THE COMPLEXITIES OF TRANSFER PRICING METHODS AND THE ROLE OF ADVANCE PRICING AGREEMENTS AND TAX AUDITS IN ADDRESSING DISPUTES

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Wavhudi Ndou

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ABSTRACT

Base erosion and profit shifting is defined as the use of tax planning strategies by multinational enterprises, often through exploiting gaps and mismatches between the countries in which they operate (OECD, 2021: p. 1). Multinational enterprises exploit these gaps through the use of transfer pricing. Goods and services are exchanged between connected persons or associated enterprises at prices that do not reflect their arm's length price, in order to shift profits from high tax to low tax jurisdictions.

In terms of section 31 of the Income Tax Act, transactions between connected persons or associated enterprises must be reflected at their arm's length price. Transfer pricing has become an issue due to the difficulties in determining an appropriate arm's length price. Disputes arise between a taxpayer and a tax administration on the methods to use to determine an appropriate transfer price. The use of Advance Pricing Agreements prevents these disputes from arising and provides tax certainty on the treatment of transactions for both the taxpayer and the tax administration. While the OECD recommends the use of Advance Pricing Agreements as a method to prevent disputes from arising, the OECD also argued that if a country has the resources to conduct an audit, an Advance Pricing Agreement will not lead to increased revenue collection.

The research therefore analyses the problems faced in determining an appropriate arm's length price and compares the role that Advance Pricing Agreements and audits play in addressing transfer pricing issues. The possible role of Advance Tax Rulings is also explored, but they are found not to be suitable, except for the most simple transactions.

The research applies a legal interpretative, doctrinal research methodology and a qualitative research method. The data comprised of relevant South African tax legislation, OECD Guidelines, the World Bank Handbook, and the UN Manual, together with the writings of acknowledged experts in the field.

The study establishes that a proper functioning audit system is crucial to increasing revenue collection once a country implements an Advance Pricing Agreement. The research therefore

recommends the adoption of Advance Pricing Agreements in South Africa as a dispute prevention measure.

Key words: taxation, international tax, transfer price, arm's length price, Advance Pricing Agreements, tax audits, Advance Tax Rulings, India, China, Botswana, Organisation for Economic Co-operation and Development Guidelines, United Nations Manual, World Bank Handbook.

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LIST OF ABBREVIATIONS AND ACRONYMS

APA – Advance Pricing Agreement

ATR – Advance Tax Ruling

BEPS – Base erosion and profit shifting

BPR – Binding Private Ruling

BRICS – Brazil, Russia, India, China, and South Africa

CBC – Country-by-country

CP – Cost-Plus Method

CUP – Comparable Uncontrolled Price Method

DIRCO – Department of International Relations and Cooperation

DTA – Double Taxation Agreement

IMF – International Monetary Fund

IRS – Internal Revenue Service

ITR14 – Income Tax Return for Companies

MAP – Mutual agreement procedures

MNE – Multinational Enterprise

OECD – Organisation for Economic Cooperation and Development

PwC – PricewaterhouseCoopers

RP method – Resale Price method

SACU countries – Southern African Customs Union countries: Botswana, Lesotho, Namibia, South Africa and Swaziland

SAICA – South African Institute of Chartered Accountants

SARS – South African Revenue Service

TNMM – Transactional Net Margin Method

UN – United Nations

UN Manual – United Nations Practical Manual on Transfer Pricing for Developing Countries

World Bank Handbook – World Bank Transfer Pricing and Developing Economies: A Handbook for Policy Makers and Practitioners

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CHAPTER 1: INTRODUCTION

1.1 RESEARCH CONTEXT

The Organisation for Economic Cooperation and Development (OECD) (2021: p. 1) defines base erosion and profit shifting as the use of tax planning strategies by multinational enterprises, often through exploiting gaps and mismatches between the countries in which they operate. These strategies involve countries aggressively shifting their profits from high-tax countries to low-tax countries. Transfer pricing is one way in which this is achieved. A company in the high-tax country (usually a multinational company, or a company with a permanent establishment in another country) will shift profits to a low-tax company by charging a lower than market price to the connected person in the low-tax country. This reduces the company's taxable income in the high-tax country and increases the taxable income of the other company in the low-tax country. According to the publication "Southern Africa – Towards Inclusive Economic Development" (2019: p.1), foreign-owned multinationals operating in South Africa with a parent registered in a tax haven tend to report 80% lower profits than similar companies without a parent in a tax haven, resulting in an estimated loss in the South African corporate income tax of R7 billion or €400 million annually.

Section 31 of the Income Tax Act, No. 58 of 1962, as amended (the "Income Tax Act"), dealing with transfer pricing transactions, stipulates that the tax consequences of "affected" international transactions must be based on the arm's length principle. An "affected transaction" is defined in section 31(1) of the Income Tax Act as a transaction between a resident and non-resident that are connected persons, where any term or condition of the transaction is different from a term or condition that would have existed between independent persons dealing at arm's length, and that, in terms of section 31(2), results in a tax benefit. Therefore, base erosion and profit shifting would arise in South Africa from transactions between multinational enterprises that are not at arm's length.

According to Practice Note No. 7 of 1999 issued by the Commissioner for the South African Revenue Service (SARS) (1999: p.13), five transfer pricing methods are recognised by the OECD

and endorsed by the Commissioner for SARS as acceptable transfer pricing methods. These are the traditional transaction methods (the Comparable Uncontrolled Price method (CUP), the Resale Price method (RP), and the Cost-Plus method (CP)), and the transactional profit methods (the Transactional Net Margin Method (TNMM), and the Profit Split method). The method most suitable to establish an arm’s length consideration will be determined by the availability of data and the circumstances of the case.

As explained by the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) (2017b: p. 37), to determine the arm's length price of a transaction where a traditional transaction method is applied, an independent company that enters into transactions comparable to the functions performed by the associated enterprises must be identified. The OECD confirms that the exercise of finding a comparable independent company can be costly and challenging for the revenue authority and the enterprise, as a comparable industry or company may not exist for companies that offer unique products and may give rise to manipulation by multinational taxpayers. Transfer pricing has therefore become an issue due to the challenges in determining an arm’s length price for a transaction. According to PricewaterhouseCoopers (PwC) (2012: p. 8), this is mainly an issue for enterprises in Africa due to the lack of comparable transactions, unlike their counterparts in developed countries. The difficulty in finding an independent comparable company forces tax authorities to use non-domestic comparable transactions, and adjust for local market differences (PwC, 2012: p.8). Therefore, due to the complexity of determining an appropriate transfer price for transactions, disputes may arise between the tax authority and the taxpayer.

To address these issues, Becker (2014: para. 8) suggests that countries should take a practical approach to transfer pricing by providing certainty to multinationals using fixed margins and Advance Pricing Agreements (APAs). An APA is defined in the OECD Guidelines (2017b: p. 23) as:

> an arrangement [a term used interchangeably with agreement] that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An

> advance pricing arrangement may be unilateral involving one tax administration and a taxpayer or multilateral agreement of two or more tax administrations.

An APA is therefore a written contract between a taxpayer and the tax administration to determine agreed criteria for transactions, including the price, method, comparability analysis, duration, and assumptions, to prevent any potential transfer pricing audits or disputes (OECD, 2017b: p. 217). As part of the APA, the tax authorities agree to perform only high-level annual reviews to establish that the pricing was in line with the APA, instead of performing a full transfer pricing audit (OECD, 2017b: p. 218). There are three types of APAs, namely, unilateral, bilateral and multilateral agreements (OECD, 2017b: p. 216).

In February 2020, SARS released a discussion paper on APAs (SARS: 2020), explaining that the challenges faced by SARS in implementing an APA are mainly due to capacity constraints. SARS acknowledges the suggestion by the Davis Tax Committee in 2016 to outsource the required skills. However, the present challenge is how the outsourcing could be funded or how conflicts of interest could be managed in the small transfer pricing community in South Africa (SARS, 2020: p. 3). South Africa therefore does not currently use APAs as a solution to address transfer pricing, despite the recommendation by the Davis Tax Committee (2016: p.11, p.34, pp.109-112). According to the SARS discussion paper on APAs (SARS, 2020: p. 1), multinational enterprises play a vital role through their foreign investment in developing countries, fuelling economic growth.

The purpose of an APA is to avoid disputes and in turn create an environment of tax certainty that investors look for. This tax certainty for taxpayers and tax administrations is provided by ensuring predictability in the treatment of international transactions for tax purposes (OECD, 2020: p. 1), thus a proper application of the arm's length principle, providing greater certainty regarding the tax liability, reducing any risk of double taxation, and avoiding any risk of an audit and any potential penalties for the taxpayer. The OECD Guidelines (2022a: p. 218) explain that an advantage of an APA is that the transactions between taxpayers and their multinationals are declared to the revenue authorities, and thus, the onus does not fall on the revenue authority to identify the existence of these transactions through an audit or other means. Also, as stated by the OECD (2022a: p. 220), the disadvantage associated with an APA is the administrative burden of

implementing the APA and the costs associated with meeting the compliance requirements. The OECD (2022a: p. 219) confirms that APAs are highly complex, and the tax authorities must ensure that the agreement is in line with the global transfer pricing guidelines.

Whilst conceding the tax certainty advantages of APA programs, the OECD Secretariat (2012: p.4) states that, if a country has the capacity to carry out effective audits, it is unlikely that devoting resources to an APA will be more effective in raising revenue. This is, because only compliant taxpayers will apply for an APA, an effective audit programme can be targeted at the highest risk taxpayers and the threat of an effective audit gives all taxpayers an incentive to comply voluntarily with the relevant transfer pricing rules. Tax authorities would prefer joint international audits due to an ever-increasing pace of change in the transfer pricing arena (SARS, 2020: p. 5).

In terms of section 40 of the Tax Administration Act, No. 28 of 2011, as amended (the "Tax Administration Act"), SARS may select any taxpayer for an audit based on any relevant consideration, for the proper administration of the Tax Act, and does not require a justified reason for the selection. This is subject to the provisions of the Promotion of Access to Information Act, No. 2 of 2000 (Promotion of Access to Information Act), which gives taxpayers the right to be given the reasons for the selection for an audit. An audit is performed in accordance with the requirements of Part B, sections 45 to 49, of the Tax Administration Act and involves, *inter alia*, the inspection of a taxpayer's records relating to a tax period or periods.

Following the audit, if SARS finds that a transfer pricing transaction is not at arm's length, a primary transfer pricing adjustment will be made to the taxpayer's tax return, in order to reflect the arm's length consideration of the transaction (section 31(3), and the tax levied as an additional assessment in terms of section 92 of the Tax Administration Act). Additionally, an understatement penalty will also be imposed in terms of section 223 of the Tax Administration Act. In terms of section 31(3) of the Income Tax Act, the primary adjustment – the difference in the taxable income resulting from the non-arm's length transaction – will result in a deemed dividend *in specie* for a company, and subject to dividends tax at the rate of 20% (section 64E(1)(a)(i) of the Income Tax Act). In the case of a person other than a company, section 31(3)(b)(ii) of the Income Tax Act states that the difference will be a deemed donation and subject to donations tax levied at either

20% or 25%, depending on the amount of the difference. In addition, failure to comply with transfer pricing documentation requirements will attract an administrative penalty in terms of section 210 of the Tax Administration Act. These consequences of a transfer pricing infringement are severe.

The question is therefore: what problems do transfer pricing methods present in arriving at an acceptable arm's length transfer price, and what is the role of APAs and tax audits?

1.2 GOALS OF THE RESEARCH

The goal of this research is to analyse transfer pricing methods and the problems that may arise in arriving at an acceptable arm's length price, and to discuss the role of APAs and tax audits in addressing these problems from the perspective of the taxpayer and SARS.

The research goal is addressed through the following sub-goals:

- discuss the provisions of section 31 of the Income Tax Act, which deal with the transfer pricing of international transactions between connected persons;
- analyse the various transfer pricing methods and identify the problems in applying each;
- explain APAs and the role they may play in resolving disputes between the taxpayer and the revenue authorities;
- discuss the role of audits in the South African tax system, the selection criteria applying to an audit, and the audit process;
- Compare the roles of APAs and audits in addressing transfer pricing problems, from the perspective of a taxpayer and SARS; and
- make a recommendation regarding the possible adoption of APAs in South Africa.

1.3 METHODS, PROCEDURES AND TECHNIQUES

An interpretative research approach is adopted for the current research as it seeks to understand and describe (Babbie & Mouton: 2009). The research methodology applied can be described as a *doctrinal* research methodology. This methodology provides a systematic exposition of the rules

governing a particular legal category, analyses the relationships between the rules, explains areas of difficulty, and is based purely on documentary data (McKerchar: 2014). The research methodology is qualitative, based on a content analysis of documentary evidence.

The research is conducted in the form of an extended natural language argument supported by documentary evidence. The credibility of the research and the conclusions is promoted by:

- referring to relevant South African Tax legislation and the writings of acknowledged experts in the field, including OECD Guidelines, World Bank Transfer Pricing and Developing Economies: A Handbook for Policy Makers and Practitioners (World Bank Handbook) and United Nations Practical Manual on Transfer Pricing (UN Manual);
- discussing opposing viewpoints and concluding, based on credible evidence; and
- the rigour of the arguments.

1.4 ETHICAL CONSIDERATIONS

As all the documentary data are publicly available, no ethical considerations arise. No application for ethical clearance was therefore submitted using the Ethical Review Application System of Rhodes University.

1.5 STRUCTURE OF THE THESIS

This thesis consists of the following chapters:

Chapter 2: Transfer pricing and the arm's length principle

This chapter serves as an introduction to transfer pricing in South Africa, with an overview of the current transfer pricing regulation and the provisions of section 31 of the Income Tax Act. It also discusses the OECD influence on domestic policies. The arm's length principle is explained and the difficulties faced by multinational entities in determining an arm's length price are presented.

Chapter 3: Transfer pricing methods, documentation and disputes

This chapter explains the five-transfer pricing models, including the advantages and disadvantages of each method. The chapter also outlines the transfer pricing documentation used, and transfer pricing disputes that can arise.

Chapter 4: Advance Pricing Agreements

This chapter discusses Advance Pricing Agreements, the types of Advance Pricing Agreements that a multinational entity could enter into, and the advantages and disadvantages of using Advance Pricing Agreements as a method of avoiding transfer pricing disputes.

Chapter 5: Transfer pricing and the role that audits play

This chapter distinguishes between a statutory audit and a tax audit. With the focus being on tax audits, the chapter explains the legislative requirements of conducting an audit in South Africa, and the influence that audits have on compliance. The selection criteria for an audit are set out, and the different types of audits are explained.

Chapter 6: Comparison of Advance Pricing Agreements and audits

This chapter compares Advance Pricing Agreements and audits, by analysing the characteristics of each. In addition, this chapter assesses whether a taxpayer would rather risk an audit or enter into an Advance Pricing Agreement. Transfer pricing, APAs and audits in selected economies, namely, India, China and Botswana, are discussed.

Chapter 7: Conclusion and recommendation

Following the review of the role that Advance Pricing Agreements play in comparison to audits in addressing transfer pricing problems from the perspective of the taxpayer and SARS, this chapter presents the findings of each chapter in addressing the goals of the research and recommends that South Africa should adopt Advance Pricing Agreements.

CHAPTER 2: TRANSFER PRICING AND THE ARM'S LENGTH PRINCIPLE

2.1 INTRODUCTION

The main goal of the research is to analyse transfer pricing methods and the problems that may arise in arriving at an acceptable arm's length price, and to discuss the role of APAs and tax audits in addressing these problems, from the perspective of the taxpayer and SARS. It is therefore necessary to describe the background to transfer pricing before addressing the research goal.

The chapter provides the definition of transfer pricing, with specific reference to the OECD and its link to base erosion and profit shifting. The OECD policies that influence the domestic transfer pricing policies are then discussed, followed by the domestic transfer pricing provisions in section 31 of the Income Tax Act. Crucial to the application of section 31 of the Income Tax Act is the arm's length principle on which all affected transactions are to be based. Therefore, the arm's length principle is explained, and the issues described that multinational enterprises encounter in identifying a comparable company on which to base the arm's length price of a transaction.

This chapter therefore addresses the first sub-goal of the research – to discuss the provisions of section 31 of the Income Tax Act, which deal with the transfer pricing of international transactions between connected persons.

2.2 DEFINITION OF TRANSFER PRICING

According to the OECD (2022b: p.1), base erosion and profit shifting (BEPS) is costing countries between USD 100 and 240 billion in lost revenues annually. BEPS is defined as tax planning strategies used by multinational enterprises that exploit gaps and mismatches in tax rules to avoid paying tax (OECD, 2022b: p.1). BEPS and transfer pricing are inextricably linked as Multinational Enterprises (MNEs) use transfer pricing in order to aggressively shift profits from high tax jurisdictions to lower tax jurisdictions through connected persons/associated enterprises. Transfer pricing is described as the systematic manipulation of prices in order to reduce or increase profits

artificially or to cause losses and avoid taxes in a specific country (Oguttu, 2006: p. 2). A MNE does this by, for example, overstating the cost of an intercompany sale or service in a high tax jurisdiction, in order to minimize the income subject to tax in the high tax jurisdiction while maximising this taxable income in the low tax jurisdiction. Prices are not negotiated in a free and open market and deviate from unconnected person transactions, where each party strives to benefit (OECD, 2022a: p.30). According to the UN Practice Manual (2017: p. 27) transfer prices serve to determine the income of both parties involved in the cross-border transaction. The transfer price therefore influences the tax base of the countries involved.

The South African transfer pricing provisions, as set out in section 31 of the Income Tax Act, are used to address the tax avoidance stemming from non-arm's-length transfer prices. Section 31 was first introduced into the Income Tax Act with effect from 19 July 1995 as a result of recommendations by the Katz Commission in 1995 (Katz Commission Report, 1995: p. 4). The section was introduced to counter transfer pricing practices that may have adverse tax implications for the South African fiscus (SARS, 1999: p. 6). Section 31 of the Income Tax Act is read together with Practice Note 7 (SARS: 1999), issued by the Commissioner for SARS.

2.3 OECD INFLUENCE ON DOMESTIC POLICIES

According to Practice Note 7 (SARS, 1999: p. 6) the OECD Guidelines are acknowledged as an important influential document that reflects unanimous agreement amongst the member countries. In terms of this Practice Note, the OECD Guidelines should be followed in the absence of any specific guidance, the provisions of section 31, or the tax treaties entered into (SARS, 1999: p. 6).

