of Various Functions

6.1 The sheer weight of functions performed by a particular member of a multinational is not decisive in determining whether that member should derive the greater share of the profit. It is the relative importance of each function that is relevant. The functions performed by a member of a multinational may be relatively few in comparison with those performed by the other members, but if they are the most significant functions in the multinational's operations that member should be entitled to the major share of the profit.

6.2 In identifying and comparing the functions performed it is, therefore, also relevant and useful to consider the assets that are employed or to be employed. This analysis should consider the type of assets used (whether they are plant and equipment, or valuable intangibles). The analysis should also consider the nature of the assets used (such as their age, market value, location and property right protections which are available).

6.3 When intangibles are identified, it is necessary to clearly establish their nature, before attempting to attribute to them any value or to take them into account in applying an arm's length pricing method. Intangibles with different strengths will need to be rewarded differently. For example, a patented production process may be useful, but it may be fairly simple to design around the patented aspects in order to achieve a similar outcome. This type of intangible should not receive the same level of relative reward as a breakthrough patent that uniquely reduces production costs and improves the product so that there is greatly improved customer demand.

6.4 A functional analysis can assist in identifying the intangibles and the way in which they are used. While judgment will still be needed to determine an appropriate reward for their use, a better decision is likely to be made once the nature of the intangibles and their role in the profit-earning process are properly understood.

6.5 For example, an enterprise may be the legal owner of a trademark and the name that it legally protects. It may attribute to these trademarks a high value for which it seeks a direct reward. Under licence, subsidiary enterprises in different countries may separately produce, market and support goods bearing this name and trademark. A functional analysis should identify each party's contribution to any manufacturing intangible or marketing intangible. If the economic contribution to the intangible is shared between the parties, but only one party enjoys legal ownership of the intangible, the other party would, at arm's length, be expected to seek some form of reward for its contribution. This would need to be taken into account in determining the arm's length price, and could influence the selection of a transfer pricing method or the manner by which comparability is assessed against uncontrolled licence agreements.

7 Treatment of Risk

7.1 A significant portion of the rate of return earned by a company reflects the fact that the company is bearing risks of various kinds. In the open market, this assumption of increased risk will be compensated by an increase in the potential expected return (although this does not mean that the actual return must necessarily also be higher, because this will depend on the degree to which the risks borne are actually converted into realised profits).

7.2 An appraisal of risk is also important in determining arm's length prices. For example, controlled and uncontrolled transactions will not be comparable if there are significant differences in the risks assumed for which appropriate adjustments cannot be made.

7.3 The possible risks assumed that should be taken into account in the functional analysis include:

a) risks of change in cost, price, or stock;
b) risks relating to success or failure of research and development;
c) financial risks, including change in the foreign exchange and interest rates;
d) risks of lending and payment terms;
e) risks for manufacturing liability; and
f) business risk related to ownership of assets or facilities.

7.4 The functions carried out will, to some extent, determine the allocation of risks between the parties and, therefore, the conditions each party would expect in arm's length dealings. For example, a distributor taking on the responsibility for marketing and advertising is risking its own resources in these activities. It would, therefore, be expected to have a commensurately higher anticipated return from the activity than if it did not undertake these functions. This is in contrast to a distributor acting merely as an agent and who is reimbursed for its costs and receives the income appropriate to that lower risk activity. Similarly, a contract manufacturer or a contract research provider that takes on no meaningful risk would be entitled to a smaller return than if it had assumed the risk.

