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**A comparative analysis of the legislative requirements of transfer pricing
documentation**

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ABSTRACT

Transfer pricing is currently a very topical subject and it has been like that for the last decade. Transfer pricing concerns the prices charged between related or connected companies trading in different countries for goods, services or intangible traded between themselves. The arm's length price is widely acceptable globally as an arbitrary price that should be charged between these related companies to circumvent tax base erosion as a result of transfer prices that move profits from high tax jurisdictions to low tax jurisdictions to reduce the tax burden on the inclusive group of companies.

In South Africa transfer pricing legislation has been in existence since 1995. Practice Note No. 7 was issued by the South African Revenue Service in 1999 to provide guidelines on the procedure to follow to comply with the transfer pricing legislation. However uncertainty still exists as to the procedures taxpayers need to abide by to satisfy documentation requirements.

This study is aimed at investigating shortcomings of legislated transfer pricing documentation requirements in South Africa compared to international standards, being Australia, Canada and the Organisation for Economic Co-operation and Development with the aim of making recommendations for improvement.



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Chapter 1: Introduction

1.1 Background

Transfer pricing refers to the pricing of goods and services between related parties who could be located domestically or internationally (Hines, 2000). Cross border transfer pricing has given rise to transfer pricing manipulation globally, where multinational entities arrange their transactions in such a way that profits are moved illegally and taxed in favourable jurisdictions to reduce their tax burden (Hines, 2000).

In South Africa (SA), the “manipulation of profits between jurisdictions by way of what is normally referred to as transfer pricing is regulated by section 31 of the Income Tax Act No. 58 of 1962 (the Act)” (Davis, Olivier, Urquhart, Engels, Roeleveld, Wessels & Henk, 2012: 31-33). According to John Jones (2013), the amendments to transfer pricing, which commenced on 1 April 2012, incorporated the provisions of thin capitalisation into the general transfer pricing provisions, whereas in the past, thin capitalisation had specific independent provisions.

The administration of documentation requirements for transfer pricing is governed mainly by Practice Note 7 (PN 7), issued by the South African Revenue Service (SARS) in 1999. It is currently not a statutory requirement in SA for taxpayers to prepare or maintain transfer pricing documentation, but it is highly recommended (Weston, 2010). SARS follows the Organisation for Economic Co-operation and Development (OECD) documentation requirements in terms of Article 9 of the OECD Model Tax Treaty (Olivier & Honiball, 2011). This is in contrast to Australia and Canada, which have specific documentation requirements upon the submission of a tax return (PWC, 2011).

A survey by the author of the available literature has revealed that significant research has been done on the transfer pricing arm’s length methods and principles, including empirical studies, but there has not been adequate research done to establish the sufficiency, or practicality of the documentation that ensures compliance with transfer pricing in SA. This research conducts a comparative study of current SA documentation administration and the requirements of section 31 of the Act with those of Australia, Canada and the OECD. The aim is to identify the important areas that South Africa could

benchmark or learn from in these foreign jurisdictions. The reason for choosing Australia and Canada is that SA legislators have followed Australian and Canadian tax law in the past. In addition, South Africa has in place bilateral double taxation agreements and tax information exchange agreements with both Australia and Canada (Bowman, 2015). As mentioned above, South Africa to a large extent follows the OECD guidelines in dealing with transfer pricing issues (Olivier & Honiball, 2011). For this reason, the OECD guidelines provide a basis for the comparative analysis.

1.2 Research problem and objectives

1.2.1 Research problem

Section 31 of the Act and Practice Note 7, as at July 2015, creates uncertainty regarding the specific documentation requirements, and has increased the burden of proof on taxpayers in terms of documentation preparation of arm's length transactions with connected foreign persons (SAICA, 2013).

1.2.2 Objectives

The research objective is to analyse different transfer pricing documentation administration in several foreign jurisdictions, and to determine whether or not South Africa could use any of the Australian, Canadian and the OECD methods to improve its own transfer pricing administration. To this end the following were done:

- An analysis of the current South African legislation on transfer pricing documentation administration;
- An analysis and discussion of transfer pricing documentation legislation of Australia, Canada and the OECD guidelines;
- A comparative analysis of transfer pricing documentation administration of South Africa, Australia, Canada and the OECD guidelines.

1.3 Research design

The research design is a plan that ensures that the collected evidence answers the research question as clearly as possible. It is widely accepted that the role of research is to eliminate the danger of drawing incorrect conclusions from data (University of New

York, 2013).

1.4 Research paradigm

An important methodological choice is whether a research should follow a qualitative, quantitative or multiple research design method (Saunders, Lewis, & Thornhill, 2012). In addressing the research question of whether or not the transfer pricing documentation requirements should be amended, this research follows a qualitative approach. Saunders, *et al.* (2012), differentiates between quantitative research and qualitative research as the former being derived from numeric data and the latter from non-numeric data. It is explained that the quantitative research approach is deductive, where mostly data is used to test a theory, while a qualitative approach mostly builds from an inductive approach to a richer theoretical perspective than already exists in the current literature.

This research study is not intended to test data by using numeric evidence, nor is it intended to resolve numeric measurements or relationships. Rather, it is intended to give a descriptive account of a situation. For these reasons, a qualitative approach was adopted.

1.5 Research approach and methods

An interpretative research approach was adopted for the research, as this approach seeks to understand and describe (Babbie & Mouton, 2001). The research methodology and approach used is the doctrinal research methodology. Doctrinal research is based purely on documentary data and is a two-part process (Hutchinson & Duncan, 2012). The first part entails identifying the sources of the law followed by an interpretation and evaluation of the text. The second part requires a full clear description of, for example, the use of deductive reasoning or logic, inductive reasoning and analogy where appropriate (Hutchinson & Duncan, 2012:110-111).

The documentary data used for the first part of the research, i.e. identifying the sources of the law including analysis and interpretation¹⁷ of the text, consisted of:

- South African Income Tax Act No. 58 of 1962;
- Australian Income Tax Act 1997;

- Canadian Income Tax Act RSC 1985;
- Applicable South African Revenue Service Interpretation Notes and Practice Notes applicable to transfer pricing, as effective at July 2015;
- The OECD commentary including other international organisation reviews such as the European Union, as effective at July 2015;
- United Nations commentary, as effective at July 2015;
- International case law;
- Research and academic journals from the University of Johannesburg library;
- Books on transfer pricing;
- Taxation seminar papers;
- The World Wide Web (Internet).

The information, analysis and interpretation of the documentary data in the first part of the research were used to complete the second part of the research process, i.e. to analyse and recommend.

1.6 Outline of chapters

Chapter 1: Introduction and Background

This chapter introduces the background to transfer pricing documentation; in addition, the research problem, objectives and research methodology are also defined and discussed.

Chapter 2: Transfer pricing arm's length principle

This chapter discusses the arm's length principle, which in the researcher's opinion is the backbone of transfer pricing. The discussion includes the definition of the arm's length principle, followed by a detailed breakdown of the different transfer pricing methods. The transfer pricing methods are discussed under two main headings: the traditional methods and the profit methods. It is possible that there are other transfer pricing methods outside the ones discussed in this chapter, but for the purposes of this study, the author has focused only on the OECD prescribed methods. The reason for this is that the countries being compared, namely Australia and Canada, also refer to and recommend the OECD

transfer pricing methods to their respective taxpayers, according to a recent Deloitte publication (Deloitte, 2015: 10,30).

Chapter 3: Historical development of transfer pricing and documentation challenges

This chapter begins with a discussion on the historical development of transfer pricing in South Africa, Australia, Canada and the OECD. This is followed by a discussion on the challenges that taxpayers are facing due to not having clear transfer pricing documentation provisions.

Chapter 4: South African and international transfer pricing documentation guidelines

This chapter discusses the regulations that govern the documentation requirements for South Africa, Australia, Canada and the OECD.

Chapter 5: Conclusion and recommendations

This chapter compares the results of transfer pricing documentation of South Africa with those of Australia, Canada and the OECD, drawing from the literature review and specific country requirements. It then links this back to the research problem and summarises the objectives of the study. Finally, recommendations are given to improve the documentation requirements in the South African context.

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

2.1 Introduction

This chapter deliberates the arm's length principle and the different transfer pricing methods commonly used when establishing the arm's length price in cross border transactions. Transfer pricing methods and arm's length principles are, in my opinion, key to the understanding of transfer pricing documentation. It is for this reason that this entire chapter is dedicated to arm's length principles and transfer pricing methods. The chapter begins by defining what the arm's length principle is before going into a detailed discussion of other, different transfer pricing methods. The United Nations transfer pricing methods do not differ from those of the OECD and have therefore also been used in this chapter (Deloitte, 2013).

2.2 The Arm's Length Principle

The arm's length principle is described as the financial characteristics of transactions between independent enterprises, under conditions where each party strives to acquire the utmost possible value from such a transaction (South African Revenue Service, 1996).

The reasoning behind the arm's length principle is based on the premise that transactions in an economy are generally governed by the market conditions, therefore it is most ideal to account for transactions between related companies or companies belonging to the same group, as equal to those between independent companies. Where the arm's length principle is applied, the related enterprise transactions or intercompany transactions are analysed and may be changed if the transfer prices do not match the comparable arm's length transaction. The arm's length principle is generally accepted widely, as it uses the marketplace as the norm when determine a price (United Nations, 2013).

The determination of an arm's length consideration is not straightforward, but requires judgment. This is because many products and services may seem to be similar, but are in many instances different. When determining the arm's length price therefore one should refrain from adopting a blanket approach, and apply distinctive business and market realities applicable to the set of facts. An arm's length price could be a series of prices and not necessarily made up of a single price, and the facts of each case should establish

where, within that series, a specific arm's length price lies (South African Revenue Service, 1996).