Cooper, Fox, Loeprick, and Mohindra (2016: p. 9) state that, in practice, the OECD Guidelines are the most influential source of guidance on transfer pricing, and that the UN Manual for Developing Countries will also play an influential role in the development of transfer pricing practices in transition and developing economies. The authors confirm that both the OECD Guidelines and the UN Manual provide guidance for multinational corporations and tax administrations regarding the practical application of the arm's-length principle.

The OECD Guidelines were first published in 1995, following reports on transfer pricing in 1979 and 1984 (OECD, 2022a: p. 14). The OECD Guidelines represent a consensus among OECD member countries, where the governments of these countries shape policies that foster prosperity, equality, opportunity and well-being for all (OECD, 2022c: p. 1). The OECD currently has 38 member countries (OECD, 2022c: p. 1). South Africa is not a member of the OECD, but has observer status (Department of International Relations and Cooperation (DIRCO), 2004: p. 1). This means that South Africa participates in 23 OECD bodies and projects, including areas of anti-corruption, tax and science and technology (OECD, 2020: p.10). In May 2007 the OECD Council, at Ministerial level, adopted a resolution to strengthen the co-operation between the OECD and South Africa via the "Enhanced Engagement Programme" (OECD, 2022c: p.1). The OECD (2022c: p.1) therefore regards South Africa as a key partner. While South Africa is not a member state of the OECD, it follows the OECD guidance on transfer pricing application and the transfer pricing methods. The OECD Guidelines provide supporting guidance for the application of the arm's length principle included in the South African domestic transfer pricing legislation.

2.4 TRANSFER PRICING LEGISLATION: THE PROVISIONS OF SECTION 31

Section 31 of the Income Tax Act provides guidance for determining taxable income arising from international transactions between connected persons. According to section 31(1), an affected transaction should be based on the arm's length principle. The definition of an affected transaction is thus vital in applying section 31 of the Income Tax Act. An "affected transaction" is defined in section 31(1)(a) as follows:

> **"affected transaction"** means any transaction, operation, scheme, agreement or understanding where—
>
> *(a)* that transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected between or for the benefit of either or both—
>
> (i) (*aa*) a person that is a resident; and
>
> (*bb*) any other person that is not a resident;
>
> (ii) (*aa*) a person that is not a resident; and

(*bb*) any other person that is not a resident that has a permanent establishment in the Republic to which the transaction, operation, scheme, agreement or understanding relates;

(iii) (*aa*) a person that is a resident; and

(*bb*) any other person that is a resident that has a permanent establishment outside the Republic to which the transaction, operation, scheme, agreement or understanding relates; or

(iv) (*aa*) a person that is not a resident; and

(*bb*) any other person that is a controlled foreign company in relation to any resident, and those persons are connected persons in relation to one another; and

The definition of an "affected transaction" in section 31(1)(a) of the Income Tax Act refers to the relationship between "connected persons". A "connected person" is defined in section 1 of the Income Tax Act and includes natural persons, trusts, partnerships and companies. Section 31 was amended in 2019 to refer to "associated enterprises or connected persons" with effect from 1 January 2023, which is broader and in line with the wording used in Article 9 of the OECD Model Tax Convention (BDO Global, 2019: p. 1).

2.5 THE ARM'S LENGTH PRINCIPLE

The arms' length principle is adopted in South Africa in terms of section 31(1) of the Income Tax Act as the tax payable in respect of international transactions is to be based on the arm's length principle. A definition of "arm's length" is not provided in the Income Tax Act. However, a description of the treatment is provided in paragraph (b) of the definition of "affected transaction" which states that "any term or condition of that transaction, operation, scheme, agreement or understanding is different from any term or condition that would have existed had those persons been independent persons dealing at arm's length". Paragraph 1 of Article 9 of the OECD Model Tax Convention (OECD, 2017a: p. 11) 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.

A more simplified definition of “arm’s length” is provided by the South African Institute of Chartered Accountants (SAICA) (Hofmeyer, 2016: p. 1) as the price of that transaction in the open market, between a willing buyer and seller. Kamdar (2018: p. 19), on the other hand, defines it as a negotiated price under market conditions by a willing buyer and willing seller. This 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 (SARS, 1999: p. 8).

According to the UN Manual (2017: p. 38), the process to arrive at the appropriate arm’s length price typically involves a comparability analysis, evaluation of transactions, and evaluation of separate and combined transactions. These steps are consistent with those provided in the OECD Guidelines (2022a: pp. 29-93) and the comparability analysis will be discussed in more detail as this is the cornerstone of determining an appropriate arm’s length price.

2.6 COMPARABILITY ANALYSIS

Comparability analysis is referred to as the heart of the application of the arm’s length principle (OECD, 2022a: p. 39). In order for a company or associated enterprise to determine the arm’s length price of a transaction, a company must identify a comparable company to obtain the basis of an independent transaction in an open market between a willing buyer and willing seller (OECD, 2022a: p. 39). A comparable company is defined by the United Nations (UN) (2017: p. 69) as one where the characteristics of the industry, business operations and activities are similar to that of the taxpayer. The business operations include the functions performed, assets used, risks assumed, the nature of products/services transferred, the terms and conditions of the transaction, and the economic circumstances. The taxpayer has the duty to gather the basic information about the company and may experience some challenges in obtaining this information.

According to the OECD (2022a: p. 39), there are two key aspects in performing a comparability analysis, the first step is to accurately define those transactions by analysing their economically

relevant characteristics and conditions. Analysing the economically relevant characteristics and conditions involves obtaining relevant information about a competitive company, including information sourced from annual reports, research reports, internal reports, and news reports (UN, 2017: p. 70). The second aspect is to compare the conditions and economically relevant transactions between independent enterprises (OECD, 2022a: p. 39). The second aspect analyses the price of those transactions under the arm's length principle (OECD, 2022a: p. 39).

2.7 CHALLENGES IN DETERMINING AN ARM'S LENGTH PRICE

There are a number of challenges that are faced in determining an arm's length price. These are also the issues currently faced with transfer pricing.

2.7.1. Complexity

Transfer pricing is complex due to the difficulty in administering the rules (UN, 2017: p. 60). The challenge in administering the rules is based on the subjectivity involved in determining an appropriate arm's length price, the expensive databases managed by the MNEs for their transfer pricing arrangements, and the expertise required (UN, 2017: p. 60). According to the UN (2017: p. 60), the administrative challenges are costly for both the tax administration and the taxpayer who has to prepare and submit the required transfer pricing documentation and reports.

Tax administrations of many developing countries do not have sufficient resources (UN, 2017: p. 60; SARS, 2020: p. 1) to examine the facts and circumstances of each case so as to determine the acceptable transfer price, especially in cases where there is a lack of comparables (UN, 2017: p. 60). This leads to lengthy transfer pricing audits by tax authorities, as they need to be performed on a case-by-case basis and are often complex and costly tasks for all parties concerned (UN, 2017: p. 61). This complexity, in turn, adds to the resource constraints that are faced in the transfer pricing arena.

The complexity and knowledge required to comply with the OECD Guidelines, or to audit these transactions, therefore puts pressure on both tax authorities and taxpayers, especially in developing

countries where resources tend to be scarce and the appropriate training in such a specialised area is not readily available (UN, 2017: p. 60).

2.7.2 Lack of comparables

The comparability analysis is at the heart of the application of the arm's length principle (OECD, 2022a: p. 39). Therefore, problems will arise when an MNE is not able to identify a company or transaction on which to base their arm's length price. The availability of data is important in a taxpayer's choice of transfer pricing method (SARS, 1999: p. 14). South Africa is a relatively small economy and under certain circumstances this means that reliable comparables may be difficult for taxpayers to locate (SARS, 1999: p. 14).

This problem is confirmed almost two decades later by the UN. According to the UN Manual (2017: pp. 59-60), developing countries face the following issues in finding comparable data to apply to satisfy the arm's length principle:

- There are fewer operators in any given sector.
- Information about an independent enterprise may not exist or might be difficult to analyse as the resources and processes are not available. This issue is heightened by the fact that databases relying on transfer pricing analysis focused on developed country data which may not be available in developing countries, or may be very costly to access.
- Companies in transition countries (emerging economies) may be operating in unexplored or unexploited markets, and therefore lacking comparables.

While the United Nations have developed a toolkit jointly with the International Monetary Fund (IMF), OECD, and the World Bank (UN, 2017: p. 60), the issues highlighted remain a challenge within the transfer pricing community in developing countries.

2.8 CONCLUSION

Transfer pricing is described as the systematic manipulation of prices in order to reduce or increase profits artificially or to cause losses and avoid taxes in a specific country (Oguttu, 2006: p. 2). To curb the use of transfer pricing as a method of avoiding taxes, section 31 of the Income Tax Act was introduced in 1995, and this is read together with Practice Note 7 to the Income Tax Act (SARS, 1999).

South Africa applies the OECD Guidelines; therefore, the chapter also explored the influence that the OECD has on domestic policies. While South Africa is not a member of the OECD, it has observer status, and is part of the "Enhanced Engagement Programme" signed in 2007 (OECD, 2022c: p.1). This means that South Africa participates in 23 OECD bodies and projects and is therefore a key partner.

Section 31 of the Income Tax Act states that the tax payable of an affected transaction should be based on the arm's length principle. The description of the arm's length principle in section 31 of the Income Tax Act is discussed, and the application of the arm's length principle explored in terms of the OECD Guidelines. The chapter also discusses the comparability analysis required to establish the arm's length price, as well as determining an appropriate comparable, and highlights the challenges faced in determining the arm's length price. These challenges include complexity and the lack of comparable data.

The next chapter discusses the transfer pricing methods that are used in determining an appropriate arm's length price, transfer pricing documentation and transfer pricing disputes.

CHAPTER 3: TRANSFER PRICING METHODS, DOCUMENTATION AND DISPUTES

3.1 INTRODUCTION

The previous chapter defined transfer pricing, discussed the provisions of section 31 of the Income Tax Act and the arm's length principle in order to provide a base upon which the transfer pricing methods, transfer pricing documentation and transfer pricing disputes are discussed.

This chapter addresses the second sub-goal of the research by analysing the various transfer pricing methods and identifying problems in applying each. The transfer pricing methods are therefore defined and the strengths and weaknesses of each method examined. These are addressed through the use of the OECD Guidelines, the UN Manual, and the World Bank Handbook. Following the discussion of the methods, the transfer pricing documentation required for filing purposes once a connected person or associated enterprise identifies an "affected transaction" as defined in section 31(1) of the Income Tax Act, together with the OECD Guidelines, are discussed in the context of the specific requirements in South Africa.

According to the OECD (2017b, p. 174), disputes will arise in the application of the arm's length principle even if the guidelines are followed. Disputes are discussed in two parts: preventing disputes from arising, and once disputes do arise, how quickly a tax administration can facilitate the dispute resolution. This discussion identifies the use of Advance Pricing Agreements as a dispute resolution tool.

3.2 TRANSFER PRICING METHODS

Other than section 31 of the Income Tax Act, South African domestic transfer pricing legislation does not include specific legislation or guidelines dealing with the methodology that taxpayers should use in order to determine an appropriate arm's length price. Practice Note 7 issued by the Commissioner for SARS (1999), which is read with Notice 1334 of Government Gazette 40375 (2016: p. 13), stipulates that South Africa relies on the OECD Guidelines for the purpose of considering and selecting the most appropriate transfer pricing method.

According to the OECD Guidelines (2022a: p. 288) and the World Bank Handbook (Cooper *et al.*, 2016: p. 155), there are five globally accepted transfer pricing methods. These methods are split into traditional and transactional type methods OECD (2022a: p. 288). According to Kamdar (2018: p. 20), traditional transaction methods measure terms and conditions of actual transactions between independent enterprises and compare these with those of a controlled transaction using the basis of price and gross margins. Transactional transfer pricing profit methods do not measure the terms and conditions of actual transactions but measure the net operating profits realised from controlled transactions, and compare those profit levels to the profit level realised by independent enterprises that are engaged in comparable transactions (Kamdar, 2018: p. 20). The traditional methods use a basis of price or gross profit, while the transactional profit methods rely on profit level.

Section 31 of the Income Tax Act does not impose a hierarchy for the transfer pricing methods, which is in line with the OECD Guidelines (SARS, 1999: p. 13). The Commissioner for SARS 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 (SARS, 1999: p. 13). According to the OECD (2022a: p. 94), the traditional and transactional methods can both be applied in a reliable manner but recommends the use of the traditional transfer pricing method as a more preferential method (OECD, 2022a: p. 96).

The traditional transaction methods are regarded as the most direct means of establishing whether the conditions in the commercial and financial relations are at arm's length (OECD, 2022a: p. 93). This is because the arm's length price of a transaction will be determined based on the relative stand-alone price or gross profit on that transaction rather than on the company profitability level (Kamdar, 2018: p. 20). It could be argued that transactional methods are regarded as indirect due to the fact that they take into account other cost drivers that might not be relevant to the MNE or associated enterprise. The Commissioner therefore recommends that, of these methods, the Comparable Uncontrolled Price (CUP) method is preferred as it looks directly to the product or service transferred and is relatively insensitive to the specific functions performed by the entities being compared (SARS, 1999: p. 13). Furthermore, OECD Guidelines do not require the use of

more than one method in any given transaction (OECD, 2022a: p. 96). However, the MNE or associated enterprise must apply a transfer pricing method that will provide a more reliable result than others, depending on the quality of available data and the taxpayer's circumstances (SARS, 1999: p. 13).

SARS (1999: 14) requires that where a taxpayer has considered a number of methods, reasons must be documented for discarding some of the methods. In order to select a method that will yield a more reliable result, consideration may be given to the strengths and weaknesses of each method; the nature of controlled transactions, the availability of reliable information, and the degree of comparability between controlled and uncontrolled transactions (UN, 2017: p. 149; OECD, 2022a: p. 94).

3.3 TRADITIONAL TRANSFER PRICING METHODS

This section discusses in detail the traditional transfer pricing methods and how these are applied, namely, the Comparable Uncontrolled Price (CUP) method, the Resale Price (RP) method and the Cost Plus (CP) method.

3.3.1 Comparable uncontrolled price

According to the OECD Guidelines (2022a: p. 97) and UN Manual (2017: p. 61) the CUP method compares the price charged for a property or service transferred in a controlled transaction to the price charged for a comparable property or service transferred in a comparable uncontrolled transaction in comparable circumstances. The World Bank Handbook (Cooper *et al.,* 2016: p. 155), defines this as a comparative analysis between price charged in controlled and uncontrolled situations but under similar trading environments to determine the arm's length price.

A controlled transaction is thus defined as a transaction that takes place between associated enterprises (OECD, 2022a: p. 21). An uncontrolled transaction is a transaction that takes place between independent parties in an open market (OECD, 2022a: p. 27).

The CUP method therefore uses price information available on a specific product or service in an existing market to determine an appropriate price between a willing buyer and willing seller (which represents an uncontrolled transaction). The existing market to be used as a comparable may exist internally, within the MNE or associated enterprise, where goods and services are also provided to independent third parties, or externally through the use of competitor data (OECD, 2022a: p. 157). The determined price is then used as the basis of the arm's length price in an affected transaction referred to in section 31 of the Income Tax Act.

For an uncontrolled transaction to be comparable to the controlled transaction, one of the following two conditions need to be met (OECD, 2022a: p. 97):

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

The main strengths of the CUP method are that the method requires a detailed transaction analysis, and because the price in the transaction is the subject of the analysis, it is not a one-sided analysis (Cooper *et al.,* 2016: p. 155). On the other hand, the authors also state that a limitation of the method is that the method can be difficult to apply due to the lack of detailed information about transactions that are publicly available.

Furthermore, where detailed data may exist, it is often not comparable due to the independent parties operating or transacting in a different geographical market, or level (Cooper *et al.,* 2016: p. 155). All these factors would have an impact on the price of the transaction. However, where such transactions are identified that are potentially comparable, but have a difference that can materially affect the price, for example operating in a different geographical market, adjustments can be made to the transactions in order to neutralise the impact of these differences (Cooper *et al.,* 2016: p. 157; OECD, 2022a: p. 97). Adjustments are therefore made to the price to reflect the differences between the comparable transaction and the MNE or associated enterprise related party

transactions (OECD, 2022a: p. 98). The OECD Guidance further states that the extent and reliability of the adjustments will affect the reliability of the analysis.

The evidence therefore suggests that a shortcoming in the method is that the adjustments made to the price by the MNE or associated enterprise may distort the price of the transaction and could be manipulated due to the significant judgement required. Practice Note 7 Issued by the Commissioner for SARS (SARS, 1999: p. 13) highlights that where information constraints exist arising from the lack of comparable uncontrolled transactions or published data on gross margins, which prevents the application of the traditional methods, the taxpayer must resort to the transactional profit methods. This method is applied, provided the traditional transactional method is not used merely because it is difficult to obtain data concerning an uncontrollable transaction (OECD, 2022a: p. 94). The criteria determining whether the traditional profit method can be relied upon must be assessed and the method must qualify (OECD, 2022a: p. 94). If the criteria are not met in all prescribed methods, the OECD (2022a: p. 95) provides the MNE or associated enterprise with the freedom to apply any other methods, on condition that these satisfy the arm's length principle in accordance with OECD Guidelines.

3.3.2 Resale price method

The OECD (2022a: p. 101) states that the resale price method (RP method) is most useful when it is applied to market operations and defines it as follows:

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

According to the UN (2017: p. 39) the RP method is used to determine the price to be paid by a re-seller for a product purchased from an associated enterprise and resold to an independent enterprise. The purchase price is set so that the margin earned by the re-seller is sufficient to cover its selling and operating expenses and make an appropriate profit (UN, 2017: p. 39).

Where the MNE or associated enterprise purchases an item from a related party and then re-sells the item to an independent third party, the RP method applies the price that will be charged to the final user to determine an appropriate arm's length cost for the product. The RP method is thus reflected in the formula in the World Bank Handbook (Cooper *et al.,* 2016: p. 158):

Arm's-length price = resale price x (1-gross profit margin)
Gross profit margin = Gross profit/Revenue *100

When assessing comparability for the purposes of applying the RP method, it is important to consider that minor differences in the characteristics of the product may not materially affect the condition being examined (Cooper *et al.,* 2016: p. 158). This is because reasonably accurate adjustments can be made to eliminate the material effects of such differences (OECD, 2022a: p. 97).

According to Cooper *et al.* (2016: p. 160), the main strengths of the RP method are that there is less scope for variables unrelated to the transfer price in the controlled transaction to impact the price. In addition, the method uses market prices as the starting point, which makes it easier to obtain comparable information (UN, 2017: p. 39).