7.5 Consistency of risk allocation with economic substance:

a) It must also be considered whether a purported allocation of risk is consistent with the economic substance of the transaction. In this regard, the parties' conduct should generally be taken as the best evidence concerning the true allocation of risk. A manufacturer may, for example, sell property to a related distributor in another country and claim that the distributor assumes all of the exchange rate risk. However, if the transfer price appears to be adjusted to insulate the distributor from the effects of exchange rate movements, the purported allocation of exchange rate risk may be challenged on the basis that it is inconsistent with the conduct of the parties.

b) An additional factor to consider in examining the economic substance of a purported risk allocation is the consequence of such an allocation in arm's length transactions. In arm's length dealings it generally makes commercial sense for parties to be allocated a greater share of those risks over which they have relatively more control, and from which they can insulate themselves more cheaply than the other party can.

c) There are many risks, such as general business cycle risks, over which normally neither party has significant control. At arm's length, these risks could be allocated to either party to a transaction. Analysis is required to determine to what extent each party bears such risks in practice.

d) For example, when considering who bears any currency exchange or interest rate risk, it will be relevant to consider the extent to which the taxpayer or the multinational has a business strategy that deals with the management of such risks. Financial arrangements such as hedges, forward contracts, as well as put and call options, both "on-market" and "off-market", are now in common use. Where, as a result of the multinational’s business strategy, the taxpayer bearing the currency and interest rate risk fails to address such exposure, it will be evident that the taxpayer is not actually bearing the economic currency and interest rate risk. Such a practice, if not accounted for appropriately, could lead to significant profits or losses being made which are capable of being inappropriately sourced in the most advantageous place to the multinational.

8 Concluding Comments

8.1 The preparation of a functional analysis is an important tool that can assist in ensuring that an arm’s length consideration is determined in accordance with internationally accepted principles.

8.2 A functional analysis can be performed with varying levels of detail and can serve a variety of purposes. The scope of the analysis will be determined by the nature, value and complexity of the matters covered by international dealings and the nature of the taxpayer’s business activities. These include the strategies that the enterprise pursues and the features of its products or services. Also, factors such as the pricing method that is used and availability of data will affect the extent to which the analysis can be conducted.

8.3 By determining the relevant functions to be priced, the functional analysis can assist in the selection of a transfer pricing method. It can also assist in the analysis of the level of comparability present in controlled and uncontrolled dealings and in an assessment of the relative contribution of the parties when a profit-split method is used.

8.4 It is important, however, not to confuse the use of functional analysis with the determination of a transfer price. Functional analysis is not an alternative to searching for comparables. It is a means to establish what sort of comparables should be sought.

8.5 Annexure B sets out a four-step practical approach for determining transfer prices. The discussion in that annexure further considers functional analysis in a practical context.

THE FOUR-STEP APPROACH

1 Step 1: Understand the cross-border dealings between connected parties in the context of the business

1.1 The taxpayer and the Commissioner will have to understand the nature and extent of the dealings between the taxpayer and connected parties in the context of the taxpayer's business. It is important for a taxpayer to be able to explain:

1.1.1 how the international connected-party dealings of the enterprise are undertaken;

1.1.2 the purpose or object of the dealings;

1.1.3 what the taxpayer obtains from its participation in the dealings (for example products, services or strategic relationships);

1.1.4 the significance of the dealings to the taxpayer's overall business activities and to those of the multinational.

1.2 At this stage of the process the taxpayer should, therefore, prepare some documentation that outlines these considerations. The insight developed in this process will assist in determining the extent of any functional analysis that might be necessary for an analysis of comparability in applying the arm's length principle.

1.3 The taxpayer should also develop a preliminary functional analysis to consider the broad functions performed by the relevant members of the multinational. This will assist in determining an appropriate pricing method in step 2 of the process.

1.4 The functional analysis should not be comprehensive at this stage. As will be discussed in step 3 of the process, the detail included in a functional analysis is affected by a taxpayer's choice of pricing method. At this stage, the aim of the functional analysis should be to determine which method (or methods) is/are likely to be appropriate to the taxpayer's circumstances. The nature of the information that will be required to apply that method should also be determined.

1.5 Location of comparables: A taxpayer should also, at this stage, begin to assess potential sources of information on which to base its analysis. These comparables may be identified internally within the group (if a member of the multinational transacts with an independent external party), or by reference to transactions between independent external parties.