There are drawbacks associated with the arm's length principle. Companies operating in highly specialised industries, offering specialised goods or services, or dealing in intangibles or intellectual property, may find it very difficult to apply the principle. This is because such goods or services are not traded in open markets (Cheng & Lagerqvist, 2009: 23).

Complying with the arm's length principle adds to an administrative burden and increases demands on both companies and tax authorities. The arm's length principle also increases the financial burden on companies, as sourcing arm's length prices and the required administration can be very costly (Cheng & Lagerqvist, 2009: 23).

Despite these drawbacks, there is no significant option that exists for an alternative solution. An abandonment of the principle would not only lead to a threat to international harmonisation, but also to an increase in the possible threat of double taxation (Cheng & Lagerqvist, 2009: 23).

2.3 Transfer Pricing Methods

In order to achieve the arm's length principle, the OECD Guidelines, to which South Africa subscribes, split the transfer pricing methods into two main categories:

- The traditional transaction-based methods; and
- The profit-based methods.

The different transfer pricing methods can be illustrated diagrammatically as follows:

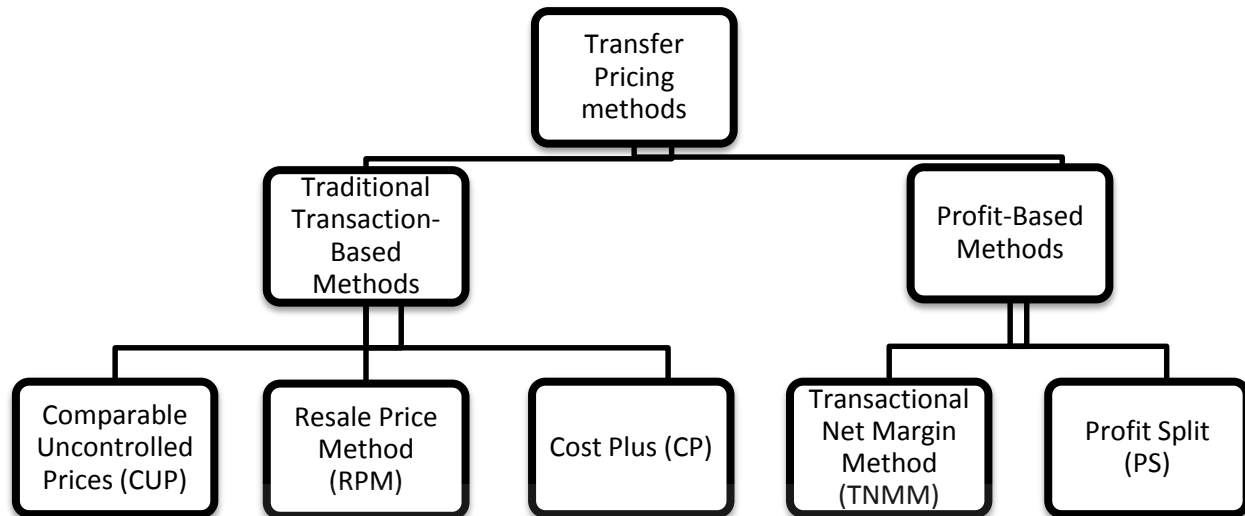


Figure 2.1: Transfer pricing family tree (Tyrrall & Atkinson, 1999)

In my view, the distinction between the two main categories of transfer pricing methods is that the traditional transaction-based methods are based on information and prices at which uncontrolled and comparable transactions between unconnected parties will take place. On the other hand, the profit-based methods determine the division of profits that independent parties would expect to realise from a specific transaction. The different methods for both the traditional transaction methods and the profit-based methods are discussed below.

2.4 Traditional Transaction-Based Methods

2.4.1 Comparable Uncontrolled Prices (CUP)

This method dictates that prices charged for goods and services in a controlled transactions environment, or between related companies in the same multinational entities group, should be compared to prices of transactions charged in an uncontrolled environment or between unrelated companies. Controlled transactions are defined as those that occur in the same group of companies between related parties, while uncontrolled transactions are defined as those that take place between independent, unrelated parties where there is a willing buyer and a willing seller (Tyrrall & Atkinson, 1999).

The CUP method can be represented diagrammatically as follows:

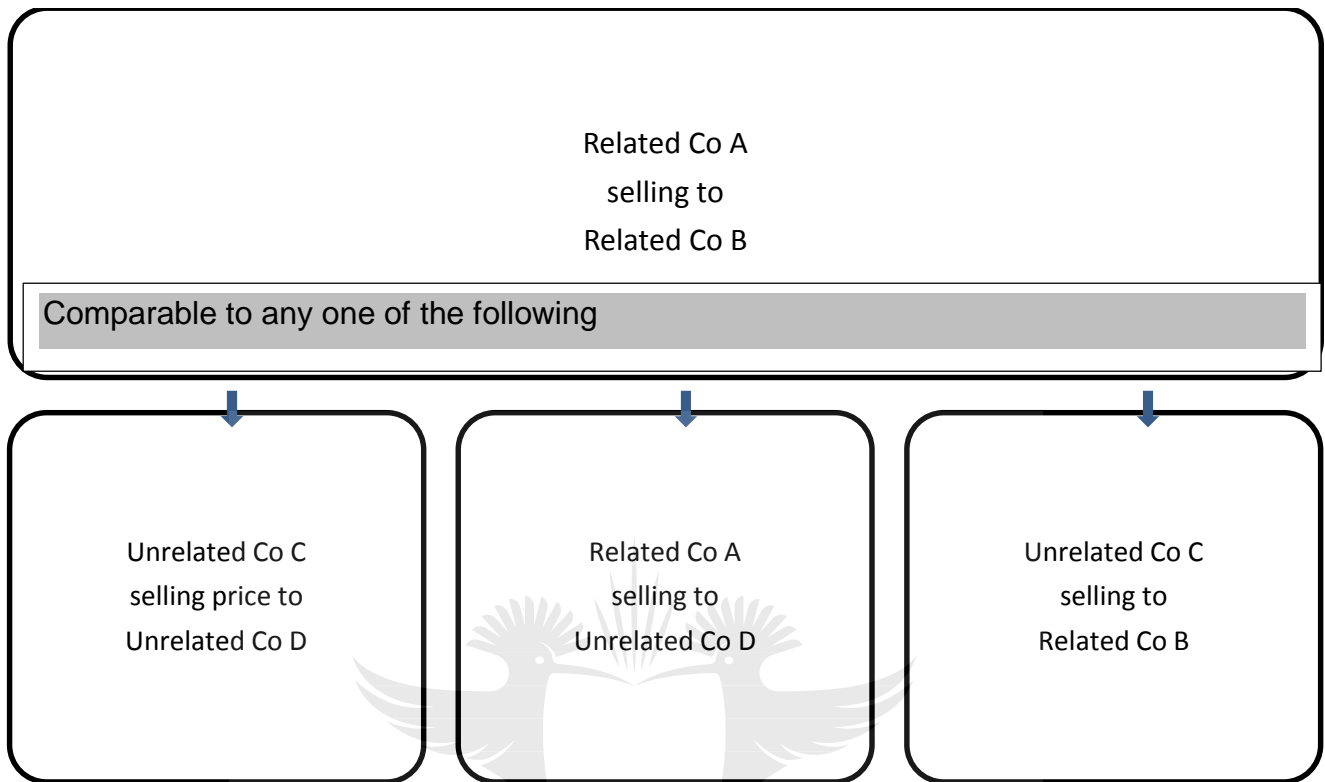


Figure 2.2: Comparable uncontrolled prices (CUP) (Tyrrall & Atkinson, 1999)

Figure 2.2 illustrates that Co A, in finding a comparable price when transacting with a related party, Co B, may consider prices charged between unrelated Co C and Co D. However, such information is not always available. In such circumstances, it is sufficient to consider prices charged by Co A to unrelated Co D. Similarly, it is also sufficient to compare prices charged by unrelated Co C when selling to a related Co B (Tyrrall & Atkinson, 1999).

The CUP method is generally considered to be the best method for determining the correct arm's length price in comparison to the other methods. However, in most cases, it is difficult to establish a similar comparable uncontrolled price, due to differences in products and services (Olivier & Honiball, 2011: 631).

2.4.2 Resale price method

The resale price method works in instances where there is an independent distributor/seller of a company's goods, services or products. The arm's length price is determined by deducting from the selling price charged by the distributor any resale price margins (United Nations, 2013).