Some weaknesses in the method are that issues can arise where a tax administration is presented with an analysis that relies on a foreign entity that is used as a benchmark for comparable company (Cooper *et al.,* 2016: p. 160). Furthermore, since gross margin data may not be reported, and where there are differences in accounting treatment that cannot be reliably adjusted for due to the unavailability of data (OECD, 2022a: p. 97). As a result, availability of reliable gross margin data for the purposes of applying the resale price method can be problematic in practice (Cooper *et al,* 2016: p. 160).

3.3.3 Cost plus method

The UN Manual (2017: p. 39) defines the Cost Plus (C+ or CP) method as follows:

> The Cost Plus Method is used to determine the appropriate price to be charged by a supplier of property or services to a related purchaser. The price is determined by adding to costs incurred by the supplier an appropriate gross margin so that the supplier will make an appropriate profit in the light of market conditions and functions performed.

According to OECD Guidelines (2022a: p. 106), the CP method is defined as follows:

> The cost plus method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to an associated purchaser. An appropriate cost plus mark-up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction.

Thus, the CP method applies where the MNE or associated enterprise supplies goods or services to which it has added the most value. The method determines the direct and indirect cost of production to mark up to a comparable transaction selling price. The comparable transaction selling price may exist internally within the MNE or associated enterprise where goods and services are also provided to independent third parties, or externally through the use of competitor data. This cost mark-up is then used as the arm's length basis on which to mark up the relevant costs in arriving at a suitable selling price.

The CP method is thus reflected in the below formula by the World Bank Transfer Pricing guidance (Cooper *et al.,* 2016: p. 161):

Arm's-length price = Cost base x (1 + gross profit margin)

Gross profit margin = Gross profit/Revenue *100

Gross margin is calculated as the gross profit/ revenue. Gross profit is determined by revenue less cost of sales. Therefore, in accordance with the reasoning in Practice Note 7 issued by the Commissioner for SARS (1999: p. 13), the operating expenses are excluded and therefore any impact on the relative cost structure should not be material.

According to Cooper *et al.* (2016: p. 160) the main strengths of the CP method are that there is less scope for variables unrelated to the transfer price in the controlled transaction to impact on the price. In addition, the method uses market prices as the starting point which make it easier to obtain comparable information (UN, 2017: p. 39).

Some weaknesses in the method are that issues can arise where a tax administration is presented with an analysis that relies on a foreign-tested party (Cooper *et al.,* 2016: p. 160). Furthermore, gross margin data may not be reported, and there may be differences in accounting treatment that cannot be reliably adjusted for, due to the unavailability of data (OECD, 2022a: p. 97). As a result, availability of reliable gross margin data for the purposes of applying the CP method can be problematic in practice (Cooper *et al.,* 2016: p. 160).

3.4 TRANSACTIONAL PROFIT TRANSFER PRICING METHODS

This section discusses in detail the transactional profit transfer pricing methods and how these are applied, namely, the transactional net margin method (TNMM), and the profit split method. According to the OECD (2022a: p. 94) methods that are based on profits can be accepted only insofar as they are compatible with Article 9 of the OECD Model Tax Convention.

3.4.1 Transactional net margin method

The UN Manual (2017: p. 39) defines the TNMM as follows:

> Profit comparison methods (TNMM/CPM). These methods seek to determine the level of profits that would have resulted from controlled transactions by reference to the return realized by the comparable independent enterprise. The TNMM determines the net profit margin relative to an appropriate base realized from the controlled transactions by reference

> to the net profit margin relative to the same appropriate base realized from uncontrolled transactions.

According to the World Bank Handbook (Cooper *et al.,* 2016: p. 163), TNMM is defined as follows:

> The transactional net margin method examines an appropriate financial indicator (based on net profit) that the tested party realizes in controlled transactions and compares it with that realized in uncontrolled transactions. The profit allocation based on profit indicators for the functions performed by the enterprise.

Another definition is provided in the OECD Guidelines (2022a: p. 113) and states that the TNMM examines the net profit relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realises from a controlled transaction. The guidance further states that the TNMM is similar to the CP method and RP method, and must be applied consistently with those methods in order to be reliable.

The method therefore compares the net profit realised by independent parties to that realised in a transaction with an associated enterprise, against an appropriate base. Net profit is determined by taking into account all sales and expenses, including the tax, and the MNE or associated enterprise may decide to adjust ratios for costs to improve the comparability. The MNE or associated enterprise must determine the appropriate base to use by calculating an appropriate ratio. According to the OECD (2022a: p. 114), the ratio should be a net profit indicator such as return on assets, operating income to sales, and any other suitable measure of net profit.

The OECD Guidelines (OECD, 2022: p. 119) further state that the selection criteria for an appropriate net profit indicator should follow the guidance used in determining an appropriate transfer pricing method. The selection criteria should therefore take into account the strengths and weaknesses of the possible indicators, the appropriateness of the indicator determined through a functional analysis, the availability of reliable information, and the degree of comparability, after taking into account possible adjustments or differences.

As a matter of principle, only those items that meet the following criteria should therefore be taken into account in the determination of the net profit indicator (OECD, 2022a: p. 119):

(a) directly or indirectly relate to the controlled transaction at hand; and
(b) are of an operating nature for the application of the transactional net margin method.

The main strengths of the TNMM are that, as the condition being examined is at the net margin level. There is more potential comparable information available (Cooper *et al.*, 2016: p. 164). This is due to the net margin being less likely to be materially affected by differences in the product or service or minor functional differences. According to the OECD (2022a: p. 114), the net profit indicators are less affected by transactional differences in comparison with the CUP method. The OECD further states that the net profit indicators are more tolerant to functional differences between controlled and uncontrolled transactions in comparison to gross profit margins.

In addition, the TNMM is also very flexible in its application, in that the net margin can be compared to different bases depending on the financial indicator (Cooper *et al.*, 2016: p. 164). SARS Practice Note 7 issued by the Commissioner for SARS (1999: p. 13) refers to this method as being reasonably objective because comparables are applied. However, the Practice Note states the method is inferior to the RP method or CP method if there is available information available to apply all three methods (SARS, 1999: p. 14). This is because comparing operating expenses requires a similar structure of business to be truly reliable (SARS, 1999: p. 14).

A weakness in the method is that the net profit indicator of a MNE or associated enterprise can be influenced by factors that would not have an effect on the price or gross margins between independent parties (OECD, 2022a: p.115). For example, related party fees and other transactions, which may be difficult to pinpoint, may affect the net profit determined and thus make it difficult to obtain an accurate and reliable arm's length net profit.

In addition to this weakness, many factors that are unrelated to transfer prices may affect the net profits and there may be difficulties in determining an appropriate corresponding adjustment (OECD, 2022a: p. 116). These potential issues are highlighted by the OECD as matters relating to

the inclusion of interest due to the correlation between credit terms and sales prices, foreign exchange gains and losses, interest on financing activities, differences in accounting treatment, and the treatment of start-up and termination costs, where the guidance has left this decision to the associated enterprises to determine the treatment based on the relevant circumstances.

Central to determining the arm's length price is the accessibility and availability of comparable information. The OECD (2022a: p. 115) states that information on uncontrolled transactions at the specific time of the transaction may be difficult to obtain, however this could be mitigated through the use of multiple year data.

3.4.2 Transactional profit split method

In 2022 the OECD updated the transfer pricing guidelines that were previously published in 2017, and the updates to the guidelines relate to the profit split transfer pricing method. According to Mukumba and Hofmeyer (2022: p. 29), the guideline contains further specific information on circumstances in which the profit split method is most appropriate, and provides further guidance on how to apply the method. These changes are also discussed in more detail below.

According to the OECD (2022a: p. 24), the transactional profit split method is defined as:

> A transactional profit split method that identifies the relevant profits to be split for the associated enterprises from a controlled transaction (or controlled transactions that it is appropriate to aggregate under the principles of Chapter III) and then splits those profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been agreed at arm's length.

The definition has not changed from the definition provided in the UN Manual (2017: p. 40) and defines the profit-split method as follows:

> Profit-split methods take the combined profits earned by two related parties from one or a series of transactions and then divide those profits using an economically valid defined basis that aims at replicating the division of profits that would have been anticipated in an

agreement made at arm's length. Arm's length pricing is therefore derived for both parties by working back from profit to price.

The profit allocation within a value supply chain on the functions performed is based on a profit allocation that would have been agreed by independent parties in an open market. This method will therefore apply where there are different parties involved in supplying the goods or services in the transaction.

The transactional profit split method would therefore be most appropriate to use in the following transfer pricing scenarios (Mukumba & Hofmeyer, 2022: p. 29):

- where the parties are making unique and valuable contributions under the intragroup transaction, as there will not likely be comparable transactions as the contributions are unique;
- where the business operations of the transacting parties are highly integrated, because in such instances the value created and to be apportioned is dependent on the existence of the integration; and
- where the parties share the economically significant risks in a transaction, such that each party can expect a share of profits, the risks may not be susceptible to reliable separation for each party.

According to the OECD (2022a: p. 132), a party that has a "unique and valuable" contribution under an intragroup transaction must meet the following criteria:

(i) they are not comparable to contributions made by uncontrolled parties in comparable circumstances; and
(ii) they represent a key source of actual or potential economic benefits in the business operation.

According to Cooper *et al.* (2016: p. 168), when applying the profit split method, different approaches may be used for determining the appropriate (arm's-length) split of profits between the parties:

- Contribution analysis: Combined profits from the controlled transactions allocated between the associated parties on the basis of their relative contributions;
- Comparable profit split: Combined profit (or loss) is split by reference to comparable splits between independent enterprises; or
- Residual analysis: Two-step approach that first allocates profits to nonunique (routine) activities and then splits the residual profit on an economically valid basis.

According to the OECD (2022a: p. 137), the transactional profit split method aims to split the relevant profits from controlled transactions on an economically valid basis to reflect independent circumstances. The guidance further states (OECD, 2022a; p. 142) that the following criteria should be used when splitting the profit:

- Independent of transfer pricing policy formulation, i.e. they should be based on objective data (e.g. sales to independent parties), not on data relating to the remuneration of controlled transactions (e.g. sales to associated enterprises),
- Verifiable, and
- Supported by comparables data, internal data, or both.

These split methods are therefore discussed briefly below.

3.4.2.1. Contribution analysis

The contribution analysis requires that combined profits from the controlled transactions be determined and then allocated between the associated parties on the basis of their relative contributions in deriving those profits (Cooper *et al.,* 2016: p. 169). The allocation should be based on sound economic principles and should reflect an approximation of the division of the profits that would have been agreed by independent parties (Cooper *et al.,* 2016: p. 169). The profits will generally be split at the operating profit level. The authors, however, also state that a split of gross profits or otherwise may be appropriate depending on the facts and circumstances. According to the OECD (2022a: p. 137), the determination of the approach can be made by comparing the nature and degree of each party's differing contribution.

Cooper *et al.* (2016: p. 169) describe four approaches that could be applied (either alone or in combination) to quantitatively evaluate the contributions of the parties, based on:

- Capital investment – Assessment of the relative contributions of the parties based on the capital they have invested;
- Compensation – Use of labour cost data to quantify the parties' contributions;
- Bargaining theory – evaluate the relative bargaining positions of the parties and thus obtain insight into their respective contributions; or
- Survey – Use of expert opinions of internal and external observers regarding the assumptions for the split.

3.4.2.2 Comparable profit split

A comparable profit split requires that the profits are allocated between the parties to the controlled transactions with reference to similar splits of profits between independent parties (Cooper *et al.,* 2016: p. 169). The authors also state that the split method is often not applied in practice due to the limited availability of information.

3.4.2.3 Residual analysis

The residual analysis is applied where some contributions of the parties can be reliably valued by reference to a one-sided method and benchmarked using comparables, while others cannot (OECD, 2022a: p. 138). Residual analysis divides the profits under examination into two categories, referred to as a two-step approach, for determining the allocation of the combined profits from the controlled transactions (Cooper *et al.,* 2016: p. 169):

1. Each party is allocated profits based on their non unique (or routine) contributions; and
2. The residual profits (profits remaining after step 1) are allocated on an economical basis with reference to the particular facts and circumstances.

The main strength of the transactional profit split method is that can offer a solution and flexibility for cases where both parties make unique and valuable contributions to the transaction (OECD, 2022a: p. 129). This is because where the associated enterprises enter into a transaction and the economic contributions relevant to the transaction are difficult to value, the transactional split method will base the arm's length profits on the profit split of a comparable company with a similar transaction between independent third parties.

In addition, the transactional split method can provide a solution for highly integrated operations for which a one-sided method would not be appropriate (OECD, 2022a: p. 129). The OECD Guidelines identify further relevance, in that the contribution and the relative values of each party are directly evaluated in the transaction in order to determine the arm's length profit.

According to the OECD (2022a: p. 130), a weakness of the transactional profit split method relates to the difficulties with its application due to the detailed information required for the application. The guidance further states that it may be difficult to identify operating expenses related to a comparable transaction and to allocate these costs between the transactions and the other activities that the comparable may engage in.

3.5 TRANSFER PRICING DOCUMENTATION

Any transfer pricing arrangement has two aspects, a local and an international aspect. This means that transfer pricing documentation must apply the domestic principles of all countries in which the transaction is taking place (OECD, 2022a: p. 239). Transfer pricing documentation is therefore important for uniformity and alignment of the information supplied to each tax authority. According to Alexander and Miller (2022: p. 28), the documentation is essential for supporting the arm's length nature of these transactions.

In terms of section 25 of the Tax Administration Act, a person is required under a Tax Act or by the Commissioner to submit a return in the prescribed form and manner. Therefore, the first documentation requirement will be the income tax return (known as the ITR14 for companies). The ITR14 contains a detailed section that the taxpayer must complete in relation to its cross-border transactions entered into with its connected persons (SARS: 2022a, 1).

Further documentation is required to be kept in terms of section 29 of the Tax Administration Act. This documentation includes records, books of account or any documents that would prove compliance with the Tax Act.

3.6 COUNTRY-BY-COUNTRY REPORTING

According to SARS (2022a: p. 1), MNE Groups with group annual revenue less than R10 billion are not required to file Country-by-Country (CBC) returns, while those MNE Groups with revenues that exceed R10 billion (or EUR 750 million) are required to file returns within 12 months of the financial year.

Taxpayers who have to file for CBC or have "potentially affected transactions" (affected transaction as defined in section 31 of the Income Tax Act) that exceed or are reasonably expected to exceed R100 million are required to submit a master file and local file detailing the transaction (SARS, 2022a: p. 1). The submission must detail the company's pricing policies and the supply chain of the business (SARS, 2022a: p. 1). For transactions less than R100 million, no documentation is required (SARS, 2022a: p. 1). Where a CBC report is required to be filed, a CBC report, master file and local file must be filed by the Ultimate Parent Entity or the Constituent Entity (SARS, 2022a: p. 1).

A multinational taxpayer is required to maintain master file, local file documentation and CBC reporting. The content and scope across the three files is expected to be consistent. According to Cooper *et al.* (2016: p. 254), there are three key aspects relating to compliance which are relevant for foreign investment in another country and directly applicable to transfer pricing documentation:

1. the existence of procedural rights and duties of all taxpayers in the other country, including the burden of proof create an environment for tax certainty;
2. a balanced approach reduces tax compliance costs; and

3. strong confidentiality rules and the appropriate use of information rules. Any request for information beyond BEPS action 13 should be carefully considered in terms of a risk assessment and justified. Confidentially conditions are included in the master file and local file documentation reports.

Section 31 of the Income Tax Act does not provide for any specific penalties or compliance incentives pertaining to the filing of transfer pricing documentation; however, general administrative penalties apply. These penalties are described in 3.7.2.2 below:

3.7 TRANSFER PRICING DISPUTES

According to the OECD (2022a: p. 173), disputes between a taxpayer and a tax authority may arise even if the transfer pricing guidelines have been followed in applying the arm's length principle. Due to the complexity, judgement and interpretation required, taxpayers and tax authorities can reach different conclusions on the transfer pricing method or its calculation. The OECD further states that where there are two or more tax administrations, double taxation may occur. This section will therefore discuss disputes between a taxpayer and tax authority arising from transfer pricing adjustments and double taxation.

According to Cooper *et al.* (2016: p. 317), the cost of transfer pricing disputes can be substantial, given the need for intensive factual development of cases. In the context of disputes, these will be discussed below in two sections: preventing disputes from arising, and once disputes do arise, how quickly an administrator is able to resolve these.

3.7.1 Preventing disputes from arising

The following methods can be applied to prevent transfer pricing disputes from arising between a taxpayer and the tax authority.

3.7.1.1 Advance pricing agreements

According to Cooper *et al.* (2016: p. 319), an advance pricing agreement (APA) is an agreement that specifies the transfer pricing approach that the taxpayer will use for intercompany transactions. An APA covers multiple years in the future, and allows multinational taxpayers and tax authorities to avoid or reduce the potential for audits, uncertainty, investor risk, and compliance costs (Cooper *et al.,* 2016: p. 319). In addition, an APA may also decrease the likelihood of double taxation and proactively prevent transfer pricing disputes (OECD, 2022a: p. 213). According to the OECD (2022a: p. 213), APAs are intended to supplement the traditional administrative, judicial, and treaty mechanisms for resolving transfer pricing issues. The OECD further states that an APA is most useful where the traditional mechanisms fail or are difficult to apply.

South Africa does not currently apply APAs, however a proposed model for establishing an Advance Pricing Agreement Programme in South Africa and draft legislation (draft APA legislation) were issued by SARS in 2021 for public commentary (SARS, 2021d: pp. 1-13). According to SARS (2021d, p. 4), the decision to issue a proposed model for public commentary follows the SARS transfer pricing capacity issues previously raised and SARS notes that the draft APA legislation system uses the lessons learnt from the existing advance tax ruling system as a basis.

According to Nkonki and van Rooy (2022: p. 10), the draft APA legislation is likely to take between 18 to 30 months to put in place. SARS (2021d: p. 6) states that the APA program legislation is envisaged to form part of section 90A to 90Q in Chapter 7 of the Tax Administration Act. The draft legislation also states that the APA pilot phase will only accept bilateral APAs and will take the resulting experiences into consideration before branching out into multilateral and unilateral APAs.

While South Africa does not have APAs in place, any person who engages in transfer pricing transactions is required to comply with the requirements for transfer pricing documentation (SARS, 2022a: p. 1). APAs will be explained in more detail in the following chapter.

3.7.1.2 Safe harbours

According to Cooper *et al.* (2016: pp. 318-319), safe harbours are a simplification measure applying to a group of taxpayers and/or transactions providing certainty with respect to the appropriate applicable transfer pricing method and/or result. Safe harbours substitute simpler obligations for those under the general transfer pricing regime (OECD, 2022a: p. 205). These may include exemption from the application of all or part of the general transfer pricing rules, or relief from compliance obligations associated with transfer pricing documents. Similar to an APA, the OECD Guidelines state that a safe harbour can be unilateral, bilateral or multilateral.