1.6 If internal comparables can be located, it is likely that they will be more reliable than external comparables. This is because:

1.6.1 they are more likely to "fit" the affiliated transaction as they occur within the context of the group's business;

1.6.2 more information about the comparable situation should be readily available;

1.6.3 one representative internal comparable may be sufficient to support a defence of the transaction under review, whereas a wider base of support may be required if external comparables are used.

1.7 It should be noted, however, that internal transactions may not provide reliable comparables for determining an arm’s length price if they do not occur on normal arm's length terms. For example, internal transactions are unlikely to provide reliable comparables for determining an arm's length price if:

1.7.1 they are not made in the ordinary course of business; or

1.7.2 one of the principle purposes of the uncontrolled transaction is to establish an arm's length price to be used as a comparable for the controlled transaction.

2 Step 2: Select the pricing method or methods

2.1 In terms of the OECD Guidelines, the choice and resultant application of a method or methods for calculating an arm's length price should be made and documented, having regard to:

2.1.1 the degree of comparability between the uncontrolled transactions used for comparison and the controlled transactions of the taxpayer;

2.1.2 the completeness and accuracy of the data relied on;

2.1.3 the reliability of all assumptions;

2.1.4 the sensitivity of any results to possible deficiencies in the data and assumptions.

2.2 The application of these criteria will depend on the quality of the information available to the taxpayer. Thus, at this stage of the process, the taxpayer will need to make an assessment of the quality of the data it has available. This assessment should be made for the purpose of determining which pricing method (or methods) is likely to provide the greatest consistency with the factors mentioned above and result in the most reliable measure of the arm's length price required under section 31.

2.3 To this end, the information obtained in step 1 can assist with the:

2.3.1 determination of comparability, when traditional transaction methods are appropriate; and/or

2.3.2 determination of comparability between enterprises, when pricing methods using profit comparisons are appropriate; and/or

2.3.3 allocation of the consideration between the enterprises, when a profit split method is applicable.

3 Step 3: Application of the pricing method or methods

3.1 Once a pricing method (or methods) has been chosen, the preliminary functional analysis prepared in step 1 can be extended to reflect that choice of method.

3.2 If a pricing method involving external benchmarking with independent enterprises is being used, the functional analysis assists in determining the comparability of the multinational’s dealings with uncontrolled dealings of the independent parties. The main purpose of this is to establish the degree of comparability. It is, therefore, not necessary to value the functions, assets and risks of each of the enterprises separately. However, it is essential to ensure that, if there are differences in the significance of the functions, assets and risks to each of the businesses, these differences are taken into account.

3.3 The functional analysis can be performed with varying levels of detail and can serve a variety of purposes. The analysis may be applied on a product, a divisional basis for individual transactions, or on all levels up to corporate group level. The scope of the analysis will be determined by the nature, value and complexity of the matters covered by international dealings. It will also be determined by the nature of the taxpayer's business activities, including the strategies that the enterprise pursues and the features of its products or services.

4 Step 4: Arriving at the arm's length amount and introducing processes to support the chosen method

4.1 The taxpayer will be required to document and demonstrate how its data has been used in the application of its chosen pricing method to determine an arm's length amount.

4.2 Adherence to the process up to this stage should result in a taxpayer having an objective, documented and considered review of the available material and possible choices for arriving at an arm's length outcome. However, the nature of the arm's length principle is such that there are a number of practical problems in its application. Transfer pricing will always require an element of judgment and taxpayers and the Commissioner need to bear this in mind in undertaking their transfer pricing analysis.

4.3 It should also be noted that transfer pricing does not end with the initial analysis. Taxpayers will need to implement appropriate processes to:

4.3.1 ensure the availability of data for subsequent review analyses; and

4.3.2 allow for changes in the choice and application of a pricing method, to reflect changes in their circumstances or market conditions, or if the process followed does not result in a commercially realistic outcome.