The resale price method can be illustrated by the following example:

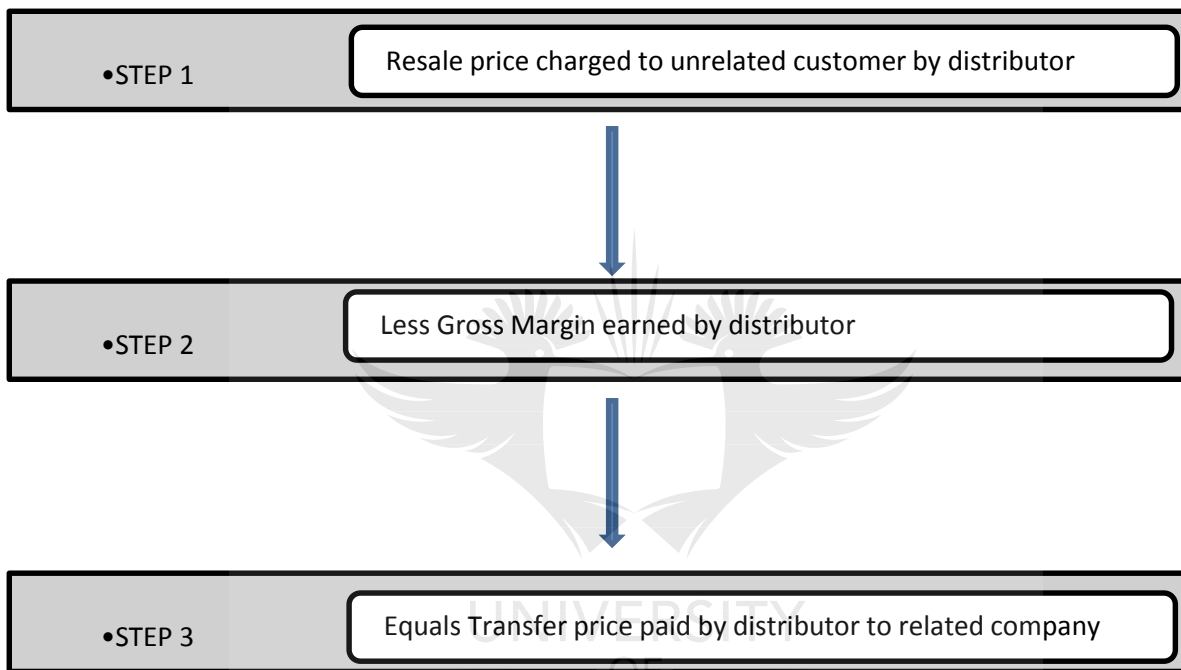


Figure 2.3 – Resale price equation (Tyrrall & Atkinson, 1999)

As explained above, the resale price method determines the arm's length price where the distributing company is a related company. Figure 2.3 illustrates that the arm's length price as depicted in Step 3 is the net of gross margins charged by the distributing company. The resale price method is best suited in circumstances where the distributor does little to add value to the product other than conducting normal sales (United Nations, 2013).

2.4.3 Cost plus Method

The last transfer pricing method considered under the traditional transaction-based method is the cost plus method. The cost plus method is ideally and most commonly used where one related company is a manufacturer, while the other related company is the

seller of the product. The model focuses on the related party manufacturer to arrive at the arm's length price. The cost plus method can be illustrated in the example as indicated below (United Nations, 2013).

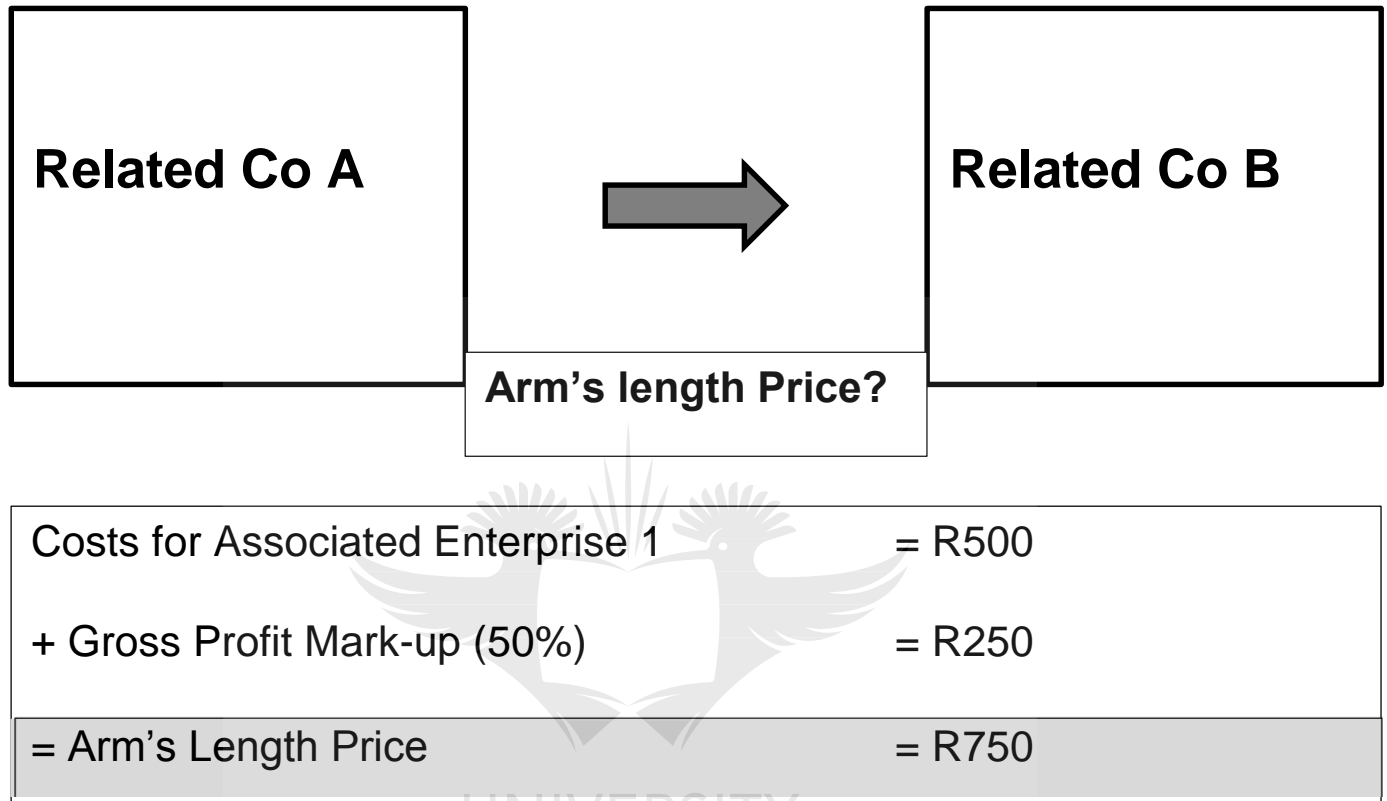


Figure 2.4: Cost Plus Method (United Nations, 2013)

Figure 2.4 illustrates that Related Co A, a manufacturing company in country 1, manufactures for [under contractual obligation] related Co B. Co B instructs the manufacturer Co A on the required quantities and quality of the commodities to be manufactured. Related Co A is guaranteed sales to related Co B and faces little risk. The cost plus method and resale price methods can be used only if the CUP method cannot be applied (OECD,1998). In the example above, because related Co A has fewer complexities with regards to functions and risks when compared to Co B, the examination would focus on Co A as the tested enterprise. The fact that Co A is being seen as (a simple) manufacturing company, the cost plus method is the most appropriate method of analysis in this instance. The cost plus method examines the gross profit mark-up earned by Co A and determines whether or not it is arm's length. The cost plus method can

therefore be described as an indirect method in terms of testing whether or not a transfer price is arm's length, especially when compared to the CUP method (United Nations, 2013).

2.5 PROFIT-BASED METHODS

This section discusses profit methods. The profit methods generally begin with examining profits resulting from certain controlled transactions to establish whether or not a transfer price is arm's length. As depicted in Figure 2.1 above, there are two main categories of profit methods: the transactional net margin method and the profit split method. These are discussed below.

2.5.1 Transactional Net Margin Method

The transactional net margin method focuses on the net margin/profit generated by a related company in determining the arm's length transfer price. The transactional net margin method is mostly used where a related company employs intangible asset/s whose returns cannot be easily determined. In such circumstances, the arm's length return of the related company is computed by establishing the margin realised by companies that are involved in a similar function with unconnected parties. The balance is thereafter left to the connected enterprise that controls the intangible asset. In other words the return to the intangible asset is what is left after other activities have been rewarded at arm's length (United Nations, 2013).

The first step in determining the arm's length prices where transactional net margin method is used, is to determine the net margin realised by the company from cross border transaction entered into with a related company. This is followed by determining the net margin realised by an unrelated company from a comparable, uncontrolled transaction. Adjustments are then made for any differences before establishing the arm's length price (OECD 1998 Report, 1998:39).

Net margins for the purposes of the transactional net margin method can be compared on different bases, e.g. cost, assets or sales. These bases are also commonly referred to as profit level indicators. In practice, there are four ratios commonly used as bases or profit level indicators. These are summarised on the family tree shown in Figure 2.5 below.

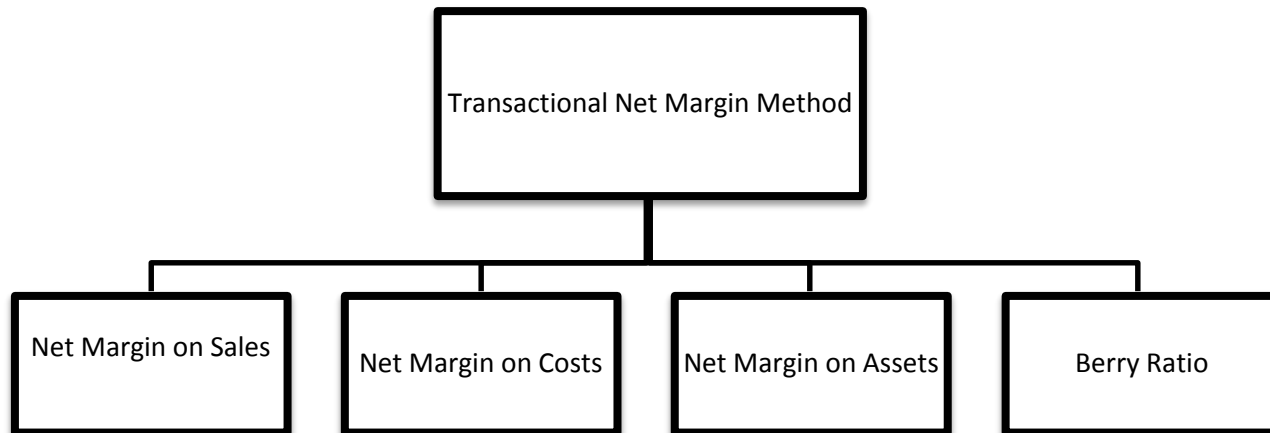


Figure 2.5: Ratios commonly used in applying TNMM (Cheng & Lagerqvist, 2009: 23).

a) Net Margin on Sales

The net margin on sales ideally is the operating profit before interest and tax, rather than the profit before tax. This approach eliminates the funding differences between businesses (Tyrrall & Atkinson, 1999).

b) Net Margin on Costs

The net margin on costs measures profitability relative to direct expenditure and overhead expenditure. This approach eliminates the problem related to classification of expenditure between cost of sales and operating expenditure (Tyrrall & Atkinson, 1999).

c) Net Margin on Assets

This approach is based on the returns on total operating assets rather than the returns on equity in order to eliminate differences in financing by equity holders. Operating assets will exclude investments in long-term assets. Adjustments may also need to be made for different methods of asset valuation, e.g. revaluation method against the costs model, differing accounting policies and age of the assets, among other factors (Cheng & Lagerqvist, 2009: 23).

d) Berry Ratio

This ratio measures returns based on operating expenses and is calculated by dividing gross profit by operating expenses. The berry ratio assumes that there is a direct linkage between the level of operating expenditure and the level of gross profit earned (United

Nations, 2013).