Safe harbours are suitable for entities that do not assume important risks or make use of valuable intangibles (Cooper *et al.,* 2016: pp. 318-319). A safe harbour is thus appropriate for taxpayers who have low transfer pricing risk and when they are adopted on a bilateral or multilateral basis (OECD, 2022a: p. 204). According to Deloitte (2013: p. 2), indicators of a low transfer pricing risk include the following:

- a low volume of transactions;
- the presence of comparable uncontrolled transactions that are used to establish the transfer price;
- transactions with entities in jurisdictions with relatively higher marginal tax rates; and
- the presence of minority shareholders whose interest would be influences by the division of profit between the related parties.

The OECD (2022a, p. 203) does not advise or recommend the use of unilateral safe harbours. The guidance clarifies that this is because the application of safe harbour rules raise fundamental problems on the compatibility of measures with the arm's length principle, which may therefore have a negative impact on the tax revenues.

The benefits of bilateral or multilateral safe harbours include compliance relief for the taxpayer, certainty for the taxpayer, and administrative simplicity due to the limited scrutiny of the transfer prices (OECD, 2022a: pp. 205-206). The shortcomings of safe harbours, according to the OECD Guideline, include: that the simplified measurement of affected transactions is not in accordance

with arm's length principles, the increased risk of double taxation, that it may potentially create avenues for inappropriate tax planning, and that it lacks equity and uniformity in the application for the taxpayers involved.

Due to the limitations of safe harbours, an APA is more widely used and accepted as a dispute resolution and tax certainty tool by tax authorities in response to BEPS. Therefore, an APA would first be considered before a safe harbour. South Africa does not currently apply safe harbours and there are no reported publications on the topic.

3.7.1.3 Transfer pricing audit coordination

International transfer pricing disputes arise after unilateral audits of cross-border transactions (Cooper *et al.,* 2016: p. 327). Coordination between tax administrations at an early stage of an audit may thus help ensure that both tax administrations' audit teams take into account the position of the other country (Cooper *et al.,* 2016: p. 327). International coordination of transfer pricing audits can be achieved by conducting simultaneous or joint audits.

In the context of South Africa, coordination is limited to the exchange of information and reciprocal assistance provided for in international tax agreements to enable unilateral tax investigations (Fairbairn & Sease, 2022: p. 26). There are no reported international coordinated transfer pricing audits or cases. According to Fairbairn & Sease (2022: p. 26), this is because there is no regulatory framework in place to enable SARS and foreign administrations to work together to conduct a joint audit. The authors further state that this will soon change following the announcement by the Minister of Finance of the introduction of rules that enable SARS to conduct joint audits with foreign tax administrations.

According to SARS (2020, p. 5), tax authorities would prefer joint audits due to an ever-increasing pace in the transfer pricing arena. The OECD Secretariat (2012: p.4) stated that, if a country has the capacity to carry out effective audits, it is unlikely that devoting resources to an APA will be more effective in raising revenue. The OECD statement applies to an existing and functioning area within the tax administration. Due to the lack of regulatory framework in place for joint audits in

South Africa, the discussion below will be based on the application of unilateral transfer pricing audits.

3.7.2 Resolving transfer pricing disputes

The following can be considered as ways in which transfer pricing disputes could be resolved once they have occurred between a taxpayer and the tax authority.

3.7.2.1 Mutual agreement procedures

According to the OECD (2022a: p. 181), a mutual agreement procedure (MAP) is defined as a well-established means through which tax administrations consult to resolve disputes regarding the application of double tax conventions. According to SARS (2022b: p. 1), MAP is a procedure that allows the competent authorities or designated representatives of the competent authorities of the governments of the contracting states/jurisdictions to interact with the intent to resolve international tax disputes. Article 25 of the OECD Model Tax Convention (2017a: p. 21) authorises the competent authorities or their designated representatives to communicate with each other directly, for the purpose of resolving the matters that might be brought before them.

In the context of South Africa, section 108 of the Income Tax Act states that South Africa "may enter into an agreement with the government of any other country, whereby arrangements are made with such government with a view to the prevention, mitigation or discontinuance of the levying, under the laws of the Republic." Double Taxation Agreements (DTAs) therefore permit the use of MAP for resolving issues that arise from the application of a particular article between two states. According to SARS (2022b: 1), a MAP request for assistance may include transfer pricing adjustment requests.

3.7.2.2 Penalties

According to the OECD (2022a: p. 178), penalties are directed towards providing disincentives for non-compliance. This is done by charging a penalty for tax underpayments and other types of non-compliance to make this more expensive than the cost of compliance (OECD, 2022a: p. 178). The OECD (2022a: p. 180) states that an overly harsh penalty system in one jurisdiction may give taxpayers an incentive to overstate taxable income in that jurisdiction, contrary to Article 9 of the OECD model tax convention.

In the context of South Africa, penalties are levied in terms of section 210 of the Tax Administration Act for failure to comply with transfer pricing documentation. If an affected transaction is not stated at its arm's length price in terms of section 31 of the Income Tax Act, section 31 provides for a primary transfer pricing adjustment to the taxpayer's taxable income, in order to reflect the arm's length consideration of the transaction (section 31(3)), and the tax is levied as an additional assessment in terms of section 92 of the Tax Administration Act. Additionally, an understatement penalty will also be imposed in terms of section 223 of the Tax Administration Act. In terms of section 31(3) of the Income Tax Act, the primary adjustment – the difference in the taxable income resulting from the non-arm's length transaction – will result in a deemed dividend *in specie* for a company, and be subject to dividends tax at the rate of 20% (section 64E(1)(a)(i) of the Income Tax Act). In the case of a person other than a company, section 31(3)(b)(ii) of the Income Tax Act states that the difference will be a deemed donation and subject to donations tax levied at either 20% or 25%, depending on the amount of the difference, in terms of section 64 of the Income Tax Act.

According to the OECD (2019: p. 25), no single prevention or resolution tool can resolve all the possible disputes, but together they can significantly advance the tax certainty agenda. While South Africa does apply MAP and penalties as resolutions for potential transfer pricing disputes, there are no methods currently used that prevent the disputes from occurring. Therefore, to enhance tax certainty, the use of APAs in comparison to audits will be discussed in the following chapter.

3.8 CONCLUSION

This chapter discusses the various transfer pricing methods. According to the OECD Guidelines (2022a: p. 288), there are five globally accepted transfer pricing methods, namely, the Comparable Uncontrolled Price (CUP), Resale Price (RP), Cost Plus (CP), Transactional Net Margin Method (TNMM), and the profit split method.

CUP is a traditional transfer pricing method and uses the information that is available in an existing market to determine an appropriate price for the transaction between a willing buyer and willing seller. In order for the transaction to be comparable, the OECD (2022a: p. 97) requires that one of the following two conditions must be met:

a) None of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or
b) Reasonably accurate adjustments can be made to eliminate the material effects of such differences.

While a detailed analysis required by the method is one of its strengths, the main drawback in applying the CUP is the information constraints that may exist, or the difficulty in determining and making accurate adjustments to eliminate material effects of any differences.

RP is a traditional transfer pricing method that takes into account the price that will be charged to the final buyer of the product and it uses that to work back to an appropriate cost of the product. The main strength of the RP method is that it is easier to obtain information due to the fact that the method uses market prices as the starting point, rather than internal information. A drawback of the method is that it may be difficult to obtain the gross profit percentages that will enable MNEs to work back to the cost.

CP is a traditional transfer pricing method that uses the cost of production to mark up to an appropriate selling price on which to base the arm's length price. The main strength of the method is that there is less scope for variables that are unrelated to the price of the transaction that could impact on the price, due to the fact that operating expenses are excluded.

TNMM is a transactional profit transfer pricing method and compares the net profit realised by an independent party to the MNE. The main strength of the TNMM is that there is more comparable information based on the net margin method. While there is more information readily available for the MNE to use as a comparable, the main drawback is that the method is not reliable unless the MNE can prove that the operating structure of the businesses are similar and therefore would incur the similar operating expenses.

Profit split is a transactional profit transfer pricing method and uses the profit allocation that would have been agreed by independent parties in an open market as a basis for an arm's length cost. There are three different approaches to determining the profit allocation between parties. According to Cooper *et al.* (2016: p. 168), these are the contribution analysis, the comparable profit split and the residual analysis.

In order to determine an appropriate transfer price in terms of section 31 of the Income Tax Act, a taxpayer must select a method that will provide the most reliable information and basis for an arm's length price based on the facts and circumstances of the case. The OECD Guidelines (2022a: p. 96) do not require the use of more than one method and a hierarchy is not provided for these methods, however the traditional methods are preferred.

In addition to the transfer pricing methods, the chapter also discusses the required transfer pricing documentation and approaches to resolving transfer pricing disputes. In addition to filing an Income Tax return, a MNE that has an affected transaction that is expected to exceed R100 million or is required to file CBC reporting, must file a local file and a master file in each country where the transaction took place. CBC reporting is also required where the group annual revenue of the MNE exceeds R10 billion.

In the context of transfer pricing disputes, these were considered in two parts, preventing disputes from arising and once disputes do arise, how quickly a tax administration can facilitate the dispute resolution. One way of preventing disputes from arising is by entering into an APA. This therefore leads into the next chapter, which explores the use of APAs. South Africa does not currently apply APAs due to the challenges faced by SARS in implementing an APA, which are mainly due to capacity constraints. SARS acknowledged the suggestion by the Davis Tax Committee (2016) to outsource the required skills. However, the present challenge is how the outsourcing could be funded or how conflicts of interest could be managed in the small transfer pricing community in South Africa (SARS, 2020: p. 3). A proposed model for establishing an APA programme and draft legislation was issued in 2021 by SARS (1999) for public commentary.

Advance pricing agreements are discussed in the next chapter.

CHAPTER 4: ADVANCE PRICING AGREEMENTS

4.1 INTRODUCTION

The previous chapter discussed transfer pricing methods, transfer pricing documentation, and transfer pricing disputes, and how these are resolved. The OECD (2022a: p. 213) recommends that one method of avoiding transfer pricing disputes is through the use of APAs. This chapter therefore defines and discusses APAs and the role they play in avoiding tax disputes, thus addressing the third sub-goal of the research.

According to Nkonki and van Rooy (2022: p. 10), transfer pricing audits are one of the largest risks for multinationals and the use of an APA proactively avoids disputes for the tax authority and taxpayer, and creates greater tax certainty. The role APAs play is therefore discussed by defining APA, discussing the three different types of APAs, namely, unilateral, bilateral and multilateral, and how these are applied between a taxpayer and the tax authority. The advantages and disadvantages of using APAs for a taxpayer and the tax authority are discussed. The chapter concludes by discussing Advance Tax Rulings as a possible alternative to APAs, the types of Advance Tax Rulings, and the advantages and disadvantages in comparison to an APA.

4.2 ADVANCE PRICING AGREEMENTS

According to the OECD Guidelines (2022a: p. 213), an APA is an –

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

Another definition that can be found in the UN Manual (2017: p. 52) focuses on the cross-border component of the definition of an APA:

> These APAs are so named because pricing methodologies are agreed in advance in relation to certain types of transactions, often called the "covered transactions." APAs provide greater certainty for the taxpayer on the taxation of certain cross-border transactions and are considered by the taxpayers as the safest way to avoid double taxation, especially where they are bilateral or multilateral. Many countries have introduced APA procedures in their domestic laws though these may have different legal forms. For example, an APA may be a legally binding engagement between taxpayers and tax authorities in certain countries. In contrast, it may be a more informal arrangement between the tax authorities and the taxpayer.

According to Cooper *et al.* (2016: p. 319), an APA is defined as an agreement that specifies the transfer pricing approach that the taxpayer will use for intercompany transactions. Therefore, an APA is a written contract between a taxpayer and tax administration to determine agreed criteria for transactions, including the price, method, comparability analysis, duration, and assumptions, to address potential transfer pricing audits or disputes. Ultimately, the purpose of APAs is to avoid disputes and create an environment of tax certainty that investors look for.

An APA may include all transfer pricing issues on which a taxpayer wishes to obtain advance certainty. Since an APA determines the pricing of future transactions, it is mandatory to include critical assumptions. According to Givati (2009: p. 30), the taxpayer discloses to the tax authorities details of the business operations and other relevant information, and submits a proposed transfer pricing methodology. These cover aspects such as operational and economic conditions that may affect the reliability of the pricing method. The purpose of the critical assumptions is to protect both the taxpayer and the tax administration against the risk that an agreement may result in an outcome that is not in accordance with the arm's-length principle.

According to the OECD (2022a: p. 216), once a tax administration enters into an APA, compliance with the agreement must be monitored, and this is done in two ways. The OECD states that the first involves requesting the taxpayer to file annual reports demonstrating the extent of its compliance with the terms and conditions stipulated in the APA. According to Cooper *et al.* (2016: p. 319), this also confirms whether the critical assumptions still remain relevant. Secondly, the OECD states that compliance is monitored by examining the taxpayer's records as part of the audit

cycle, without revaluating the methodology. Cooper *et* al. (2016: p. 319) confirm that this is usually done through a verification.

4.3 TYPES OF ADVANCE PRICING AGREEMENTS

According to the OECD (2022a: p. 215), an APA can be either unilateral, bilateral, or multilateral.

4.3.1 Unilateral Advance Pricing Agreements

Cooper *et al.* (2016: p. 319) explain that unilateral APAs are agreements between a taxpayer and tax authority. A unilateral APA will therefore be entered into by a single taxpayer and one tax authority.

An affected transaction as defined in section 31 of the Income Tax Act involves a resident and non-resident, therefore the transaction does not solely take place in one country. A unilateral APA entered with one country will therefore not avoid the possibility of double taxation, as a MNE would still need to prove the price of the transaction to the second country in which the transaction takes place or to where profits are shifted. Therefore, as stated by the OECD (2022a: p. 219), a unilateral agreement will not lead to an increased level of certainty for the taxpayer, or a reduction in double taxation.

According to Cooper *et al.* (2016: p. 319), if a country does not have a tax treaty in place between the two countries in which the parties to the transaction are tax residents, a unilateral APA is normally the only option available to taxpayers. The authors also state that a unilateral APA serves as a last resort where a request for an APA by a country with a tax treaty has been rejected by the tax treaty partner.

4.3.2 Bilateral Advance Pricing Agreements

Bilateral APAs involve a taxpayer seeking an agreement with and between two tax authorities, which is then implemented domestically in each country (Cooper *et al.*, 2016: p. 319). A bilateral agreement therefore serves to resolve tax disputes between a taxpayer and two tax authorities

(Cooper *et al.,* 2016: p. 319). This is designed to assist the taxpayer from avoiding double taxation and reducing the compliance costs involved.

A bilateral APA must be considered within the scope of the mutual agreement procedure under Article 25 of the OECD Model Tax Convention (OECD, 2022a: p. 217). Paragraph 3 of Article 25 of the OECD Model Tax Convention (2017a: p. 21) states that competent authorities must stive to resolve any difficulties in the interpretation and application of the convention and must work together to eliminate the effects of double taxation.

De Waegenaere, Sansing, and Wielhouwer (2007: p. 173) describe the process of entering into a bilateral APA: the taxpayer approaches the authorities prior to engaging in a transaction with a foreign related party to negotiate a mutually acceptable transfer price. This process would involve the choice of a transfer pricing method. The authors further state that a taxpayer provides detailed information regarding the proposed transaction and, in return, the authorities commit to a transfer price that ensures that the taxpayer will not be subject to double taxation.

According to De Waegenaere *et al.* (2007: p. 175), bilateral APAs occur less frequently when the tax rates of the two countries are similar. The authors also state that in the event that a bilateral APA is entered into by two countries with similar tax rates, the country with a marginally higher tax rate does not have to audit as frequently to deter the taxpayer from shifting its taxable income toward the lower tax rate country. This is because dispute over the tax rate is unlikely due to the insignificant difference and the risk of double tax would be mitigated through the use of DTAs.

4.3.3 Multilateral Advance Pricing Agreements

A multilateral APA is an agreement between more than two tax authorities and a taxpayer (Cooper *et al.*, 2016: p. 319). This is designed to assist the taxpayer to avoid double taxation and reduce the compliance costs involved.

A multilateral APA must also be considered within the scope of the mutual agreement procedure under article 25 of the OECD Model Tax Convention (OECD, 2022a: p. 217). It is therefore

suggested that the conclusion of these multilateral APAs, and the collaboration between the tax authorities, may present a valuable way of avoiding the uncertainties of transfer pricing audits, and the risk of double taxation.

4.4 ADVANTAGES AND DISADVANTAGES OF AN ADVANCE PRICING AGREEMENT

APAs are not a solution to all transfer pricing problems, and have both advantages and disadvantages.

4.4.1 Advantages of Advance Pricing Agreements

The advantages associated with APAs for a taxpayer and tax administration are discussed in the below.

4.4.1.1 Tax certainty

The main advantage of entering into an APA, described by the OECD is tax certainty (OECD, 2022a: p. 218). The IMF and the OECD 2019 Progress Report on Tax Certainty (2019: p. 6) state that tax certainty for taxpayers is an important component of investment decisions and can have significant impacts on economic growth, and therefore, tax certainty remains a priority issue for taxpayers and tax administrations.

According to the IMF and the OECD (2019: p. 6), the shifting focus from dispute resolution to dispute prevention is a core element of tax certainty as this ensures that disagreements between tax administrations can be resolved quickly to avoid double taxation. Uncertainty can therefore be eliminated through enhanced predictability of the taxation of international transactions (UN, 2017: p. 375, OECD, 2022a: p. 218). However, this is on the basis that critical assumptions are met (OECD, 2022a: p. 218).

According to Bankbazaar (2022: p. 1), APAs offer certainty in terms of the tax liability of taxpayers' foreign transactions by the application of arm's length pricing techniques to decide on the prices of international transactions. The IMF and the OECD (2019: p. 10) confirm that a key

component of tax certainty is ensuring that the tax rules are clear and administrable. Therefore, while tax certainty can be provided through the use of APAs, this can only be done if the tax rules are clear and administrable for the taxpayer and the tax authority.

4.4.1.2 Resolving and avoiding transfer pricing disputes

An APA involves a cooperative process with the taxpayer. An APA typically covers multiple years into the future, and allows multinational taxpayers and tax authorities to avoid or reduce the potential for audits, uncertainty, investor risk, and compliance costs (Cooper *et al.,* 2016: p. 319). APAs can provide an opportunity for both tax administrations and taxpayers to consult and cooperate in a non-adversarial spirit and environment (UN, 2017: p. 375, OECD, 2022a: p. 218). This environment is created through the opportunity to discuss complex tax issues in a less confrontational atmosphere, such as an audit (OECD, 2022a: p. 218).