2.5.2 Profit Split Method

The profit split method aims to remove the impact on profits of special conditions made in a controlled environment or between related companies. This is done by establishing the share of profits that independent and unrelated companies would have expected to realise from engaging in a similar transaction (United Nations, 2013).

The profit split method starts by ascertaining the profits to be divided from the controlled transaction between related companies. These profits are then divided between these connected companies relative to their contribution, reflecting, among others, the functions performed, risks incurred and the assets used by each company. External data on profit split between external, unrelated companies is then used to value each related company's contribution. This is done so that the division of combined profits between related companies is benchmarked or comparable with that of independent unrelated companies performing similar functions to those of related companies.

2.6 Conclusion

This chapter has discussed the arm's length principle in terms of transfer pricing in as far as it affects cross border transactions among related multinational entities. The different methods of determining the arm's length price, i.e. transfer pricing methods, were also discussed under two main categories, namely the traditional methods and the profit methods. The next topic examines the existing literature in South Africa, Australia and Canada, and the OECD commentary around issues of transfer pricing and documentation.

CHAPTER 3: HISTORICAL DEVELOPMENT OF TRANSFER PRICING AND DOCUMENTATION CHALLENGES

3.1 Introduction

Chapter 2 discussed the arm's length principle and the different transfer pricing methods. This chapter continues the discussion by briefly reflecting on how South Africa, Australia, Canada and the OECD have developed transfer pricing rules and regulations historically. This is followed by a deliberation on the literature surrounding the challenges of not having proper transfer pricing rules and regulations.

3.2 Transfer Pricing: Brief historical background

3.2.1. South Africa

South Africa did not have any transfer pricing regulations prior to 1995, except for exchange control regulations aimed at preventing manipulation of currency systems. This was largely because at that time the country was isolated and to a large extent could not trade on the international arena due to political pressures (Manyaka, 2010).

In 1994, the Katz Commission, appointed by the then Minister of Finance Mr Derek Keys, noted the vulnerability of the South African tax system against excessive price manipulation between related parties. The Katz Commission was also tasked with benchmarking with different countries and recommending a suitable approach to combat transfer pricing manipulation for the South African environment. The Commission identified the following four approaches from which the South African government could choose to implement in order to counteract transfer pricing manipulation (Katz Commission, 1995).

- a) The first was the most rigorous approach and had legislative backing. It was going to be substantiated by binding regulations which would describe what constituted acceptable transfer prices. This approach was based on the system that is used in the United States of America.
- b) The second approach had legislative backing as well similar to the first one above and had comprehensive guidelines but it did not have formal regulations. This approach

was based on the system that is used in Germany.

- c) The third approach was based on the OECD guidelines. It depended on arm's length principles to determine acceptable transfer pricing activities. The approach was based on the system that is used in the United Kingdom and other countries that have fully adopted the OECD guidelines.
- d) The fourth and final approach was not based on any particular transfer pricing regulations, instead it followed general anti-avoidance rules and common law and tax law to deter transfer pricing. This approach was based on a similar system used in the Netherlands

The Katz Commission recommended the third approach (c) as the most suitable for South Africa. Subsequently, section 31 of the Act was amended in July 1995, and in August 1999 Practice Note 7 was also introduced by the National Treasury, reflecting the adoptive approach of the Katz Commission as described above.

3.2.2. Australia

Transfer pricing rules in Australia were initially enacted into law in 1982 through Division 13 of the Income Tax Assessment Act 1936 (Moore Stephens, 2012). Major reforms to modernise Division 13 in an attempt to address challenges related to transfer pricing came in 1993, when the Australian Tax Office (ATO) established an international tax division whose mandate was to focus on international transactions and globalisation (Killaly, 2000). The objective of this division was to work towards obtaining Australian portion of tax, based on the input or value added by Australian enterprises in accordance with acceptable global transfer pricing principles. According to Killaly (2000), this was necessitated by the genuine risks of rising international trading and ATO estimated 60% of international trading transactions to be among multinational entities and the majority of these transactions were between connected enterprises.

In 1994, the ATO released a legally binding ruling, TR94/14, which was the first in a series of rulings that provided guidance on transfer pricing (Australian Tax Office, 1994). TR94/14 gave guidance by explaining the domestic provisions on transfer pricing and by giving practical guidance on their application (Killaly, 2000). According to Killaly (2000), in

parallel to this initiative, Australia was also represented on the nine-member country committee that drafted and produced the OECD guidelines in June 2005. In 1998, the ATO released two further rulings (TR98/11 and TR98/14), which were closely aligned to the OECD guidelines and dealt with the selection process and application criteria of transfer pricing methods and practical methodologies to dealing with risk evaluation and documentation respectively.

In an effort to improve the administration around transfer pricing, Australia introduced Advanced Pricing Agreements (APAs) in 1995; today they are still being used in Australia as an alternative compliance method to transfer pricing (Markham, 2013).

3.2.3. Canada

Transfer pricing in Canada originated in the 1970s and certain industries and large corporations were subjected to comprehensive audits by the Canadian Revenue Authority (CRA) (Zorzi & Rizzuto, 2013). However, during this time, the CRA faced a number of challenges, such as little access to appropriate transfer pricing documentation and obtaining information, particularly where such information was in the possession of non-resident companies and those residing in non-treaty countries. This led to a legislative amendment under section 231.6 of the Canadian Income Tax Act (Canadian Act, 1985) in 1988, and the CRA was given authority to obtain any necessary information or documentation relating to cross border transactions. These amendments were introduced with a retrospective reassessment of up to seven years (Zorzi & Rizzuto, 2013).

This was followed by the introduction of APAs. The APAs started with two bilateral agreements with the United States of America on a trial basis, and a positive evaluation and interest from taxpayers led to the formal adoption of APAs in July 1993 (Zorzi & Rizzuto, 2013: 420). According to Zorzi and Rizzuto (2013: 421), the interest in APAs grew dramatically after their introduction from taxpayers who sought certainty with prospective treatment of their transfer pricing activities and documentation requirements. In December 1994, the CRA released information circular (ic 94-4), which offered specific APA guidance. This guidance provided the taxpayers with the opportunity to enter into unilateral, bilateral, or multilateral APAs (Markham, 2013).

Information circular (ic 94-4) defined APAs as a contract between the tax authorities and a taxpayer and is mainly concerned with the transactions and events of the taxpayer with no-resident enterprises or persons. These APAs set out the transfer pricing methodologies and gave guidance to the taxpayer to assist when dealing with the actual transactions. The main distinction of APAs is that they are preapproved, are applicable for a agreed upon time frame, and are specific in terms of legal application on non-arm's length transactions. (Canada Revenue Agency, 2001). Following the implementation of APAs in 1993, the CRA has spent the next two decades promoting this as an ideal way of complying with transfer pricing requirements, citing cost effectiveness and it being less onerous than the normal transfer pricing documentation procedures as the main advantages (Markham, 2013).

Following the release of the OECD guidelines in 1995, Canada introduced the then new transfer pricing rules, which mirrored those of the OECD in terms of arm's length requirements. Section 247 of the Canadian Act was effective from the years after 1997 and also dealt with transfer pricing documentation requirements (Zorzi & Rizzuto, 2013). (Section 247 is discussed in Chapter 4).

3.2.4 The Organisation for Economic Cooperation and Development

The Organisation for Economic Cooperation and Development (OECD), of which most major industrial countries are members, issued the first transfer pricing guidelines report in 1979. This report provided guidelines to multinational entities on how to determine arm's length prices with regard to transfer pricing (United Nations, 2001: 7).

The 1979 OECD report did not cover transfer pricing documentation, but discussed the following in detail: the transfer pricing treatment of transactions such as goods (Chapter 2); technology, including trademarks (Chapter 3); treatment of services in transfer pricing context (Chapter 4); and treatment of loans (Chapter 5) (United Nations, 2001: 7)

The OECD issued another report in 1984 called the *Transfer Pricing for Multinational Enterprises – Three Taxation Issues*. This report was an expansion of the 1979 report and like the 1979 report did not address detailed transfer pricing documentation requirements, but dealt with the following three specific issues (United Nations, 2001: 7):

- Mutual agreements procedure;
- Transfer pricing in the banking sector;
- The allocation of central costs.

In 1995, the OECD issued the OECD Guidelines report. This was a revised version of the 1979 OECD report which it replaced. It contained additional chapters including Chapter 8 (Documentation), which discussed transfer pricing documentation. This chapter provided guidance to tax administrations and taxpayers on the types of documentation appropriate to prove arm's length on transactions between connected multinational entities on cross border trades (OECD, 1995: 63).

Thus far, this chapter briefly reflected on how South Africa, Australia, Canada and the OECD have developed transfer pricing rules and regulations. A deliberation of the challenges of not having proper transfer pricing rules and regulations now follows.

3.3 Challenges surrounding transfer pricing and transfer pricing documentation

Many multinational entities doing business in South Africa and Africa in general are exposed to uncertainties on how tax authorities handle transfer pricing, because most countries do not have formal transfer pricing legislation, but refer to the OECD guidelines, which in most cases are used selectively in the case of disputes (Havinga, 2011). "There is a major flaw in the transfer pricing legislation in SA which goes against the basic principle of certainty on which tax legislation should be built, and this causes a major confusion on multinational entities who want to do the right thing but do not know what to do" (SAICA, 2013:1).

A study by Weston (2010: 42) revealed that transfer pricing documentation in South Africa differed from company to company, and in most cases was based on what companies felt to be important. In addition, the study says that taxpayers in most instances do not understand the reasons for documentation, including the goals and objectives. The problem with the transfer pricing documentation policy in South Africa is that it is not defined in the Act, and neither is it mentioned in SARS information on tax guidelines (Honiball, 2005: 42).

It is important for multinational entities with transfer pricing arrangements to keep documentation, and failure could prompt SARS to perform an audit review on a company (Ernst & Young, 2012). The importance of transfer pricing documentation accompanying section 31 of the Act cannot be over emphasised. Documentary evidence of the transfer pricing methods applied or used by taxpayers in complying with the arm's length principle is of critical importance to tax authorities because they have a responsibility of establishing whether or not transfer prices used by the taxpayer are arm's length (Siwela, 2011: 29).

With the amendments to section 31 of the Act, the burden of proof of arm's length prices on transfer pricing will initially rest with the taxpayer, which has effectively converted transfer pricing into a self-assessment provision (Ernst & Young, 2012: 155). In my opinion, this raises the question of what documentation is sufficient for the purposes of transfer pricing. The OECD guidelines, which SARS recommends its taxpayers to follow, raise the following potential documentation problems (OECD, 2010).

- The cost and administration burden of getting and keeping transfer pricing arm's length documentation may get out of control;
- Such documentation may contain confidential information like trade secrets and scientific secrets;
- The length of the period that this documentation should be retained is unknown.

In my view the South African tax authorities do not give clear guidance to address these potential problems. Despite the lack of clear guidance on the required documentation SARS interprets the absence of transfer pricing documentation as if the taxpayer is not sufficiently complying with arm's length requirements and cannot therefore rationally assert that the transfer prices used are at arm's length. (Ernst & Young, 2012: 155).

In her research on Transfer Pricing in South African Income Tax Law, Lord (2007:37) isolates the following two main risk areas associated with poorly prepared documentation or no documentation at all facing multinational entities:

- Poorly prepared or no documentation at all on transfer pricing flags and draws SARS's attention to the taxpayer and triggers an investigation;

- The investigation by SARS has a potential for putting multinational entities' taxpayers in a worse of situation because SARS will likely impose on what it deems as an arm's length, including potential penalties.

Given the problems with documentation as highlighted above, most of the OECD member states have adopted the Advanced Pricing Agreements (APAs). According to Malevu (2011: 72), APAs do take away the frustration associated with documentation requirements and completely eliminate future litigation as a result of incorrect documentation emanating from transfer pricing documentation. APAs are defined as contractual agreements that may be valid for a several years between a taxpayer and a tax authority and they determine the transfer pricing methods and methodologies that a taxpayer will use to account for its cross border transactions with related enterprises or persons (PWC, 2013).

Another method of simplifying the administration of documentation is linked to the size of the company. Multinational entities with income not exceeding a pre-defined threshold are not required to submit any documentation on transfer pricing (Australian Tax Office, 2015). This is already practised in Australia. In Spain, on the other hand, the legislation requires limited documentation from multinational entities that have transferred shares or securities, real estate and intangibles (Glaize, 2011).

Transfer pricing documentation has become a very important focus area for the South African government, which recently announced that they want to increase monitoring of companies that illegally shift their profits to other jurisdictions. In the budget speech 2013/14, the then Minister of Finance, Mr Pravin Gordhan, warned multinational entities involved in transfer pricing manipulation in a strong worded statement. He emphasised that it is not fair that South African taxpayers are carrying the tax burden on behalf of multinational enterprises which are involved in shifting profit from South Africa to tax friendly foreign jurisdictions, while benefiting from the country's resources, infrastructure and protection (Gordhan, 2013: 21).

In my opinion, the problem with transfer pricing documentation guidelines is not unique to South Africa, but to many other countries globally. However, there is evidence that in the

past decade, many countries have taken a stance to address any potential weaknesses arising from lack of clear documentation guidelines by adopting specific guidelines for their jurisdictions. The number of countries with specific documentation requirements has risen from 14 in 2001 to 58 in 2011 (United Nations, 2001: 269).

3.4 Conclusion

This chapter has considered the challenges around the absence of clear transfer pricing documentation provisions and the historical development of transfer pricing in South Africa, Australia, Canada and the OECD. The next chapter builds from this literature review and considers specific documentation requirements for each jurisdiction under discussion.



CHAPTER 4: SOUTH AFRICAN AND INTERNATIONAL TRANSFER PRICING DOCUMENTATION GUIDELINES

4.1 Introduction

The previous chapter provided a brief summary of the historical development of transfer pricing as well as the challenges that taxpayers face with transfer pricing and transfer pricing documentation. This chapter focuses on the current legislation and related guidance to transfer pricing documentation requirements in each of the jurisdictions under discussion.

4.2 Transfer Pricing and documentation requirements – South Africa

Transfer Pricing rules in South Africa are regulated in terms of Section 31 of the South African Income Tax Act No. 58 of 1962. Detailed guidance on documentation for the purpose of transfer pricing in South Africa is found in Practice Note 7, issued in 1999 and amended in 2005 (Deloitte, 2015: 198). The 2005 amendment titled, *Transfer Pricing: Addendum to SARS Practice Note 7 dated 6 August 1999: Submission of Transfer Pricing Policy Document*, discusses the position of SARS in terms of documentation requirements and submission thereof (South African Revenue Services, 2005).

It is not mandatory to prepare or submit transfer pricing documentation in South Africa; however, failure to prepare such documents might disadvantage the taxpayer in terms of proving the arm's length principle when required (South African Revenue Services, 2005). Practice Note 7 recommends the OECD prescribed transfer pricing methods when determining arm's length prices as listed below (South African Revenue Services, 1996): (Transfer pricing methods are discussed in Chapter 2):

- The comparable uncontrolled pricing method (CUP);
- The resale price method;
- The cost plus method;
- The profit split method; and
- The transactional net margin method (TNMM).

It has already been mentioned that SA does not have legislated requirements for transfer

pricing documentation, but the OECD Guidelines on the nature of documentation required are recommended (South African Revenue Services, 1996). The OECD transfer pricing documentation requirements are discussed in Section 4.5 of this chapter.

4.3 Transfer Pricing and Documentation requirements – Australia

Transfer Pricing rules in Australia are regulated in terms of Division 815-A of the Australian Income Tax Assessment Act 1997 (hereafter referred to as the Australian Act). Division 815 is subdivided into four subdivisions and covers the following main areas (Australian Income Tax Assessment 1997: 138-163):

- 815-A Treaty-equivalent cross border transfer pricing rules;
- 815-B Arm's length principle for cross border conditions between entities;
- 815-C Arm's length principles for permanent establishments;
- 815D Special rules for trust and partnerships.

The following methods are acceptable when determining arm's length transfer pricing in Australia, although other alternative methods or a combination of methods are also acceptable if they result in the most appropriate arm's length outcome (Deloitte, 2015: 12) (Transfer pricing methods are discussed in Chapter 2):

- The comparable uncontrolled pricing method (CUP);
- The resale price method;
- The cost plus method;
- The profit split method; and
- The transactional net margin method (TNMM).

Detailed guidance on documentation requirements for the purpose of transfer pricing in Australia is discussed under Subdivision 284-E in Schedule 1 to the Taxation Administration Act 1953 (Australian Tax Office, 1997: 149). Section 284-E of the Taxation Administration Act 1953 does not make it mandatory to prepare documentation in Australia; however, failure to prepare documentation has devastating effects as the taxpayer will not be in a position to provide a reasonably arguable position on cross border transactions due to lack of documented evidence (PWC, 2015)

Table 1 below provides a legislative reference to transfer pricing documentation requirements in Australia. The Australian Tax Office provides guidance to the specific document details for the fulfilment of transfer pricing documentation through Schedule 1 of the Tax Administration Act 1953 and Australian Act.