The bilateral and multilateral APAs entered into require input, examination and consultation in agreeing at an appropriate price for the transaction. Therefore, according to the OECD (2022a: p. 218), this close consultation and co-operation between the tax administrations may lead to closer relations with treaty partners on transfer pricing issues.

Transfer pricing is intensive with regard to the documentation required, and transfer pricing documentation involves local files, master files and CBC Reporting for each of the jurisdictions involved. An APA, specifically a bilateral or unilateral agreement, will provide for uniformity in the documentation and disclosure of the involved transaction/s. The disclosure and information aspects of an APA programme, as well as the cooperative attitude under which an APA can be negotiated, may assist tax administrations in gaining insight into complex international transactions undertaken by MNEs (UN, 2017: p. 375).

4.4.1.3 "Roll back" as a mechanism for resolving prior disputes

According to the World Bank Handbook (Cooper *et al.,* 2016: p. 319), an important advantage of an APA is a "roll back". A rollback involves a taxpayer requesting an APA term (going forward), but also for the agreed result to be "rolled back" for the number of years to documents already filed (Cooper *et al.,*2016: p. 319). It is thus also an important decision whether or not to allow rollback of an APA (Cooper *et al.,* 2016: p. 319).

In the final report to Action 14 of the BEPS project (OECD, 2015: p. 21), recommendation 2.7 states that in appropriate cases a rollback of APAs should be performed where a country has a bilateral advance pricing arrangement programme. The report further states that this is subject to the applicable time limits where the relevant facts and circumstances in earlier tax years are the same and subject to the verification of these facts and circumstances on audit. This recommendation in Article 14, therefore uses the rollback as a mechanism for resolving audit cases. This grants the tax administration power to identify transactions in prior years for which a taxpayer might not have been selected for an audit.

4.4.1.4 Cost savings for the taxpayer and tax authority

According to the IMF and the OECD (2019: p. 15), APAs require considerable time and effort to conclude as the agreement may take several years to negotiate, and the issues of asymmetric information can pose significant risks to tax authorities. However, the authors further elaborate that such upfront diligence and costs can result in future time-savings and prevent disputes from arising.

According to the OECD (2022a: p. 218), an APA may prevent costly and time-consuming examinations and litigation in respect of major transfer pricing issues for taxpayers and the tax administration. The OECD guidance explains that for the tax administration, this is due to the fact that once an APA has been agreed, less resources will be needed over the term of the agreement for subsequent examination of the taxpayer's returns. An APA therefore gives an authority the ability to reduce expenses of administration in the future. For the taxpayer, these cost savings will be as a result of lower costs incurred over the years for specialist guidance regarding the treatment

of transactions with their associated enterprises, and possible legal costs for transfer pricing disputes.

The OECD (2022a: p. 219) states that bilateral and multilateral APAs substantially reduce or eliminate the possibility of juridical or economic double taxation. Therefore, an added advantage for the taxpayer that results in lower compliance costs over the term of the APA is the elimination of double taxes.

4.4.2 Disadvantages of Advance Pricing Agreements

The disadvantages associated with APAs for a taxpayer and tax administration are discussed below.

4.4.2.1 May be too specific

According to the OECD (2022a: p. 213), a key issue in APAs is how specific they can be in prescribing a taxpayer's transfer pricing over a period of years. The guidance elaborates on this by stating that great care must be taken if the APA goes beyond the methodology and the critical assumptions, as more specific conclusions rely on the predictions about future events.

4.4.2.2 Adverse tax liabilities of associated enterprises in other jurisdictions

According to the OECD (2022a: p. 214), a unilateral APA may affect the tax liability of associated enterprises in other tax jurisdictions. This is because a unilateral APA is an agreement between a taxpayer and one tax administration and will only take into account the impact of those transactions in one country, without the involvement of other jurisdictions. The OECD further explains that a unilateral agreement may result in double taxation for the taxpayer and recommends the use of a bilateral or multilateral agreement to provide greater certainty to the taxpayer and to all tax administrations involved.

4.4.2.3 Not suitable for all transactions

A limitation of APAs is that they may not be suitable for all transactions. According to the OECD (2022a: p. 220), an APA may include an unreliable prediction of changing market conditions, without adequate critical assumptions. This could either be due to the difficulty associated with forecasting or the associated enterprise operating in a market that is volatile. According to Cooper *et al.* (2016: p. 319), this includes transactions that may be too small to justify entering into an APA, fast-moving industry transactions, which make it difficult to set prices into the future, and transactions with tax havens based on aggressive tax planning that are better handled as part of an audit.

4.4.2.4 Time consuming process

Another potential disadvantage of an APA is that it is a time-consuming process for the tax administration. Cooper *et al.* (2016; p. 319) explain that the fact gathering process can take time since care has to be taken to consider where the business is headed in future rather than evaluating past results. Unlike an audit, which will evaluate past results, having to predict the data to be agreed upon in an everchanging market may require the use of economists or actuaries and other specialists, which will be a time-consuming and costly process. The authors further state that the negotiation process with taxpayers or foreign tax authorities under tax treaties can take a considerable amount of time before reaching an agreement, and is therefore difficult to plan.

4.4.2.5 Resource constraints and misallocation of scarce resources

According to the OECD (2022a: p. 220), an APA may initially place a strain on transfer pricing audit resources. The fifth disadvantage is therefore the resource constraints and misallocation of scarce resources. The process of entering into an APA and agreeing on a price may be time consuming, especially when a tax administration is applying APAs for the first time. Cooper *et al.* (2016: p. 319) state that certain APAs may involve compliant taxpayers who would not have been flagged for an audit. This means that the tax administration will have to forego the revenue that they would have been able to obtain by potentially identifying non-compliant taxpayers if they had continued to use their resources on transfer pricing audits.

4.4.2.6 Difficult to measure and evaluate effectiveness

The last disadvantage of APAs is the difficulties of measurement and evaluation. Cooper *et al.* (2016: p 319) state that the performance of the audit division is easily measured based on the amount collected, as well as other potential measures, such as the number of audits conducted in a tax period, or the number of non-compliant taxpayers identified. The effectiveness of an APA is not as easy to measure and a tax administration will therefore not be able to determine if an APA process is an effective tool to avoid transfer pricing disputes, or if they should rather devote more resources to identifying non-compliant taxpayers through the use of audits. The authors further confirm that, while a tax administration can assess the effectiveness of an APA based on the number of cases closed, no two cases are alike and without knowing what the taxpayer would have filed in the absence of an APA, or what the adjustments would have been required in a regular audit, there is no baseline from which to measure and evaluate the effectiveness of the APA cases.

4.5 ADVANCE TAX RULINGS

South Africa has not yet implemented APAs despite the release of the draft legislation. According to Nkonki and van Rooy (2022: p. 10), the draft APA legislation is likely to take between 18 to 30 months to put in place. It is possible as an alternative measure, under certain circumstances, for taxpayers to request an Advance Tax Ruling (ATR) to obtain a ruling on a transfer price that is acceptable to the taxpayer and SARS.

An ATR system is used to obtain clarity and certainty on the Commissioner's interpretation and application of the tax laws about proposed transactions (SARS, 2023a: p. 1). An ATR is described in section 75 of the Tax Administration Act to include a binding general ruling (BGR), binding private ruling (BPR) or a binding class ruling (BCR). According to SARS (2023c: p.1; 2023d: p. 1; and 2023b: p.1), a BPR, BGR and BCR is issued in response to an application and clarifies how the Commissioner would interpret and apply the provisions of the tax laws relating to a specific proposed transaction. Section 77 of the Tax Administration Act states that SARS may make an advance ruling on any provision of a tax Act. An ATR should therefore be able to be used by the taxpayer to obtain clarity over the interpretation and application of the provisions of section 31 of the Income Tax Act to a specific proposed transaction.

According to SARS (2023c: p. 1), a BGR is issued on matters of general interest or importance and clarifies the Commissioner's application or interpretation of the tax law relating to these matters. Section 75 of the Tax Administration Act defines a BGR as "written statement issued by a senior SARS official under section 89 regarding the interpretation of a tax Act or the application of a tax Act to the stated facts and circumstances". As a single taxpayer would require a ruling only for a transfer pricing transaction relating to a MNE, a BGR ruling would not be applicable.

Section 75 of the Tax Administration Act defines a BCR as "written statement issued by SARS regarding the application of a tax Act to a specific 'class' of persons in respect of a 'proposed transaction'". Section 75 states that "class" means an unrelated group of persons with a similar affected transaction or in the case of a company, its shareholders, members or beneficiaries. Although a BCR applies to a specific class of persons, it only deals with the interpretation of a South African tax Act, and would not be suitable for a transfer pricing issue of an MNE.

Section 75 of the Tax Administration Act defines a BPR as a "written statement issued by SARS regarding the application of a tax Act to one or more parties to a 'proposed transaction', in respect of the 'transaction'". The OECD (2022a: p. 215) states that the facts underlying a private ruling may not be questioned by the tax administration because a private ruling is limited to addressing questions of a legal nature based on the facts that the taxpayer presents. Unlike an APA, which is thoroughly analysed and investigated and will cover all of a taxpayer's international transactions for a given period of time in contrast to a single transaction (OECD, 2022a: p. 215)**,** a disadvantage of an ATR is therefore that it only applies to a specific transaction.

Another disadvantage of an ATR is that, if the resolution of the matter would be resource intensive or time-consuming, the application could be rejected (section 80(e) of the Tax Administration Act). The application process and costs involved could therefore discourage MNEs from considering an ATR. Section 80(b) of the Tax Administration Act states that an application for an ATR may be rejected by SARS if the application includes an issue that is under an audit, investigation or proceeding involving the applicant or any connected persons at the time of the application, is subject to dispute, or is the subject of a policy document or draft legislation that has been published.

A BPR is designed to apply to one transaction or a number of transactions that are materially the same. Unless this is the case with a transfer pricing issue, a series of BPRs would be required for each different transaction, making the process to time consuming and expensive. Another problem is that the BPR only applies to the taxpayer and SARS, and this would not answer the transfer pricing issue of the other party to the transaction or transactions.

Therefore, conceptually a BPR could be applied for a transfer pricing transaction, but it is unlikely to be used to address a transfer pricing problem.

4.6 CONCLUSION

This chapter discusses the definition of an APA, which is a written contract between a taxpayer and tax administration to determine agreed criteria in transfer pricing transactions, including the price, method, comparability analysis, duration, and assumptions, to mitigate any potential transfer pricing audits or disputes. Ultimately, the purpose of an APA is to avoid disputes and create an environment of tax certainty that investors look for.

The chapter then discusses the three different types of APAs, which are, unilateral APAs, bilateral APAs, and multilateral APAs. A unilateral APA applies between a taxpayer and its tax authority, while a bilateral APA will involve the two tax authorities in the countries in which the transaction takes place and the taxpayer, and a multilateral APA is one that is entered into by more than two tax authorities and the taxpayer. The multilateral agreement is therefore the most complex and involves substantial input from the tax authorities and the taxpayer. The multilateral APA is noted to provide the most tax certainty, as all countries involved in the transaction agree to a price.

The advantages and disadvantages of APAs are then discussed, with the greatest benefit being the tax certainty they provide for the taxpayer and the tax authority, and prices are agreed upon prior to the transaction taking place. The taxpayer also avoids any surprise audit. The disadvantages are mainly the initial costs and resources that must be allocated to APAs, at the cost of existing transfer pricing audits that could have been performed.

In addition to APAs, the chapter also briefly discussed the possible use of an ATR as an alternative transfer pricing resolution measure, considering that APAs have not yet been implemented in South Africa. The definition of an advance ruling is provided in section 75 of the Tax Administration Act and includes a BGR, BPR or BCR. A brief discussion of the possible application by a taxpayer for a BPR is presented, together with the advantages and disadvantages of ATRs. It is concluded that BPRs are unlikely to be used to resolve transfer pricing questions.

The next chapter discusses the role that audits play in the functioning of a tax system, and as they apply to transfer pricing.

CHAPTER 5: TRANSFER PRICING AND THE ROLE THAT AUDITS PLAY

5.1 INTRODUCTION

The previous chapter discussed the role that Advance Pricing Agreements play in avoiding or limiting the transfer pricing disputes that may arise between a taxpayer and a tax authority. In addressing the fourth sub-goal of the research, this chapter discusses the role of audits in the South African tax system, the selection criteria applying to an audit, and the audit process. This will assist in examining the reason why the OECD Secretariat (2012: p. 4) stated that if a country has the capacity to carry out effective audits, it is unlikely that devoting resources to an APA will be more effective in raising revenue.

The effectiveness of audits is discussed by first defining an audit, secondly, by understanding how audits influence the compliance of taxpayers through the use of the deterrence model and the norms model, finally, through reviewing the SARS 2020/2021 financial year audit data (2021a), which will indicate the number of audits performed by the revenue authority and the additional revenue raised as a result. Having identified the importance of an effective audit system in the collection of taxes, the selection criteria and the process involved in conducting an audit is discussed in accordance with the requirements stipulated in the Tax Administration Act.

5.2 STATUTORY AUDITS *VERSUS* TAX AUDITS

In terms of section 1 of the Auditing Profession Act No, 26 of 2005 (“Auditing Profession Act”), an audit is defined as an examination of the financial statements with the objective of expressing an opinion. The SARS (2021c: p. 3) guidance describes two instances in which an audit will occur, a statutory audit and a tax audit. According to SARS (2021c: p. 3) the aim of a statutory audit is to express an opinion on the financial statements as a whole, which are issued for the use of interested parties including SARS. A tax audit, on the other hand, is defined on the SARS website (2021b: p. 1) as an examination of the financial and accounting records and/or the supporting documents of the taxpayer to determine whether the taxpayer has correctly declared his/her tax position to SARS.

In terms of section 46 of the Tax Administration Act, for proper administration of a tax Act, SARS may request relevant material. According to SARS (2021c: p.4), relevant material is obtained to gain an understanding of the taxpayer's operating environment and may include access to statutory audit files. In this case, SARS does not investigate whether statutory auditors have adhered to the Auditing Profession Act (SARS, 2021c: p. 4). However, in terms of section 241 of the Tax Administration Act, SARS has an obligation to report any intentional or negligent act by a person governed by a controlling body that has resulted in a taxpayer avoiding or unduly postponing performing an obligation contained in a tax act.

For the purposes of this research an audit relates to a tax audit, which is conducted by SARS in line with the Tax Administration Act.

5.3 DEFINITION OF A TAX AUDIT

A tax audit is defined by SARS (2021b: p. 1) as an examination of the financial and accounting records and/or the supporting documents of the taxpayer to determine whether the taxpayer has correctly declared his/her tax position to SARS. SARS further states that where the taxpayer has not made a declaration or filed a return, it is an investigation regarding whether the taxpayer's actions complied with the provisions of the relevant tax legislation (SARS, 2021b: p. 1).

Cerioni (2008: p. 5) defines a tax audit as any activity, such as enquiries, inspections or examinations, conducted by a competent tax authority to verify compliance by a taxpayer or group of taxpayers with the provisions of the relevant tax legislation or applicable laws. Masehela and Costa (2021: p. 2) state that tax audits are triggered by a suspicion of fraud, evasion or any related offence, and encompass a more detailed examination of a taxpayer's records.

According to the SARS (2021c: p. 1) definition of a tax audit, there is a distinction between an investigation and an examination. This distinction depends on whether a taxpayer has complied with the relevant tax legislation by filing their tax return. SARS will carry out an investigation rather than an examination on taxpayers who have not filed their tax returns. This suggests that an examination will inspect the records of the taxpayer to verify that the information declared to SARS is accurate, while an investigation exposes non-compliance with the relevant tax legislation.

A transfer pricing audit is likely to be an investigative, rather than an examination, as the South African company of a MNE is likely to have filed tax returns timeously.

5.4 TAX AUDITS AND TAX COMPLIANCE

The main mandate of SARS is to collect revenue for the State (Davis Tax Committee Report, 2018: p. 15). According to Arendse, Williams and Klue (2022), the purpose of a tax audit is to maintain and increase the compliance levels of the tax base of a country. Kirchler *et al.* (2008), Kogler *et al. (*2015), and Wahl *et al.* (2010) argue that a tax audit may promote both enforced and voluntary compliance. In order to execute the mandate of SARS, there must therefore be compliance, voluntary or enforced, that promotes tax compliance and an increase in the tax collections.

A tax administration should therefore have strategies and structures in place to ensure that non-compliance with tax law is kept to a minimum (OECD, 2004: p. 7). According to the OECD (2022a: p. 174), tax compliance practices have three main elements:

a) to reduce opportunities for non-compliance (e.g. through withholding taxes and information reports);
b) to provide positive assistance for compliance (e.g. through education and published guidance); and
c) to provide disincentives for non-compliance.

The discussion that follows therefore analyses the three main elements.

5.4.1 Reducing opportunities for non-compliance

In order to reduce non-compliance opportunities there must be tax law in place and an administration that must ensure that the law is being complied with. One way in which SARS ensures that it reduces any opportunity for non-compliance is by performing audits and verifications.

According to the South African Revenue Service Annual report 2020/2021 (2021a: p. 11), the third strategic objective of SARS is to detect taxpayers and traders who do not comply and to make non-compliance difficult and costly. As part of its strategic objectives, SARS performs audits and verifications. In the 2020/2021 year, SARS had a 96% conviction rate through the National Prosecuting Authority (SARS, 2021a: p. 11). Cases completed for the 2020/2021 year achieved a success rate of 92% on full scope audits and 79% on limited scope audits (SARS, 2021a: p. 48).

One-point-five million audits and verifications were performed in 2020/2021 (SARS, 2021a: p.13). Of these audits, SARS completed 5 106 full and limited scope specialised audit cases for the year, with the key focus areas being transfer pricing and advance import payments (SARS, 2021a: p.50). In addition, 507 audit cases involving large business and international accounts were completed, with a value of R18.2 billion (excluding objections) (compared to R18.5 billion in 2019/2020). In 2020/2021, 431 cases to the value of R15.6 billion related to full scope audits, and 76 to the value of R2.5 billion related to limited scope audits (SARS, 2021a: p. 48). This includes 45 BEPS cases to the value of R4.0 billion (SARS, 2021a: p. 48). This resulted in overall revenue collections of R378.4 billion against the revenue estimate of R369.1 billion, an overall R9.3 billion surplus (SARS, 2021a: p. 48).