Table 1: Australian legislative reference to transfer pricing documentation

DOCUMENTATION	LEGISLATIVE REFERENCES	LEGISLATIVE REFERENCES
	Schedule 1 Tax Administration Act 1953	Australian Income Tax Assessment Act 1997
The factual circumstances relating to the matter (or matters)	Section 284-255(2)(d) and (e) (the documentary evidence must allow for the profits and losses to be easily determined)	Subsection 815-125(3) about comparability of circumstances Section 815-130 about the significance of real profitmaking or economic dealings Section 815-225 (permanent establishments)
Comparable factors important to establishing the arm's length conditions.	Section 284-255(2)(b) (the documentary evidence should allow the comparable factors relating to establishing the arm's length conditions to be readily determined)	Subsections 815-125(3) and (4) about comparability of circumstances
All details of the method or methods applied to establish the arm's length conditions	Section 284-255(2)(b) (the documentary evidence should allow the specifics of the identified transfer price method used to determine the arm's length conditions to be easily determined)	Subsection 815-125(2) about the most suitable and dependable methods to be used
The arm's length circumstances and application of the	Section 284-255(1)(c) elaborates the specific way in which the Subdivision applies	Section 815-125 and 815-225 about the definition of arm's length circumstances or

Subdivision	(or does not apply) to the matter (or matters) Section 284-255(1)(c) elaborates on why this most appropriately attains dependability with guidance material	returns Section 815-115 and 815-215 about the substitution of the arm's length circumstances or arm's length profits
Identification and documentation of material changes	Section 284-255(1)(a) about contemporaneous documentation	See above

(Australian Tax Office, 2014)

The ATO issued a legally binding ruling, effective on or after 29 June 2013 as additional guidance to transfer pricing documentation requirements (TR 2014/8 Taxation Ruling Income tax: transfer pricing documentation and Subdivision 284-E) in 2014 (Australian Tax Office, 2014: 1). This ruling supplemented both the Australian Act and Schedule 1 Tax Administration Act 1953 and was meant to shed light from the Commissioner's perspective on the transfer pricing documentation a taxpayer should keep in order to meet the requirements of Subdivision 284-E of Schedule 1 to the Taxation Administration Act 1953 (TAA 1953) (Australian Tax Office, 2014: 1). The following five key questions represent a suggested framework in the form of questions that need to be considered to satisfy documentation requirements prescribed by the Australian legislation (Australian Tax Office, 2014:74-116).

- Question 1: What are the specific circumstances and details surrounding transactions affected by transfer pricing?
(Genuine commercial, business or financial factors)
- Question 2: What were the comparable indicators that were considered in determining the arm's length circumstances?
- Question 3: What transfer pricing methodology was applied to find the arm's length prices?
- Question 4: What were the factors that determined arm's length prices and were these factors sufficiently addressed?
- Question 5: Were there significant changes in the current year and have they been

acknowledged and documented?

The ATO released Practice Statement Law Administration PS LA 2014/3, which simplifies the way transfer pricing records are kept (PS LA 2014/3) (Deloitte, 2015: 13-14). According to Deloitte, this practice statement is intended to provide assistance to ATO auditors or personnel with regards to procedures to follow when examining cross border transactions between entities for the purposes of Subdivisions 815-B and 815-C of the Australian Act. The practice statement also includes guidance in terms of procedures to apply where enterprises with cross border transactions have used the online guidance Simplifying Transfer Pricing Record- Keeping options (Deloitte, 2015: 13-14).

According to a recent publication (PWC, 2015: 1), the release of (PS LA 2014/3) creates an administrative safe harbour for low-risk taxpayers involved in cross border transactions. According to PWC, the ATO recognised that the transfer pricing documentation requirements as set out in Subdivision 284-E in Schedule 1 to the Taxation Administration Act 1953 create an undue burden on low-risk taxpayers and hence this guidance, which indicates circumstances in which it will not enforce transfer pricing documentation compliance.

These safe harbours are available to qualifying taxpayers and available for an initial period of three years from the effective date (Australian Tax Office, 2015). The application of these safe harbours as set out in (PS LA 2014/3) is discussed below.

Table 2: Application of legislative Practice Statement Law Administration PS LA 2014/3 – Simplifying transfer pricing record-keeping

	<u>Safe harbour 1</u> Small (non-distribution) taxpayer	<u>Safe harbour 2</u> Small-to-medium sized distributors	<u>Safe harbour 3</u> Low-risk intergroup services	<u>Safe harbour 4</u> Low-level intragroup loans
Characteristic	• Revenue for the economic group for a	• Turnover of distributor does not exceed \$50	• Mark-up on low-risk services does not exceed	• The combined borrowings within the Australian

	<p>given year no greater than \$25 million (AUD).</p> <ul style="list-style-type: none"> • It has not incurred three or more consecutive years of losses. • It has no related party dealings in specified countries. • It has had no restructure. 	<p>million (AUD).</p> <ul style="list-style-type: none"> • Ratio of net profit before tax to turnover on a three-year weighted average basis is no less than 3%. • It has no dealings with entities in specified countries. • It has had no restructure. • It does not have related party dealings involving royalties, licenses, fees or research & development arrangements. 	<p>7.5%.</p> <ul style="list-style-type: none"> • No more than AUD 1 million of absolute international intragroup services. • Greater than AUD 1 million of absolute international intragroup service dealings, with service expenses comprising no more than 15% of total expenses and services revenue comprising no more than 15% of total revenues. 	<p>economic group do not exceed \$50 million AUD and interest rate does not exceed the rate set by the Reserve Bank of Australia.</p> <ul style="list-style-type: none"> • It has not incurred three or more consecutive years of losses. • It has no related party dealings in specified countries. • It has had no restructure.
If all conditions fulfilled	NO ENFORCEMENT OF TRANSFER PRICING COMPLIANCE AND TRANSFER PRICING DOCUMENTATION NOT REQUIRED			

(PWC, 2015:1-3 Adapted)

These guidelines in Table 2 above have been lauded widely by tax practitioners as a positive initiative by the ATO (PWC, 2015: 1-3). Among the positive spin-offs are that the low-risk taxpayers' burden of preparing transfer pricing documentation is removed and costs related to transfer pricing documentation compliance are drastically reduced. This also gives the ATO a chance to better direct its transfer pricing compliance efforts (PWC, 2015: 3).

As an alternative to the requirements of the Australian Act requirements on transfer pricing

documentation, the ATO allows the Pacific Association of Tax Administrators (PATA) Transfer Pricing Documentation Package (Borkowski, 2010: 35-54). The (PATA) Transfer Pricing Documentation Package is discussed in section 4.4.1 under Canada (below), because the Canadian Revenue Authority explicitly states that taxpayers who choose to use this guideline are deemed to have complied fully with the requirements of transfer pricing documentation (Canada Revenue Agency, 2014).

4.4 Transfer Pricing and Documentation requirements – Canada

Transfer Pricing rules in Canada are regulated in terms of section 247 of the Canadian Income Tax Act of 1985 (hereafter referred to as the Canadian Act). Section 247 of the Canadian Act is subdivided into fifteen subsections. Detailed guidance on documentation requirements for the purpose of transfer pricing in Canada is discussed under Section 247(4) of the Canadian Act (Canadian Income Tax Act 1985, 2015).

The following methods are acceptable when determining transfer pricings' arm's length in Canada (Deloitte, 2015: 30). (Transfer pricing methods are discussed in Chapter 2.)

- The comparable uncontrolled pricing method (CUP);
- The resale price method;
- The cost plus method;
- The profit split method; and
- The transactional net margin method (TNMM).

Section 247(4)(a) of the Canadian Act prescribes that a taxpayer should obtain documentation relating to transfer pricing by the submission date of the tax period, which is accurate and complete in all material respects (Canadian Income Tax Act 1985, 2015):

- a) In instances where transfer prices affect property or services, details of these transactions;
- b) The key role players involved in the transaction and the connection between these role players at the time the transaction was entered into;
- c) The roles assumed by each participant to the transaction including, services or property used or given up, the risk assumed in partaking in the transaction amongst

other things;

- d) The transfer pricing methods and the documents used to determine the prices, including assumptions used and reasons why other transfer pricing methods were disregarded;
- e) The methods used to allocate income and cost in all transfer pricing affected transactions including the strategies and policies that underline the determination of these transfer prices and;
- f) The legal implications and conditions of the transaction and how this could potentially impact on the connected enterprises relationship amongst themselves (Canadian Income Tax Act 1985, 2015).

Subsection 247(4)(b) provides that where comprehensive documentation and evidence has been prepared in the previous reporting period, the taxpayer only needs to provide updates on issues that pertain to significant changes to the transfer pricing transaction (Canadian Income Tax Act 1985, 2015).

In March 2014, the Canada Revenue Agency (CRA) released a Transfer Pricing Memorandum TPM-05R named 'Requests for Contemporaneous Documentation' (Deloitte, 2015: 30). TPM-05R is consistent with the requirements of section 247(4) (a) as discussed above, and further clarifies the obligations on a taxpayer when responding to a CRA request for contemporaneous documentation (Deloitte, 2015: 30). TPM-05R also explains that the contemporaneous documentation requirements as set out in subsection 247(4)(b) do not constitute a complete list of the documentation required to validate the arm's length principle or acceptable efforts to establish and use arm's length transfer prices (Canada Revenue Agency, 2014).

Canadian taxpayers involved in transfer pricing transactions can elect to apply the Pacific Association of Tax Administrators (PATA) Transfer Pricing Documentation Package (Canada Revenue Agency, 2014). According to the CRA, the PATA documentation package requirements consist of exhaustive lists of documents and are viewed by the CRA as sufficient to provide penalty relief (Canada Revenue Agency, 2014). The PATA transfer pricing documentation package is discussed below.

4.4.1 Pacific Association of Tax Administrators Transfer Pricing Documentation Package

The Pacific Association of Tax Administrators (PATA) is an association of tax administrators. Members include Australia, Canada, Japan and the United States of America. The purpose of the PATA Documentation Package is to provide taxpayers in member countries with transfer pricing documentation guidelines and procedures that are uniform and acceptable by their tax authorities, but do not supersede the requirements, laws and statutes of their respective countries (Pacific Association of Tax Administrators, 2014: 4-8). Although PATA members have different legal systems, statutes, regulations and administrative approaches with regard to transfer pricing, it is fully acceptable in Canada as an alternative to section 247 of the Canadian Act, and taxpayers who choose to use this guideline are deemed to have complied fully with the requirements of transfer pricing documentation.

The PATA documentation requirements are detailed as follows:

Table 3: Pacific Association of Tax Administrators Documentation Package

<p>Organisational structure</p>	<ul style="list-style-type: none"> • A listing of all the related enterprises and a description of how these enterprises are related. This should include past details and any significant changes in their relationship if any. • A depiction of the organisational structure of the taxpayer detailing all the world wide related enterprises whose transactions can have an impact in determining documented arm's length transaction.
<p>Nature of the business/ industry and market conditions</p>	<ul style="list-style-type: none"> • A description of the enterprise which includes appropriate latest history of the taxpayer, the industries and operations the business is involved, the economic and legal matters impacting the commercial activities and industry, and the taxpayer's business activities. • The commercial business strategies which provide an understanding of the nature and purpose of the applicable transactions amongst the related entities. • A depiction of internal procedures and associated internal controls in place when transactions between the connected enterprises occurred. • Investigation of the economic and legal factors which may potentially impact on the pricing of taxpayers' goods and services.

	<ul style="list-style-type: none"> • A narrative of the organisational set-up, strength and dynamics of the operating environment(s). • An analysis and description of intangible property likely to affect the pricing of services or property in controlled transactions. • Sets of annual reports and financial statements for the year to which the package relates and the prior five years. • Details of capital and operational functions performed including the risk assumed relevant to the transactions. • Clarity on sources of equity and financing, including information relating to balances of debt and source of such debt and breakdown of equity funding.
<p>Controlled transactions</p>	<ul style="list-style-type: none"> • A listing and narrative of all controlled transactions that recognise property or services which transaction relates and all the intangibles or property associated with the transactions relates. This will include the contributors, the scope, frequency, timing type and value of these transactions. Other important information including all applicable connected party transactions and geographical markets, the currencies used to transact, and the terms and conditions surrounding the transactions and in relation to the • Documentation of internal data associated with the controlled transactions. • Details of all applicable inter-company contracts and agreements.
<p>Assumptions, strategies, policies</p>	<ul style="list-style-type: none"> • Specific details about organisational strategic objectives, and the actual events that impact on decision making when setting appropriate transfer prices including business unusual events, impact on share growth, market share strategies etc. • In circumstances where the taxpayer follows a market share approach in its business, documentary evidence which shows that appropriate study was done before applying this approach, the time frames this approach was applied, and how cost were shared by the enterprises including the impact of cost incurred on expected returns to the group of companies. • Information that influenced the setting of prices and all the assumptions considered, including information and assumptions on pricing policies for the taxpayer and the group of companies as a whole.

<p>Cost contribution arrangements (CCA)</p>	<ul style="list-style-type: none"> • Details of the cost contribution arrangements that is contemporaneous with its formation (and any revision) including other contractual arrangements pertaining to the application of the CCA between the CCA participants. • A list of all parties involved in the arrangement including related enterprises that may be affected as a result of the CCA. • Information detailing how CCA are used by related enterprises not forming part of the arrangements including the total amounts payable by these non-participants for use of the CCA property. • Information relating to the extent of activities to be executed which will include intangibles in existence or planned to be developed. • Information relating to each party's participation and interest in the CCA activities. • Timelines of the arrangements. • Terms and conditions associated with participating in the agreement including buy-in and buy-out clauses and related penalties and cost involved. • The sum of all economic resources incurred in relation to the arrangement. • The initial contribution of every participant to the arrangement including initial research expenditure. This should include how the value of initial contributions is assessed and the applicable accounting treatment. • Documentation which details a forecast of estimated benefits arising from contributions, and the methodologies used to estimate these benefits including all the key assumptions made. • Information relating to the accounting treatment of contributions and benefits, including the accounting treatment of foreign currency gains and losses, materiality and assumptions made to determine materiality. • Where variances occur between the projected benefits and actual benefits the future benefits should be recalculated and documented accordingly. • Documentation of procedures to be followed in cases where additional payments needs to be made as a result of differences between projected benefits and actual benefits.
<p>Comparability, functional and</p>	<ul style="list-style-type: none"> • Details of the legislative framework, an analysis of the supply chain value, government laws and regulations quantified operational expenditure amongst other things.

risk analysis	<ul style="list-style-type: none"> • Assumptions that were considered in choosing comparables, which include sources of the data. • Processes taken to identify internal factors impacting on comparables. • Amendments made in determining comparables including all the assumptions made when effecting those amendments. • An analysis performed on the various categories (categorising similar transaction for an in-depth analysis for comparability) • Details of other transfer pricing methodology or methodologies considered, if any. • Where a series was used corroborating evidence to support the classification of these series. • If any deviations were incurred, a detailed explanation for deviating with supporting evidence.
Selection of the transfer pricing method	<ul style="list-style-type: none"> • Details of the transfer pricing methods nominated and a narrative of why it was chosen over the others. • Information on data used to determine transfer prices and all the methodologies applied, and the reasons why other methods were disregarded in determining the prices.
Application of the transfer pricing method	<ul style="list-style-type: none"> • Supporting evidence of assumptions and findings that arose as a result of ascertaining arm's length prices. • The audit trail of all workings made when applying the nominated transfer pricing methods and any material adjustments and assumptions made. • Audit trail of the previous year documentation and the relevant updates which may impact on the current year.
Background documents	<ul style="list-style-type: none"> • All documentation that substantiates or corroborate the development of transfer pricing analysis and policies.
Index to documents	<ul style="list-style-type: none"> • Clearly referenced documents and narrative of the record keeping system used.

(Pacific Association of Tax Administrators, 2014: 4-8)

4.5 Transfer Pricing and Documentation requirements the Organisation for Economic Co-operation and Development (OECD)

The OECD released their latest transfer pricing documentation called 'Guidance on Transfer Pricing Documentation and Country-by-Country Reporting' in September 2014, replacing their previous publications on transfer pricing documentation guidelines (Loyensloeff, 2014). The OECD recommends the following methods when determining transfer pricing's arm's length principle (Deloitte, 2015: 30) (Transfer pricing methods are discussed in Chapter 2):

- The comparable uncontrolled pricing method (CUP);
- The resale price method;
- The cost plus method;
- The profit split method; and
- The transactional net margin method (TNMM).

The OECD transfer pricing documentation rules are based on three main objectives. Member countries are encouraged to consider these objectives when drafting relevant transfer pricing documentation requirements (Organisation of Economic Co-operation and Development 2, 2015). These objectives are:

- a) To confirm that enterprises have carefully considered transfer pricing requirements on cross border transactions with other related enterprises when setting up transfer prices and to ensure that income and expenditure disclosed in the tax returns related to these transactions is accurate;
- b) To provide assistance and guidance to tax authorities with procedures and information that is relevant when conducting transfer pricing risk assessment ; and
- c) To assist tax authorities with relevant information and procedures to use when executing a comprehensive audit of transfer pricing practices of taxpayers that are subject to tax in their jurisdiction, although it may be necessary to corroborate the documentation with additional information during the audit.

To achieve these objectives, the OECD recommends a three-tiered approach, consisting of firstly a main file referred to as master file, which will contain consistent material and

information that relates to all multinational entities' group members; secondly a local file which refers specifically to all significant transactions of the local taxpayer; thirdly and lastly a detailed jurisdiction report which will contain specific detail relating to worldwide allocation of multinational entities' income and taxes paid together other information relating to the allocation of economic activities within the multinational entities group (OECD 2, 2015: 17). According to the OECD (2015), this approach is beneficial to both tax administration and taxpayers as it provides an opportunity to develop information useful and relevant for an audit at the same time providing a platform and incentive for the taxpayers to consider and detail their compliance with arm's length principle in material transactions. The three-tiered approach is discussed below.

The master file, the local file and the country-by-country report must contain specific information, as set out in Annexures 1, 2 and 3 respectively, in 'Guidance on Transfer Pricing Documentation and Country-by-Country Reporting',:

1. TRANSFER PRICING DOCUMENTATION – MASTER FILE
<p>Organisational structure</p> <p>Details of the legal and ownership structure of the group of companies including the geographical locations of the entities.</p> <ul style="list-style-type: none"> • Description of multinational entities' business processes <p>A description of the multinational entity operations including:</p> <ul style="list-style-type: none"> • Key drivers of profitability. • An analysis of the procurement of the multinational's main goods and services offerings (at least five). These should be classified in terms of sales or revenue and should include any other significant products or services that are material when compared to the group's turnover (at least 5% or more). • A narrative of intercompany agreements amongst the companies in the group with regards to service arrangements excluding research and development services. This will consist of information relating to the competences of the main locations which provide important information and policies that determine the transfer prices paid for intra-group services.

- An outline of the key markets for the group's products and services including their geographical location.
- Detail pertaining to key contributors of value creation within entities in the group of companies including specific functions performed, assets utilised and risks assumed.
- Details of restructuring, acquisitions, or merger transactions as a minimum, that occurred during the fiscal year.

Description of multinational entities' business

- Details of how the group is financed and details of the financing arrangements in case the financier is not a related party.
- Details regarding members of the group that provide the treasury functions within the group including their jurisdiction, and place of effective management for these entities.
- Details of the group's transfer pricing policies and procedures on intercompany financing arrangements.

Multinational entities' financial and tax positions

- Consolidated financial statements for the group of the fiscal year under review, which may be prepared for financial reporting, tax purposes or for management purposes.
- Details relating to existing advance pricing agreements and other tax rulings that affect division of income amongst countries.