During the 2020/2021 year, SARS reviewed its methodology used to detect risk and select cases for instances where non-compliance was detected (SARS, 2021a: p. 43). SARS reports that measures taken to modernize the risk profile selection of taxpayers through the use of data analytics have resulted in increased success rates of 20% in the taxpayers selected. According to SARS (2021a: p. 44), with the improvement of the risk engine rules, the percentage of cases selected for verification has decreased from 21.57% to 14.11%. This equates to a 35% reduction in cases selected for audit intervention. With reference to the adjustment rate of selected cases, SARS reports an improvement from 35.10% to 47.79%, and that the total yield from automated risk engine activities for the year ending March 2021 was R56.9 billion, which was R3.9 billion higher than the R53 billion estimate. These statistics indicate SARS' likely success in detecting transfer pricing risks and non-compliance.

5.4.2 Provide positive assistance for compliance

For taxpayers to comply with the provisions of any tax Act, the taxpayers need to be aware of the law. Taxpayers acquaint themselves with any updates to the legislation through updates and articles that are made available on the internet, using the services of a tax practitioner, by reading the legislation, or accessing SARS website for the updates. While taxpayers are able to obtain snippets of information from these sources, tax is complex and most areas require interpretation of the Act. McKee, Siladke and Vossler (2017: p. 2) find that where information services were present, regardless of whether this was accessed and when used in conjunction with audits or penalties, there was a strong and positive effect on tax compliance.

Tax knowledge is an essential element in a voluntary compliance tax system (Palil, 2005: p. 154), particularly in determining an accurate tax liability. One possible way of ensuring tax compliance, as suggested by previous studies is to enhance taxpayers' tax knowledge (Palil, 2010: p. 181). Similarly, a less complex tax system would also encourage tax compliance (Richardson, 2006: p. 160).

5.4.3 Provide disincentives for non-compliance

In terms of section 210 of the Tax Administration Act, if SARS is satisfied that non-compliance does exist, SARS must impose an appropriate penalty. Administrative non-compliance penalties are levied in terms of Chapter 15 of the Tax Administration Act and fixed amount penalties and percentage-based penalties are applied. A disincentive for non-compliance is therefore penalties. Doran (2009: p. 122) explains that penalties serve two functions. First, they serve an instrumental function of promoting tax compliance, and second, they define tax compliance. Therefore, two models are used in determining the link between tax compliance and penalties – the deterrence model and the norms model.

In the view of Doran (2009: p. 112), the deterrence model follows a familiar economic analysis of punishment, which implies that tax penalties should be severe enough that taxpayers expect the costs of non-compliance to exceed the costs of compliance. Taxpayers in terms of the deterrence model are rational taxpayers who compare the expected benefits to the expected costs. By contrast,

Doran states that the norms model implies that harsh tax penalties may undermine compliance, as taxpayers will comply with tax rules and regulations because of social or personal norms such as cooperation of others or respecting legitimate obligations. Personal norms under the norms model will depend on whether the taxpayer regards his or her tax obligations as legitimate. Doran (2009: p. 131) states that the legitimacy of these personal norms would be determined by and depend on whether the taxpayer sees legal actors, such as government tax officials, satisfying primary concerns of procedural justice, which is not limited to the fairness and neutrality in government spending.

According to Doran (2009: p. 131), the norms model positions itself as a complement to the deterrence model; it accepts that the deterrence model accounts for some taxpayer compliance but argues that the compliance left unexplained by the deterrence model can be attributed to standards of conduct imposed on taxpayers by others or by themselves. Doran proposes that the deterrence model fails to conform to general intuitions about taxpayer motivations that influence compliance. Doran further states that the model has a narrow view of taxpayers' motivation by assuming compliance decisions are made by taxpayers who compare expected costs to expected benefits without taking other factors into account.

While on the one hand, Doran (2009) proposes that penalties should be introduced to promote tax compliance, he advocates that the government should introduce penalties that will appeal to both the deterrence model and the norms model to accommodate the different types of taxpayer in any economic system. These penalties must be implemented but not be harsh enough to adversely influence taxpayer compliance behaviour.

Dare (2020) proposes that the standard economic deterrence theory stems from the economics-of-crime model developed by Becker (1968), which argues that crime is an economic activity that can be countered by punishing the offender. Based on the economics-of-crime model, Allingham and Sandmo (1972) developed the deterrence model to explain taxpayer behaviour. The Allingham and Sandmo model was later extended by Yitzhaki (1974). The Allingham-Sandmo Yitzhaki model views individuals as homogenous, egoistic, and utility maximisers whose decision to pay

taxes is arrived at after evaluating the gains of successful evasion, risk of detection, and punishment.

Dare (2020) performed a South African study on 184 participants in a laboratory experiment to examine a taxpayer's responses to changes in the audit and penalty rates by making use of both salaried and non-salaried income taxpayers. The results of the study suggest that there was a positive correlation between tax audits undertaken by SARS and compliance rates. The results further suggested that tax audits were more effective in enforcing compliance than penalty rates; however, both must function together to influence taxpayer behaviour. Although tax audits and penalties are effective enforcement measures, how they are applied must be given careful consideration, as excessive enforcement reduces taxpayers' intrinsic motivation to comply, hence reducing voluntary compliance.

These findings strengthen the position taken by Doran (2009), who finds a positive relationship between tax compliance and tax penalties. However, the author also introduces a different perspective, which is the role and impact of tax audits. According to McKee *et al.* (2017: p. 1), this is because a tax audit triggers taxpayers' response in future periods.

5.5 SELECTION CRITERIA FOR AN AUDIT

In terms of section 31 of the Tax Administration Act, SARS is granted the right to inspect the records of a taxpayer, through either an inspection or an audit in terms of Chapter 5 of the Tax Administration Act. Section 40 of the Tax Administration Act states that the basis upon which a person may be selected for an inspection, verification or audit is prescribed as either on a random or risk assessment basis.

South African taxpayers are bound to comply with the requirements of the Tax Administration Act. The Tax Administration Act is subject to the provisions of the Promotion of Access to Information Act, Promotion of Administrative Justice Act No. 3 of 2000 ("Promotion of Administrative Justice Act"), Protection of Personal Information Act No. 4 of 2013 ("POPI"), and ultimately the Constitution of the Republic of South Africa ("the South African Constitution"), which is the supreme law of the Republic of South Africa.

The taxpayer has an obligation in terms of section 29 of the Tax Administration Act to keep the financial records for a period of five (5) years after a submission of a return in a safe place and in their original form.

The Tax Administration Act is subject to the provisions of the Promotion of Access to Information Act, which provides taxpayers with the right to enquire about the reasons for a selection for an audit, inspection or verification, and SARS has an obligation to inform the taxpayer before they may request any further information. However, According to *Cart Blanche Marketing CC and others v Commissioner for the South African Revenue Service* [2020] 4 All SA 434 (GJ) (p. 8), SARS has "no legal obligation to explain the basis upon which a taxpayer was selected for the audit" as it was held that the selection for an audit is an investigation process being set in motion and does not constitute a decision that is capable of review.

According to Alberts and van Rooy (2022: pp 31-32), the following transfer pricing risks are considered a red flag for taxpayers and may increase their chances of being selected for an audit:

- High-value transactions and significant inter-company transactions: If your transactions are high-value, either standalone or in the context of your business, you are a likely audit target. It is crucial that evidence of arm's length pricing is compiled.
- TP [transfer pricing] inconsistency and misalignment of legal agreements: Making sure that TP reports, financial data, tax returns, and legal agreements are aligned with TP policies that are appropriately implemented, is a basic TP must. In practice, however, this is a common problem. Reconciliation of data is key, and mismatching data and fact patterns are an easy red flag for any tax authorities.
- TP models not supported by an appropriate level of substance: Significant people functions and substance are increasingly being challenged, particularly in low-tax jurisdictions. Ensure that economic substance has been considered in your TP model, narrative, and practice in your business.
- Lack of annual TP documentation (Master file / Local file), benchmarking, and supporting evidence: TP documentation is required to support the pricing of related-party transactions. Without TP documentation (including benchmarking studies), it is close to impossible to discharge the taxpayer's burden of proof. TP documentation

> that does not explain your business and commercial practices is potentially as bad as none.

Other risks highlighted by Alberts and van Rooy (2022: pp 31-32) include transactions involving intangibles and other intellectual property, the use of high interest rates in related-party debt, business restructuring, and an increase in transfer pricing disputes. However, an audit may identify a taxpayer that would not have opted for an APA, thus enlarging the pool of MNEs that could be selected for an audit.

SARS may select and audit as and when it chooses, however SARS must follow certain steps prior to the audit to ensure compliance with the Tax Administration Act:

- inform the taxpayer that SARS will be coming for an audit, arrange a suitable date for the taxpayer, and notify the taxpayer how long the audit will take (section 48);
- arrive at the premises where the audit will be conducted on the agreed date, with their identity card to show to the taxpayer (section 41);
- present the taxpayer with an identity document and conduct the audit in terms of section 41;
- once the audit has been conducted, SARS has a duty to inform the taxpayer what the results of the audit are prior to issuing an assessment (section 42); and
- the taxpayer is then given time to dispute or agree to the assessment, and a final assessment with a date of payment is issued to the taxpayer (section 42).

5.6 THE TAX AUDIT PROCESS

An audit is only deemed to commence once a formal Notification of Audit by a specific auditor is issued to the taxpayer (SARS, 2021b: p. 1). The notification may request that the taxpayer submit relevant information to SARS within the specified timelines in the case of a desk audit. In the case of a field audit, arrangements are made with the taxpayer.

The audit could be completed within 30 business days, or up to 12 months, or even longer (SARS, 2021b: p. 1). The length of the audit will depend on the complexity, volume of transactions, and the level of co-operation by the taxpayer. SARS can also request additional or further relevant material throughout the audit (SARS, 2021b: p. 1). If a taxpayer does not co-operate by providing the requested additional information, SARS will raise an assessment based on information readily available or obtained from a third party (SARS, 2021b: p. 1).

Following the conduct of the audit, SARS may make an original, additional, reduced, or jeopardy assessment based on an estimate. SARS will issue an audit findings letter indicating the grounds for the proposed assessments within 21 business days, granting the taxpayer at least 21 business days to respond. In terms of section 102 of the Tax Administration Act, the onus is on a taxpayer to prove that an amount received is not taxable, that the taxpayer is entitled to a deduction or rebate, or that an amount should be taxed at a particular tax rate. The taxpayer must also provide evidence to support their view where they disagree and provide reason/s and evidence as to why understatement penalties and/or interest should not be imposed (SARS, 2021b: p. 1).

In the context of verification, inspection or audit under chapter 5 of the Tax Administration Act, a taxpayer is not a suspect. However, if it appears during such verification, inspection or audit that a serious tax offence has been committed, the matter is referred for criminal investigation under the Act.

5.7 TYPES OF AUDITS

The Tax Administration Act makes provision for two types of audits. A desk audit, governed by section 46 of the Tax Administration Act, which deals primarily with the request for relevant information. The second refers to a field audit as contemplated in section 48 of the Tax Administration Act. According to Arendse *et al.* (2022) there are four types of audits - an administrative audit, an assurance audit, a refund audit, and an investigative audit.

5.7.1 Administrative audit

An administrative audit includes both desk audits and field audits in accordance with section 46 and 48 of the Tax Administration Act. Desk audits are also referred to as telephone audits, virtual audits or an inspection survey (Arendse *et al.,* 2022). A desk audit involves either inspection or enquiries without physically meeting the taxpayer or third parties. A field audit, on the other hand, is performed at the taxpayer's or third party's premises and involves physical inspection of the supporting information.

In terms of section 45 of the Tax Administration Act, SARS may perform physical inspections of premises, without prior notice, to –

> (a) identify the occupant of the premises;
> (b) determine whether the occupant of the premises is registered for tax; or
> (c) determine whether the occupant of the premises is complying with the record keeping requirements under ss 29 and 30 of the Act.

In terms of section 47 of the Tax Administration Act, SARS may require a physical interview with the taxpayer to clarify tax issues of concern that may expedite the current audit or render further audit or investigation unnecessary, provided that the taxpayer is not under criminal investigation.

5.7.2 Assurance audit

According to Arendse *et al.* (2022), assurance audits are routine or coded case audits of registered taxpayers. A routine audit involves various taxes, and taxpayers are selected randomly or according to a predetermined audit cycle. The authors also state that coded case audits, on the other hand, entail the audit of a single tax with the focal point being the compliance status of the taxpayer.

5.7.3 Refund audit

A refund tax audit is an audit conducted on a refund amount that is due to the taxpayer. This involves inspecting and verifying the information used in submitting the related tax return.

According to Theron and Swart (2021), SARS is not required to pay the taxpayer the refund until the audit is complete. The validity of the refund is therefore determined in terms of section 190 of the Tax Administration Act.

5.7.4 Investigative audit

Investigative audits consist of multi-tax or comprehensive audits on persons, where a specific allegation or suspicion of non-compliance exists (Arendse *et al.,* 2022). The objective of an investigative audit is thus to determine whether non-compliance with legislation has taken place and to obtain information about the tax position of the person. An investigative audit is therefore performed whether a taxpayer is registered or not.

A transfer pricing audit may therefore be regarded as an administrative audit, assurance audit or an investigative audit, depending on the reasons for the selection by the tax authority.

5.8 CONCLUSION

Unlike APAs, which aim to promote certainty with regard to transfer pricing, the prospect of a transfer pricing audit and the resultant penalties act as a deterrent. This chapter outlines the definition of an audit by explaining the distinction between statutory and tax audits. For the purpose of this research, a tax audit is described as an examination of the financial and accounting records and/or the supporting documents of the taxpayer to determine whether the taxpayer has correctly declared his/her tax position to the tax authority (SARS, 2021b: p. 1).

The chapter explains how audits influence the compliance of taxpayers in terms of the deterrence model and the norms model, in understanding why a tax authority would perform an audit in order to achieve their mandate of collecting revenue. The SARS audit data for the 2020/2021 financial year are reviewed, which indicated the number of audits performed and how the one-point-five million audits and verifications performed were able to raise an additional R18.2 billion (prior to objections) of the R369.1 billion collected, which equates to 5% of the total revenue collections.

Having identified the importance of an effective audit system in the collection of taxes, the selection criteria for an audit are discussed. The audit process is explained, with specific reference to the Tax Administration Act.

The following chapter compares APAs and audits to understand the role that they play and why a successful APA relies on the foundation of a properly functioning audit system.

CHAPTER 6: COMPARISON OF ADVANCE PRICING AGREEMENTS AND AUDITS

6.1 INTRODUCTION

The previous chapter discussed tax audits, the role tax audits perform in the compliance of taxpayers in a country, as well as the tax audit process. In this chapter, tax audits are compared to APAs. This comparison addresses the fifth sub-goal of the research. The comparison dealt with in this chapter attempts to resolve the question whether, if a country does have an APA system in place, a taxpayer would rather risk an audit?

APAs are compared to audits by discussing the characteristics on which the success of a dispute resolution or prevention method is determined for a taxpayer and a tax administration. This takes into account the time, use of resources, and the ability to identify non-compliant taxpayers. Secondly, APAs are compared to tax audits by discussing the factors that influence the measurement of performance and effectiveness.

Once APAs and tax audits have been compared, the chapter then determines whether the taxpayer would enter into an APA, or would choose not to enter into an APA and rather risk being selected for an audit. This discussion takes a more practical approach, and investigates the application of section 31 by the courts in previous transfer pricing court cases to determine the approach taken by SARS and the likely outcome for the taxpayer involved. Secondly, the discussion investigates how APAs have been applied by India, China and Botswana. These countries have been selected as part of the BRICS emerging economies (Brazil, Russia, India, China, and South Africa), and as part of the Southern African Customs Union (SACU), which consists of Botswana, Eswatini, Lesotho, Namibia and South Africa.

6.2 COMPARISON OF ADVANCE PRICING AGREEMENTS AND AUDITS

An APA is an agreement entered into between a taxpayer and a tax authority that determines in advance of an affected transaction an appropriate set of criteria and arm's length price for those transactions over a fixed period of time (OECD, 2022a: p. 213). An APA is thus forward-looking

due to the fact that it is agreed upon in advance. A tax audit on the other hand, is an examination of the financial and accounting records and/or supporting documents of the taxpayer to determine whether the taxpayer has correctly declared his/her tax position to SARS (SARS, 2021b: p. 1). A tax audit is thus backward-looking due to the fact that the supporting documents are examined *ex post facto*. The following are discussed in comparing APAs and audits:

1. The characteristics of APAs and audits. This will take into account the time, use of resources, and the ability to identify non-compliant taxpayers; and
2. How performance and effectiveness is measured.

6.2.1 Characteristics

The characteristics of APAs and audits are discussed below.

6.2.1.1 Use of time and resources

International transfer pricing disputes arise after unilateral audits of cross-border transactions (Cooper *et al.,* 2016: p. 325). According to the UN (2017: p. 417), transfer pricing audits are time and resource intensive. In order to perform a tax audit, there must be relevant information to inspect and to be able to draw conclusions on whether the tax treatment is appropriate. According to Action 13 of the BEPS Actions (OECD, 2022b: p.1), the lack of quality data makes it difficult for tax authorities to carry out transfer pricing assessments on linked companies, and even more difficult to carry out audits. Traditional audits or examinations are costly for the taxpayer due to the difficulty in examining transfer prices and their conditions after a period of time since the transaction took place (OECD, 2022a: p. 517).

In order to address this issue, most tax administrations employ a variety of skills within transfer pricing units, including economists, lawyers, accountants, industry experts, and generalists (UN, 2017: p. 420). Over time, these become transfer pricing specialists. Where there are insufficient transfer pricing resources it is critical that any transfer pricing audit be staffed with at least one transfer pricing specialist (UN, 2017: p. 420). Coordination between tax administrations at an early stage of an audit may help to ensure that both tax administrations' audit teams take into account

the position of the other country (Cooper *et al.,* 2016: p. 325). International coordination of transfer pricing audits can be achieved by conducting simultaneous or joint audits (Cooper *et al.,* 2016: p. 325). Coordination between tax administrations therefore suggests that the tax administrations will be able to leverage the transfer pricing resources available in other tax administrations.

According to the OECD (2022a: p. 517), the difficulty in obtaining sufficient appropriate information at the exact time the transaction took place led to the development of the APA. The objective of an APA is (OECD, 2022a: pp. 517- 518) to "facilitate principled, practical and co-operative negotiation, to resolve transfer pricing issues expeditiously and prospectively, to use the resources of the taxpayer and tax administration more efficiently, and to provide a measure of predictability for the taxpayer."