2. TRANSFER PRICING DOCUMENTATION – LOCAL FILE

Local entity

- Details regarding the management structure of the local entity, organisational chart for the local entity and details of reporting structures including who local entity reports to and jurisdictions in which such individuals are domiciled and geographical locations where principal offices are located.
- A narrative of the business operations and business strategy of the local entity. This should include all the details of transactions in cases where the local entity entered into a business restructuring arrangement, or was involved in an intangible transfer in the current or preceding year.
- Key competitors.

Controlled transactions

The following information should be provided in cases where an entity entered into significant controlled transactions:

- A listing of all the significant controlled transactions including, sourcing of manufacturing services, purchase of goods, provision of services, financing activities, financial and performance guarantees, licenses of intangibles, etc.), including the background and other supporting evidence to these transactions.
- Quantified income received and expenditure outflow arising from trading within the group and receipts and payments for all classes of controlled transactions to which the local entity was involved in (for instance expenditure and income goods and services etc.). This should include a country by country break down of the foreign payer or recipient.
- A list of all related taxpayers partaking in all classes of controlled transactions and the nature of the association between each other.
- Details of all inter-company agreements entered into by the local entity, including future planned agreements.
- A thorough comparability and functional enquiry of all the connected taxpayers in relation to each documented class of controlled transactions. This should include all the changes in comparison to the previous years.

- Assumptions made in identifying the most appropriate transfer pricing methods in relation to the different types of transactions and the reasoning behind selecting those specific transfer pricing methods.
- A listing of all connected enterprises identified as the tested parties where it applies. A detailed explanation should accompany process of identification including the reasoning behind.
- A summary of the important assumptions made in applying the transfer pricing methodology.
- Where an analysis is done for a period of more than one year an explanation should be provided as to the reasons why a multi-year analysis is ideal.
- A detailed list of all internal or external transactions which were used to inform the transfer prices including all the relevant information that was considered
- A description of any comparability changes done, including an indication of whether all the changes identified were effected on the results of the tested associated member.
- A description of all finalised transactions and the main reasons why the enterprise deems to classify them as arm's length taking into account the chosen transfer pricing methodology
- Audit trail of all supporting evidence that was used to determine the arm's length prices.
- Evidence of all agreements which the tax administrator does not form part of but which were used in determining the arm's length transfer prices which are discussed above.

Financial information

- Financial accounts and year end statements for the reporting period under review.
- Audit report and audited financial statements if available, otherwise unaudited statements will be acceptable in the event the audited statements are unavailable or that section is not audited.
- Audit trail that substantiates the linkage of data and lead schedules showing how

the financial data used in determining the transfer pricing method may be traced to the annual financial statements and other financial information.

- Audit trail and schedules of the relevant records of comparables used to determine transfer prices including the sources from which the data in the records was obtained.

3. COUNTRY-BY-COUNTRY REPORT TEMPLATE

An analysis of the distribution of revenues, income taxes and operational activities by tax country.

Name of the multinational entities group:

Fiscal year concerned:

Tax Jurisdiction	Constituent Entities resident in the Tax Jurisdiction	Tax Jurisdiction of organisation or incorporation if different from Tax	Research and Development	Holding shares or other	Purchasing or Procurement	Manufacturing or Production	Sales, Marketing or	Administrative, Management or Support Services	Provision of Services to	Regulated Financial	Insurance	Dormant	Other?	Additional Information
			Main Business Activities											
1.														
2.														

(Loyensloeff, 2014)

4.6 Conclusion

This chapter has highlighted the fundamental differences in transfer pricing documentation requirements between South Africa, Australia, Canada and the OECD. The chapter has also underlined the main similarity in terms of transfer pricing and the methods used to determine an arm's length price, particularly when dealing with affected transactions. The findings of this chapter are summarised in the Table 4 below.

Table 4: Comparison of major findings

	CRITERIA	SOUTH AFRICA	AUSTRALIA	CANADA
1.	Is there a specific requirement in the legislation to have documentation?	No	Yes	Yes
2.	Is it mandatory to prepare transfer pricing documentation?	No	No	Yes
3.	Are there clear guidelines in the Act on how the documentation should be prepared?	No (Only reference to the OECD)	Yes	Yes
4.	Are there any alternative ways of documentation preparation allowed?	No	Yes (Pacific Association of Tax Administrators)	Yes (Pacific Association of Tax Administrators)
5.	Is there relief for low-risk taxpayers from complying with documentation requirements?	No	Yes (Low-risk taxpayers exempted from complying with documentation requirements)	No

(Source, Author)

In summary, the OECD, they recommends a three-tiered approach:

- 1) Firstly a main file (master file) which will contain appropriate information that is standardised for the whole group members in the group of companies;

- 2) Secondly a local file which will contain significant transactions applicable to the local taxpayer; and
- 3) Finally a jurisdiction-by-jurisdiction report which will have the details of worldwide distribution for the group of companies and the breakdown of revenue, and income taxes received or paid by each country including information of the main activities of each enterprise in the group of companies.

The next chapter mainly draws from the findings in this chapter and concludes by discussing the particular differences in transfer pricing documentation. It ends with possible reform recommendations that could be introduced to strengthen the South African transfer pricing documentation regulations.



CHAPTER 5: CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

The objective of this research was to analyse the transfer pricing documentation requirements in South Africa, with the aim of recommending a practical resolution on how South African transfer pricing document regulation can be improved. This study addressed a number of important issues in that respect. It has already been highlighted in this study that transfer pricing has indeed come under the spotlight in recent years as a result of the increase in global trading or international trading. This trend is likely to advance in the coming years with expanding globalisation. This will also increase the potential risk of tax base erosion due to transfer pricing manipulation, once these companies start cross border trading.

The research objectives of the study were to analyse the transfer pricing documentation requirements of different jurisdictions with the aim of finding areas where the South African requirements could be improved. To this end the study made a comparative analysis to the approaches to transfer pricing documentation adopted by South Africa, to those adopted by Australia, by Canada and the OECD. The major findings of this study are summarised in 5.2 below.

5.2 Comparison

The results of the research indicate that the OECD and all the countries analysed, have legislated transfer pricing in their respective laws through their applicable income tax legislation. The results of the research also reveal that all the countries have accepted and adopted the arm's length principles as an acceptable method when dealing with cross border transactions. All the countries make reference to the OECD transfer pricing methods.

Findings with regard to documentation reveal that the South African tax authority, SARS, does not make it mandatory for a taxpayer involved in transfer pricing transactions to prepare transfer pricing documentation. The same applies to Australia; however, Canada has specific transfer pricing requirements where a taxpayer has been involved in transfer pricing. South Africa recommends the OECD documentation requirements to support

transfer pricing activities, without any adjustment to suit the South African environment. Requirements are not clear and are generically aligned to those of the OECD without any adaption to the South African environment. This is contrary to Australia and Canada in the following ways: Australia exempts low-risk taxpayers from complying with documentation requirements, while Canada has tailor-made documentation requirements for Canadian taxpayers.

South Africa does not have an alternative approach to the preparation of transfer pricing documentation besides the OECD recommended approach, while Australian and Canadian taxpayers can choose the Pacific Association of Tax Administrators Transfer Pricing Documentation Package as an alternative to their legislated methods. This provides flexibility and taxpayers in these jurisdictions can always choose a method that is less tedious and more suitable to their needs.

Table 5 below summarises the results of the comparison of transfer pricing criteria between South Africa, Australia and Canada.

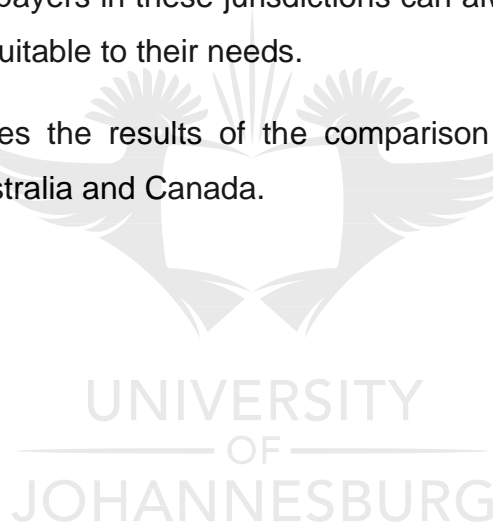


Table 5 – Comparison of transfer pricing criteria

	CRITERIA	SOUTH AFRICA	AUSTRALIA	CANADA
1.	Is there specific requirement in the legislation to have documentation?	No	Yes	Yes
2.	Is it mandatory to prepare transfer pricing documentation?	No	No	Yes
3.	Are there clear guidelines in the Act on how the documentation should be prepared?	No (Only with reference to the OECD)	Yes	Yes
4.	Are there any alternative ways of documentation preparation allowed?	No	Yes (Pacific Association of Tax Administrators)	Yes (Pacific Association of Tax Administrators)
5.	Is there relief for low-risk taxpayers from complying with documentation requirements?	No	Yes (Low- risk taxpayers exempted from complying with documentation requirements)	No

(Source, Author)

5.3 Recommendations

South Africa lacks prescriptive transfer pricing documentation requirements, and relies on the OECD transfer pricing regulations. It is recommended that South Africa should adopt the Canadian transfer pricing tax system, where the specific documentation required to satisfy, or to prove arm's length, is clearly stated in the Income Tax Act. Further, a relief approach, similar to the one used in Australia, could also be adopted where low-risk taxpayers, who can prove that the cost of complying with documentation requirements would exceed the benefits thereof from a tax compliance perspective, get a relief from complying until such time as their circumstances change.

5.4 Further Research

An area for further research would be an empirical study on the impact of transfer pricing rules on direct foreign investment. This research could focus on the ability of countries which introduce stringent transfer pricing requirements, including penalties, to still be able to attract foreign direct investments to their countries.



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