Cooper *et al.* (2016: p. 319) state that the initiation of an APA programme typically follows the establishment of a well-functioning transfer pricing audit team. This also means that the introduction of APAs does not signal the end of the transfer pricing problem (Givati, 2009: p. 34). Renewing an APA, however, will be less time consuming than initiating an APA, as this involves a MNE updating and adjusting the facts, business and economic criteria (OECD, 2022a: p. 220)

As noted with regard to the application and challenges in determining an arm's length price for an APA, finding information on a comparable company is a major challenge and therefore the same issues that exist in determining an appropriate arm's length price in an audit will still exist. Regardless of whether a taxpayer enters into an APA or is selected for an audit, the fundamental issue of the transfer pricing arrangement is on the pricing of the transaction. The focus remains on valuation.

6.2.1.2 Ability to identify non-compliant taxpayers

The hard work involved in a transfer pricing audit may result in significant revenue adjustments that can benefit a developing country (UN, 2017: p. 417). According to Lo and Wong (2007: p. 59), Ernst and Young conducted a global survey in 2005 and found that 63 percent of the responding multi-national companies had been subject to a transfer pricing audit within the group

company structure and over 40 percent of these examinations resulted in adjustments by the tax authorities. Palil (2010: p. 205) finds that taxpayers who have been audited by a tax authority will be more compliant following the audit. The author further states that this is because taxpayers who have never been audited are more likely to under-report their income and claim false deductions.

Significant interest in APAs should be expected from taxpayers who have been audited in the past, or who expect to be audited, and want to avoid a contentious drawn-out process (Cooper *et al.,* 2016: p. 319). Entering into an APA eliminates the risk associated with future audits with respect to the covered issues (Internal Revenue Service (IRS), 2017: p. 11). The United States also uses APAs to resolve previously unresolved issues from prior years identified under an audit (IRS, 2017: p. 26). Applying an APA to prior open years' returns enhances voluntary compliance and may be an effective way to address unresolved transfer pricing issues in prior open years under audit (IRS, 2017: p. 26). Bilateral or multilateral APA rollbacks depend, in part, on whether the other jurisdiction's local rules allow it (IRS, 2017: p. 26). Therefore, careful evaluation of cases should be conducted before a taxpayer is accepted into an APA programme.

According to the IRS (2017: p. 4), the United States introduced APAs in 1991 for three reasons: the first, to promote voluntary compliance by taxpayers; secondly, to minimise future transfer pricing disputes; and thirdly, to reduce the administrative burden without compromising intra-group transactions.

6.2.2 Measures of performance and effectiveness

The performance of a tax audit division is measured based on the amount collected (Cooper *et al.,* 2016: p. 319). The performance also relies on a good case selection (UN, 2017: p. 417). In the 2020/21 tax year, 45 BEPS audit cases were performed by SARS, which resulted in a tax collection of R4 billion (SARS, 2021a: p. 48), and this accounts for 1% of total revenue collection in the 2021 tax year. According to the UN (2017: p. 417), the outcome of an effective audit process has two aspects:

- increased future compliance (which indirectly contributes to future tax revenue and protection of the tax base); and

- increased current tax revenues (where cases are successfully audited).

An APA programme would be measured on the number of cases closed (Cooper *et al.,* 2016: p. 319). The authors further state that while a tax administration can assess the effectiveness of an APA based on the number of cases closed, no two cases are alike and, without knowing what the taxpayer would have filed in the absence of an APA, or what the adjustments would have been required in a regular audit, there is no baseline with which to measure and evaluate the effectiveness of the APA cases.

The previous chapter revealed that in the 2020/2021 financial year, SARS achieved a 92% success rate on full scope audits and 79% on limited scope audits (SARS, 2021: p. 48). In addition, based on the study by Doran (2009) and Dare (2020), tax audits were noted to be more effective in enforcing compliance than penalty rates; however, both must function together to influence taxpayer behaviour.

6.3 APPLICATION OF SECTION 31 BY THE COURTS

A brief discussion of the application of section 31 of the Income Tax Act by the courts follows.

Only two transfer pricing cases have been heard in South Africa: *Crookes Brothers Limited and the Commissioner of the South African Revenue Service* (Case No: 14179/2017) ("*Crookes Brothers*") and *ABC (Pty) Ltd and the Commissioner for the South African Revenue Service* (Case No: IT 14305) ("*ABC (Pty) Ltd*").

The calculation of income tax that *Crookes Brothers* made in their 2015 return was based on section 31(2) and section 31(3) of the Income Tax Act and also accounted for the payment of dividends tax that was deemed to have been declared and paid to MML in terms of section 31(3). MML is a 99% owned subsidiary of *Crookes Brothers,* was incorporated in Mozambique in 2012, and farms macadamia nuts as well as grain and vegetables.

On 18 December, *Crookes Brothers* submitted a request to SARS for a reduced assessment in terms of section 93(1)(d)(ii) of the Tax Administration Act on the basis that they had met the criteria stipulated in section 31(7) of the Income Tax Act, which deems that any transfer pricing arrangements do not apply in the case of a debt that is subordinated to a group foreign company where more than 10% of equity is held. On 20 January 2016, SARS addressed an email to *Crookes Brothers* requesting copies of the loan agreements in question. Following a response on 3 March 2016, SARS concluded that the error was in fact wrongly disputed due to the requirements of section 31(7) not being met in full. The subordination agreement with MML includes a clause that if MML were to be bankrupt, under business rescue, or liquidated, then the loan would be deemed to be payable. The case was therefore dismissed.

Crookes Brothers highlights the application of section 31(7), which was raised when the company made an application to SARS to make an adjustment due to an erroneous submission. The *Crookes Brothers* case indicates that a taxpayer could be flagged following a request to correct a submission.

In *ABC (Pty) Ltd*, the taxpayer was selected for an audit in 2014 in respect of their 2011 year of assessment. *ABC (Pty) Ltd* is in the business of manufacturing, importing and selling chemical products, with a connected party Swiss entity from which it purchases a group of precious metals to use in the production of catalysts that are then sold to customers in South Africa. In the letter of audit findings dated 22 October 2015, SARS was of the view that the purchase of precious metals from the Swiss entity was not conducted at arm's length. This was in terms of SARS's selection of the transfer pricing method and the comparable companies. SARS opted to use Transactional Net Margin Method with a Full Cost Mark-Up, while the taxpayer had applied the Comparable Uncontrolled Price method for their affected transactions. Following the audit, SARS raised an additional assessment in the 2011 year of assessment based on section 31(2) of the Income Tax Act, amounting to R114 157 077. It was found that SARS, however, acted outside of its powers by adjusting for all transactions and not just for the purchase of raw materials as stipulated in section 31. As a consequence, the additional assessment was legally impermissible.

The second issue highlighted in *ABC (Pty) Ltd* is that the tax authority used their own transfer pricing method and comparables rather than basing their audit on the taxpayer's assessed method and comparable companies. In *ABC (Pty) Ltd* decisions made in transfer pricing cases in the United States, Denmark and Canada were referred to. The cases referred to have one common element. If the tax authority believes that the method chosen by the taxpayer is not persuasive enough, or not perfectly aligned with the OECD Guidelines, an additional assessment will be raised based on the method that the tax authority will deem fit.

Myburgh and Weber (2022: p.1) state that in transfer pricing matters, SARS often rejects the taxpayer's benchmarking study (advanced in support of the arm's length nature of its transaction) and then issues an additional assessment based on its own analysis.

6.4 THE EXPERIENCE OF BRICS AND SACU COUNTRIES

South Africa joined Brazil, Russia, India and China (BRICS) in 2010, an important bloc of emerging economies (South African Government; 2022: p. 1). According to the South African Government (2022: p. 1), in 2010, these five countries had a combined GDP of R18 trillion. In 2021, the combined BRICS GDP value stood at 24.44 trillion US dollars (approximately R361 trillion) (O'Neill, 2022: p. 1). Of these emerging economies, South Africa and Brazil are the only countries that have not implemented an APA. Russia concluded its first bilateral APA in December 2020 with Finland (Dhall, 2021: p. 1). As Russia's application of APAs is fairly recent, there is limited data available to draw lessons from. Therefore, India and China's experience with APAs are discussed.

The Southern African Customs Union (SACU) consists of Botswana, Lesotho, Namibia, South Africa and Eswatini. The Customs Unions exists to advance eight key objectives contained in Article 2 of the 2002 SACU Agreement. These include, but are not limited to, facilitating the cross-border movement of goods and services between the territories of Member States, to create effective, transparent and democratic institutions which will ensure equitable trade benefits to Member States, and to facilitate the equitable sharing of revenue arising from customs, excise and additional duties levied by Member States (SACU, 2013: p. 1). Of the SACU countries, only Botswana utilises APAs.

6.4.1 India

Transfer pricing was introduced in India in 2001 (Shira, 2021: p. 10). Prior to introducing an APA, tax officers were required to refer taxpayers with international transactions having an aggregate value of more than Rs 50 million ($1.1 million) to the taxpayer's tax office for a transfer pricing audit (Rao and Nayak, 2004: p. 40). The number of tax disputes significantly increased as the number of audit years increased (Shira, 2021: p. 10). In response to this, India introduced APAs in 2012 by the Central Board of Direct Taxes to supplement appeals and other dispute resolution mechanisms (Bankbazaar, 2022: p. 1). This followed a large number of transfer pricing cases that were held up in dispute (Bankbazaar, 2022: p. 1). APAs are limited to a maximum period of five years, with a rollback of transfer pricing transactions, limited to a maximum of four preceding years.

To date, India has entered into over 425 APAs over its 10-year span (Ahluwalia, 2022: p. 1). According to Deloitte (2020: p. 47), India has reduced the litigation cases through the use of settlement schemes, reducing the number of appeals filed by tax authorities, and is moving towards more effective use of APAs. Deloitte further states that, to reduce the number of appeals filed, India has increased the monetary thresholds required for filing an appeal.

Tax audits are performed and are selected using data analytics that identify high-risk cases (Deloitte, 2020: p. 48). Deloitte elaborates that due to the increased complexity, the number of audits performed in the last few audit cycles has declined, reducing the burden on taxpayers. Nevertheless, Deloitte argues that APAs remain the most effective solution to resolve disputes and provide certainty.

Kar, Wang and Sun (2022: p. 1) highlight the following issues with the Indian APAs over the last 10 years:

- There is no mandatory pre-filing required before taxpayers can make an APA application. The APA application is voluntary, albeit non-binding, and can also be submitted anonymously.

- APA applications can be amended quite easily, which includes converting a unilateral application to a bilateral one, or *vice versa*.
- The biggest drawback of the Indian APA programme is the scarce human resources allocated to it. APAs rely heavily on facts and necessitate extensive data analysis.
- These processes are time consuming. With a large number of applications filed over the 10 years, the APA teams are burdened with too much work. Only 16 officers in four APA teams have the responsibility for processing hundreds of applications. Thus, the pace of processing applications has steadily fallen.

While India has introduced and used APAs for 10 years, India has one of the lowest tax to GDP ratios in the world, recorded at 7.8% in June 2022 (CEIC, 2022: p. 1). Notably, India also has the lowest tax to GDP ratio of the BRICS countries, with South Africa at 24.6%, Russia at 24.9%, Brazil at 16.2%, and China at 12.6%, in June 2022 (CEIC, 2022: p. 1).

In 2012, the tax to GDP ratio in India stood at 8.049% (CEIC, 2022: p. 1). This indicates that since India implemented their APAs, and while their economy has grown exponentially over the last 10 years, tax revenue collection has declined. The tax to GDP ratio and issues noted in the implementation of APAs in India, also highlight the following factors that contribute to the decrease in tax collections:

- An APA agrees on a price for the transaction in advance, this would therefore require adjustments to be made for the effects of the time value of money. This creates a challenge to the accuracy of projecting data of both a comparable company and the MNE. In the event that the data that is used as inputs into the transfer pricing arrangements is inaccurate, the revenue collection of the tax authority will be affected, and this may never be identified and corrected in future years.
- Reduced audits are performed as a result of the complexity and the use of APAs that are relied on more and more to minimise disputes with the taxpayer and provide certainty. This indicates that, while APAs are an effective method to create tax certainty for the taxpayer, the tax authority is more inclined to agree to a transaction prior to it taking place without full understanding of the facts and circumstances of that transaction.

6.4.2 China

China began using APAs on a trial basis in the late 1990s and concluded their first unilateral APA in 1998 (State Taxation Administration, People's Republic of China, 2020: p. 22). China's transfer pricing has evolved since its implementation and China has applied new rules and updates to the transfer pricing documentation to ensure full transparency in a MNE's value chain (PricewaterhouseCoopers, 2016: p. 4).

In 2021, parallel with its efforts on bilateral APAs, the State Taxation Administration introduced a simplified unilateral APA and delegated the signing authority to provincial and local tax authorities (Kar *et al.,* 2022: p. 1). The simplified unilateral APA was introduced to avoid a backlog. The APA has a 90-day processing period for a tax administration to conclude the review and inform a taxpayer of its decision as to whether a simplified unilateral APA application is accepted, and within six months thereafter to complete the negotiation process for an accepted application (Kar *et al.,* 2022: p. 1).

Transfer pricing audits have become more sophisticated in China since the implementation of their APA, with the period of investigation and negotiation becoming longer (as long as 10 years), and increasing the number of experienced personnel in the anti-avoidance department (Deloitte, 2020: p. 50). This has also led to the involvement of government officials, in addition to a panel of transfer pricing experts (Deloitte, 2020: p. 50).

China has been using APAs for over 20 years, but has continued to place emphasis on and evolve its transfer pricing audits as a result of the continued complexities in the transfer pricing arena. This is clear from the tax to GDP ratio growth. In 1996, the tax to GDP ratio stood at 10.801% and currently stands at 12.6% in June 2022 (CEIC, 2022: p. 1).

The research on China and India, emerging economy BRICS counterparts of South Africa, indicates that two countries have applied APAs for a number of years. India relied on the use of APAs to resolve disputes with their taxpayers and reduce the number of audits arising from the increased complexity in the transfer pricing, and collected less tax since the implementation of

their APA programme. By contrast, since implementing their APA programme, China has continued to place emphasis on their transfer pricing audits by making their selection process more sophisticated, increasing the number of personnel in the anti-avoidance department, and also involving government officials and transfer pricing experts, and have collected more tax since their implementation of an APA programme.

The outbreak of the COVID pandemic and the resurgence of unilateralism has made the need for cross-border tax certainty even more urgent for taxpayers (State Taxation Administration People's Republic of China, 2020: p. 22).

Therefore, the introduction of an APA programme is necessary for South Africa in order to attract and retain foreign investment. However, the introduction of an APA programme cannot result in increased revenue collections without a functioning and continuously evolving audit system. The lessons from the South African transfer pricing court cases support Myburgh and Weber's (2022: p.1) views that, in transfer pricing matters, SARS often rejects the taxpayer's benchmarking study (advanced in support of the arm's length nature of its transaction) and then issues an additional assessment based on its own analysis. Therefore, it appears that a taxpayer may not risk an audit but would rather choose to enter into an APA to avoid the alternative of being selected for an audit, which could be unfavourable.

6.4.3 SACU countries

Of the SACU countries only Botswana has introduced APAs. All the other SACU countries have not, but South Africa is considering introducing APAs, as discussed earlier with reference to the draft APA legislation that was issued.

With effect from 1 July 2019 Botswana introduced transfer pricing legislation and regulations in response to the challenges and complexities experienced with the existing anti-avoidance rules (BDO, 2019: p. 1). These were based fundamentally on the OECD Transfer Pricing Guidelines with the anti-avoidance rules intended to ensure that related party transactions are at arm's length (BDO, 2019: p. 1; KPMG, 2022a: p. 1). However, the rules were considered to be both vague and

broad to implement (BDO, 2019: p. 1). The transfer pricing provisions require that any person who engages directly or indirectly in any transaction with a connected person must ensure that the transaction is consistent with the arm's length principle (BDO, 2019: p.1). The Act defines explicitly and specifically the term "connected person" to cover both natural and legal persons (BDO, 2019: p. 1).

Generally, transfer pricing applies to cross-border transactions, however, in the context of Botswana, transfer pricing extends to related parties who are both Botswana residents, a feature considered that is considered stringent and peculiar to Botswana (BDO, 2019: p. 1; KPMG, 2022a: p. 1). Additionally, the transfer pricing law does not limit and confine itself to only the pricing, but extends to all of the terms and conditions of the transaction between related parties, including payment terms (BDO, 2019: p. 1). These all need to reflect arm's length dealing.

An additional anomaly in the Botswana transfer pricing legislation that is perceived as an onerous requirement relates to the acquisition of a new or used asset from a related party. In this context, the legislation requires that the original buyer of the asset retains the original invoice from the independent party and that the tax deductions on the second purchase are based on the original cost. This serves to prevent any increased tax deductions attributable to increased cost from a mark-up charged in the related party transaction (BDO, 2019: p. 1). At the time of introducing the legislation, some of the terms of the legislation were still outstanding and expected to be included in the transfer pricing regulation. These included guidance on how to determine whether a transaction is at arm's length, the amount of the transfer pricing adjustment, and the documentation that the taxpayer is required to keep in relation to transactions with related parties. The onerous documentation includes, but is not limited to the following, and is required to be submitted within four months after the end of the financial year (KPMG, 2022a: p. 1):

- an overview of the person's business operations, which includes the history, recent evolution, general overview of the relevant markets of reference, and an organizational chart;
- details of the taxpayer's key competitors;

- the amount of intra-group payments and receipts for each category of controlled transactions broken down by the tax jurisdiction of the foreign payer or recipient; and
- copies of all material intercompany agreements.

In relation to APAs, the transfer pricing legislation allows the taxpayers to apply for an APA with the tax authority, an agreement for a specific transaction for a fixed period of time (BDO, 2019: p. 1). Where the related party involved in the controlled transactions resides in a country with a double taxation avoidance agreement with Botswana, revenue authorities in Botswana may enter into an agreement in consultation with the tax authority of the country in which the related party resides (BDO, 2019: p. 1). Botswana United Revenue Services (BURS) will not have the power to make any adjustment where the taxpayer fully complied with the APA (BDO, 2019: p. 1).

In an effort to enforce compliance with arm's length principle in transactions between related parties, fines and penalties are imposed. For any transaction which is not at arm's length, a penalty of the greater of 200% of the additional tax arising from a transfer pricing adjustment, or BWP 10,000 is chargeable (BDO, 2019: p. 1; KPMG, 2022b, p. 22). For any failure to provide transfer pricing documentation upon request, a minimum penalty of BWP 250,000 and a maximum penalty of BWP 500,000 is chargeable (BDO, 2019: p. 1; KPMG, 2022b: p. 22).

Additionally, criminal penalties apply upon conviction, of up to BWP10,000 or imprisonment for one year for failure to furnish documentation or returns as required under the Income Tax Act or failure to comply any written notice from the Commissioner General (KPMG, 2022b: p. 22). Furthermore, a restatement of related party transactions by the Commissioner General may give rise to additional VAT, Withholding Tax and other tax liabilities plus penalties and interest charges (KPMG, 2022b: p. 22).

There is limited data available to ascertain whether the introduction of transfer pricing legislation and regulations have reduced the number of tax audits, or reduced the perceived challenges and complexities that were associated with anti-avoidance rules. Furthermore, there is no evidence regarding whether there are any prospects of the legislation being revised, or that such a project is underway. Based on the lack of evidence nearly four years later suggesting that the legislation may

be withdrawn, it appears that in the short to medium term, the introduction of APAs in Botswana is yielding positive and desired results, and possibly more tangible and quantifiable results remain to be seen in the long-term.

6.5 CONCLUSION

This chapter compares the role that audits play in comparison to APAs. As an APA is forward-looking and an audit is backward-looking, the roles that an audit and an APA play are compared: the characteristics of advance pricing agreements and audits, taking into account the time, use of resources, and the ability of tax authorities to identify non-compliant taxpayers.

The findings in this chapter indicate that the application and challenges in determining an arm's length price for the purpose of an APA, and finding information on a comparable company, is a challenge. Regardless of whether a taxpayer enters into an APA or is selected for an audit, the fundamental focus of the transfer pricing arrangement is on the pricing of the transaction, and remains the valuation. In order to increase revenue collection, provide certainty and decrease disputes, a tax authority must first increase the tax compliance in the current tax system, which is through tax audits.

The outcome of an effective audit process has two aspects, increased future compliance, and increased current tax revenues (UN, 2017: p. 417). By contrast, the effectiveness of an APA programme would be measured on the number of cases closed (Cooper *et al.,* 2016: p. 319). In the absence of an audit for a MNE, there is no baseline by which to measure and evaluate the effectiveness of APA cases (Cooper *et al.,* 2016: p. 319).

The Indian and Chinese experiences, two of the BRICS countries that have applied APAs for 10 and 22 years, respectively, was discussed. The experience from India and China in the application of their APA programmes and their transfer pricing tax audits indicates that where a country continues to place emphasis on tax audits after the introduction of an APA this led to increased tax collections.

Two transfer pricing cases are analysed, the only two transfer pricing cases to date. The objective of this analysis is to understand the likelihood that a taxpayer would escape an audit. *Crookes Brothers* was identified by SARS for an audit, due to the company's application to adjust its tax return to correct an erroneous submission, while *ABC (Pty) Ltd* was identified by SARS through a random audit. In *Crookes Brothers*, the case was dismissed, while in *ABC (Pty) Ltd*, SARS won the case and an adjustment was made to the taxable income in terms of section 31(2) and (3) of the Income Tax Act.

In addition to the BRICS countries, of the SACU countries, only Botswana has implemented and APA. The Botswana APA legislation is discussed, however there was limited evidence available to explore its link to audits, and whether the APA programme has been successful since its implementation.

The next chapter concludes the research and makes recommendations regarding whether South Africa should implement APAs.

CHAPTER 7: CONCLUSION AND RECOMMENDATION

The previous chapters discussed and compared Advanced Pricing Agreements and tax audits. The main goal of this research is to analyse transfer pricing methods and the problems that may arise in arriving at an acceptable arm's length price, and to discuss the role of APAs and tax audits in addressing these problems, from the perspective of the taxpayer and SARS. To achieve this goal, the following sub-goals are addressed:

- discuss the provisions of section 31 of the Income Tax Act, which deal with the transfer pricing of international transactions between connected persons;
- analyse the various transfer pricing methods and identify the problems in applying each;
- explain APAs and the role they may play in resolving disputes between the taxpayer and the revenue authorities;
- discuss the role of audits in the South African tax system, the selection criteria applying to an audit, and the audit process;
- compare the roles of APAs and audits in addressing transfer pricing problems, from the perspective of a taxpayer and SARS; and
- make a recommendation regarding the possible adoption of APAs in South Africa.

This chapter summarises the research findings and makes a recommendation regarding the possible adoption of APAs in South Africa.

7.1 SUMMARY OF FINDINGS

BEPS is defined as tax planning strategies used by multinational enterprises that exploit gaps and mismatches in tax rules to avoid paying tax (OECD, 2021: p. 1). BEPS and transfer pricing are inextricably linked as MNEs use transfer pricing in order to aggressively shift profits from high tax jurisdictions to lower tax jurisdictions. MNEs shift these profits by conducting activities with their related parties that are not stated at their arm's length price. To curb this practice, South Africa introduced its transfer pricing legislation in 1995. South Africa's transfer pricing legislation is

found in section 31 of the Income Tax Act, read with Practice Note 7, issued by the Commissioner for SARS (1999: p.13).

7.1.1 Chapter 1

Chapter 1 discusses the context of the research, including the goals of the research, the research methodology, ethical considerations, and the structure of the thesis.

The context of the research highlights that transfer pricing has become an issue due to the challenges in determining an appropriate arm's length price for a transaction. This is heightened by the difficulty encountered in finding an independent comparable company and the complexity involved in the calculations. Due to these issues, disputes may arise between the tax authority and the taxpayer. To address these issues, Becker (2014: para. 8) recommends the use of APAs, while the OECD Secretariat (2012: p. 4) states it is unlikely for a country that has the capacity to carry out effective audits to be more effective in raising revenue.

This, therefore, leads to the question: what problems do transfer pricing methods present in arriving at an acceptable arm's length price, and what is the role of APAs and tax audits?

7.1.2 Chapter 2

Chapter 2 addresses the first sub-goal of the research dealing with the provisions of section 31 of the Income Tax Act, which provides for the transfer pricing of international transactions between connected persons, and the arm's length price of these transactions.

The Commissioner for SARS acknowledges the importance of the OECD guidelines as they establish the grounds for the application of the arm's length principle that is included in the South African domestic transfer pricing legislation (SARS, 1999: p. 6). Section 31 of the Income Tax Act provides that the tax consequences of "affected" international transactions must be based on the arm's length principle. The arm's length price is therefore crucial to the application of section 31 of the Income Tax Act. An "affected transaction" is defined in section 31(1) of the Income Tax Act as a transaction between a resident and non-resident that are connected persons, where any

term or condition of the transaction is different from a term or condition that would have existed between independent persons dealing at arm's length, and that, in terms of section 31(2), results in a tax benefit.

In order to determine an appropriate transfer price in terms of section 31 of the Income Tax Act, a taxpayer must select a method that will provide the most reliable information and basis for an arm's length price, based on the facts and circumstances of the case. The research identifies two main challenges in determining an arm's length price for MNEs and tax administration; the lack of comparable companies and the complexity in administering the transfer pricing rules. The process of determining an appropriate arm's length price consists of the following:

- a comparability analysis;
- an evaluation of results; and
- an evaluation of separate and combined transactions

In the process of determining an appropriate arm's length price, the comparability analysis is fundamental to this objective. The lack of comparable data creates challenges for the taxpayer where there are few operators in any given sector and little information about independent enterprises. The challenges faced by tax administration with the complexity of the determination is that tax administrations do not have sufficient resources to examine facts and circumstances of each case. This is due to the subjectivity in determining an appropriate arm's length price.

7.1.3 Chapter 3

The second sub-goal of the research was to analyse the various transfer pricing methods and identify the problems in applying each. According to the OECD Guidelines (2022a: p. 288), there are five globally accepted transfer pricing methods, divided into traditional and transactional methods, namely, the Comparable Uncontrolled Price (CUP), Resale Price (RP), Cost Plus (CP), Transactional Net Margin Method (TNMM), and the profit split method. The OECD Guidelines do not require the use of more than one method and a hierarchy is not provided for these methods;

the traditional methods are, however, preferred by the OECD (2022a: p. 96). The Commissioner for SARS specifies that of these methods, the CUP is preferred.

The findings in relation to each method are summarised below:

Comparable Uncontrolled Price

- The CUP method uses price information available on a specific product or service in an existing market to determine an appropriate price between a willing buyer and willing seller.
- The method cannot be used if there are differences between the transaction or comparable company that could materially affect the price in the open market.
- The detailed transaction analysis required in the method serves as a strength and a weakness. On one hand, a detailed analysis will result in a more accurate comparable that is not one-sided, while on the other hand, the detailed comparable information required may be difficult to obtain.

Resale price method

- The RP method only applies to reseller MNEs, where the product is purchased from an associated enterprise and resold to an independent party.
- The main strength of the method is that market prices are used as the starting point, which makes is easier to obtain comparable information. However, the gross margin data may be difficult to obtain or unavailable, therefore making it difficult to adjust for price or comparable company differences with accuracy.

Cost plus method

- Similar to the RP method, the CP method uses the market prices as a starting point, and will therefore encounter the same challenges as the RP method.

Transactional Net Margin Method

- The MNE or associated enterprise must determine the appropriate base to use by calculating an appropriate ratio. The ratio should be a net profit indicator such as return on assets, operating income to sales, and any other suitable measure of net profit.
- A weakness in the method is that the net profit indicator of a MNE or associated enterprise can be influenced by factors that would not have an effect on the price or gross margins between independent parties

Profit split method

- The profit split method is most useful when the parties are making unique and valuable contributions, business operations are highly integrated, and the parties share economically significant risks in the transaction.
- The profit can be split using the following approaches: contribution analysis, comparable profit split, and the residual analysis.
- The main challenge of the method is the availability of comparability information due to the required detailed information required in applying the method.

7.1.4 Chapter 4

The third sub-goal of the research is to explain APAs and the role they may play in resolving disputes between the taxpayer and the revenue authorities. In the context of transfer pricing disputes, the role of APAs is discussed in two parts, preventing disputes from arising, and once disputes do arise, the measures available for a tax administration to facilitate the dispute resolution. A tax authority can prevent disputes in three ways: through the use of APAs, safe harbours, or coordination of audits. Of these methods, APAs are considered to be the most suitable, with the overarching objective of providing tax certainty to the taxpayer and the tax administration. MAP and penalties are identified as the measures available to facilitate dispute resolution, both of which are already applied in South Africa.

There are three types of APAs: a unilateral APA, a bilateral APA and a multilateral APA. The research establishes that a unilateral APA will not avoid the possibility of double taxation, thereby failing to provide an increased level of certainty for a taxpayer. Bilateral and multilateral APAs on the other hand, avoid double taxation through the use of MAP, and reduce the compliance costs that would have been incurred in the absence of an APA. Thus, APAs provide both dispute resolution and prevention in their application.

Once a tax administration enters into an APA, compliance with the agreement must be monitored, and this is done in two ways:

1. requesting the taxpayer to file annual reports demonstrating the extent of its compliance with the terms and conditions stipulated in the APA; and
2. examining the taxpayer's records as part of the audit cycle, without re-evaluating the methodology.

Advantages associated with an APA:

- Tax certainty – this can only be achieved if the tax rules are clear and administrable for the taxpayer and the tax authority.
- Resolving and avoiding tax disputes – aligning the required transfer pricing documentation and avoiding transfer pricing disputes. Transfer pricing documentation includes an income tax return, a local file, a master file and a Country-by-country report.
- "Roll back" as a mechanism for resolving prior disputes – a mechanism for resolving audit cases by granting the tax administration power to verify transactions in prior years of a taxpayer who might not have been selected for an audit.
- Cost savings for the taxpayer and the tax authority – this prevents costly and time-consuming examinations and litigation relating to major transfer pricing issues of taxpayers and the tax administration.

Disadvantages associated with an APA:

- The agreement may be too specific – critical assumptions may require reliance on predictions about future events.
- Adverse tax liabilities of associated enterprises in other jurisdictions – a unilateral APA may affect the tax liability of associated enterprises in other tax jurisdictions as the agreement involves a single taxpayer and tax administration.
- Not suitable for all transactions – may include an unreliable prediction of changing market conditions, without adequate critical assumptions.
- Time consuming process – fact gathering process can take time since care has to be taken to consider where the business is headed in future rather than evaluating past results, as is the case with an audit.
- Resource constraints and misallocation of scarce resources – may initially place a strain on transfer pricing audit resources as certain APAs may involve compliant taxpayers who would not have been flagged for an audit.
- Difficult to measure and evaluate effectiveness – the effectiveness of an APA is not as easy to measure and a tax administration will therefore not be able to determine if an APA process is an effective tool to avoid transfer pricing disputes

7.1.5 Chapter 5

The fourth sub-goal of the research is to discuss the role of audits in the South African tax system, the selection criteria applicable to an audit, and the audit process. The mandate of SARS is to collect revenue and, to execute this mandate, there must be compliance, voluntary or enforced. There are therefore three elements to tax compliance (OECD, 2022a: p. 174):

- reduce opportunities for non-compliance;
- provide positive assistance for non-compliance; and
- to provide disincentives for non-compliance.

The third objective of SARS is to make non-compliance difficult and costly, and therefore any opportunities for non-compliance are reduced through the performance of audits and verifications. A South African study by Dare (2020) suggests a positive correlation between audits performed by SARS and tax compliance rates, and this is confirmed by the 2020/2021 Annual Report by SARS (SARS, 2021a: p. 48), which shows a success rate of 92% on full scope audits and 79% on limited scope audits. Where information on the tax provisions relating to transfer pricing is available to taxpayers, their compliance improves, thereby providing positive assistance to comply. In addition, complexity influences tax compliance, and it is argued that a less complex tax system would encourage tax compliance.

Disincentives for non-compliance relate to penalties imposed by the tax administrations. The functions that penalties serve are to promote compliance (Doran, 2009: p. 122). The research explores this through the deterrence model and the norms model of compliance. The findings are as follows:

- in the deterrence model, penalties should be severe enough that the cost of non-compliance should exceed the cost of compliance.
- the norms model accepts that the deterrence model accounts for some taxpayer compliance, and the compliance left unexplained is attributed to standards of conduct imposed on taxpayers by others or by themselves.
- tax audits are noted to be more effective in enforcing compliance than penalty rates; however, both must function together to influence taxpayer behaviour.

A tax audit is performed in terms of Chapter 5 of the Tax Administration Act and can be an administrative audit, assurance audit, refund audit or an investigative audit. A transfer pricing audit can therefore be performed as any type of audit, depending on the objective and reason for the audit. Section 40 of the Tax Administration Act states that the basis on which a person may be selected for an inspection, verification or audit is either on a random or risk assessment basis.

The provisions of the Promotion of Access to Information Act provide taxpayers with the right to require the reasons for a selection of audit, inspection or verification, and the obligation of SARS

to inform the taxpayer before requesting for information. However, in *Cart Blanche Marketing CC and Others* (p. 8), the court established that SARS has “no legal obligation to explain the basis upon which a taxpayer was selected for the audit” as an audit is an investigation process and does not constitute a decision that is capable of review.

7.1.6 Chapter 6

The fifth sub-goal of the research is to compare the roles of APAs and audits in addressing transfer pricing problems, from the perspective of a taxpayer and SARS. The goal is addressed in chapter 6 in two parts; the first discusses the characteristics of APAs and audits by comparing the use of time, resources, and the ability to identify non-compliant taxpayers. The second, compares their performance and effectiveness. The research indicates that implementing an APA would put pressure on the available resources of the revenue authorities that are currently utilised to identify non-compliant taxpayers.

Assessing the performance and effectiveness of an audit requires a consideration of the likelihood of a taxpayer obtaining a favourable outcome if selected for an audit. *Crookes Brothers* made an application to SARS to make an adjustment to their tax return following an erroneous submission. Whilst SARS does not disclose how their audit clients are selected, the *Crookes Brothers* case indicates that a taxpayer could be flagged following a request to correct a submission. In *ABC (Pty) Ltd,* on the other hand, the taxpayer was selected for an audit. Following the audit, SARS raised an additional assessment, applying a different transfer pricing method and comparable. SARS, however, acted outside of its powers by adjusting for all transactions and not just for the purchase of raw materials. As a consequence, the additional assessment was legally impermissible.

If the tax authority believes that the method chosen by the taxpayer is not persuasive enough, or not perfectly aligned with the OECD Guidelines, an additional assessment will be raised based on the method that the tax authority will deem fit.

The performance and effectiveness of APAs is considered by assessing whether APAs in China and India have resulted in increased revenue collections and reduced tax audits. The tax to GDP

ratios of these countries prior to the implementation is compared to the 2022 data. The tax administrations' attitude towards a transfer pricing audit since the implementation of an APA is reviewed. The findings are as follows:

- India relied on the use of APAs to resolve disputes with their taxpayers and reduce the number of audits arising from the increased complexity in the transfer pricing but collected less tax after the implementation of their APA programme.
- China continued to place emphasis on their transfer pricing audits by making their selection process more sophisticated, increasing the number of personnel in the anti-avoidance department, and also involving government officials and transfer pricing experts, and have collected more tax since their implementation of an APA programme.

Botswana implemented APAs in July 2019. There is no information available on APAs entered into and their effectiveness.

7.2 RECOMMENDATION

The research establishes that a tax administration that has a proper functioning audit system should rather devote its resources to tax audits than on APAs, due to the fact that only compliant taxpayers will enter into an APA. The research findings are consistent with this view and show that the use of APAs in the selected countries has not been successful without an efficient auditing system. In order to prevent or resolve disputes that arise between the taxpayer and the tax authority, the measures have to be used simultaneously. The adoption of an APA in South Africa is therefore recommended as the role of APAs is to provide tax certainty for taxpayers and tax administrations, while the role of an audit is to provide disincentives for non-compliance and to identify non-compliant taxpayers.

SARS has not updated its transfer pricing guidance. This is clear from the fact that Practice Note 7 issued by the Commissioner for SARS was issued in 1999. Practice Note 7 should be updated regularly in line with changes in the transfer pricing arena. This will serve as simplified guidance for MNEs and may have a positive impact on the compliance of MNEs.

7.3 LIMITATION OF SCOPE AND FURTHER RESEARCH OPPORTUNITIES

The research is based on four primary sources. These are the OECD Guidelines, the UN Manual, the World Bank Handbook, and legislation in the countries included in the research. The research is also limited to the four countries selected: South Africa, India, China and Botswana. There is limited data on the practical application of APAs in Botswana and Russia due to the fact that APAs were implemented in 2019 and 2020, respectively. This research only considered BRICS and SACU countries, and therefore an extended comparative study presents opportunities for future research on the effectiveness of APAs and audits.

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