

**TRANSFER PRICING AND THE GLOBAL
TRADING OF FINANCIAL INSTRUMENTS**

BY

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DECLARATION

I, the undersigned, hereby declare that the work contained in this thesis is my own original work and that I have not previously in its entirety or in part submitted it at any university for a degree.

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MARCH 2000

TRANSFER PRICING AND THE GLOBAL TRADING OF FINANCIAL INSTRUMENTS

Sections 31(1) and (2) were introduced to the Income Tax Act 58 of 1962 ("the Act") in 1995. These sections grant the fiscus the power to adjust transfer prices to reflect an "arm's length price".

A transfer price is the price placed on a transaction between parts of a single organisation or between members of a group of companies. The term is a way of indicating that it is a price arranged within the same group, and not arrived at in the open market (i.e. not an arm's length price).

Transfer pricing is widely considered to be one of the most important tax issues facing multinational companies. The same goes for governments and revenue authorities, which have become more stringent in their efforts to maximise their income.

The issue of Practice Note No. 7 on August 6, 1999 by the Commissioner of the South African Revenue Service ("SARS") and the disclosure requirements in company income tax returns (IT 14) of transactions between connected persons are indications that SARS may enforce the provisions of Section 31(1) and (2) more stringently in the near future.

Technological changes, the communications revolution, and the spread of financial deregulation have had a dramatic effect in globalising financial markets. Financial firms have developed innovative financial instruments such as derivatives, to meet the global demand to finance trade and investment and to reconcile the often different demands of borrowers and investors. Financial institutions (mainly banks) have organised their activities to be able to meet the demands of investors for global financial products, twenty-four hours a day. As the global trading of financial instruments is usually conducted over several tax jurisdictions and global trading organisations are often highly integrated it poses significant transfer pricing implications.

The aim of this study is to:

- consider and discuss transfer pricing in South Africa,
- to analyse and discuss the global trading of financial instruments,
- to apply transfer pricing methodologies to the global trading of financial instruments and

- to specifically consider the use of traditional transaction methods versus profit split methods for the determination of arm's length prices in the context of the global trading of financial instruments.

To this end the study provides a detailed analysis of South Africa's transfer pricing legislation and acceptable methods for the determination of transfer prices as set out in Practice Note No. 7.

The factual background, structure of the business, business strategies and organisation of trading activities of a typical global trading organisation are discussed. Furthermore, a detailed functional analysis of the typical global trading organisation is performed. The functional analysis identified the following critical functions that are usually performed by a global trading organisation: sales and marketing; trading and risk management; support/back office; and capital/risk assumption.

The application of the various methods set out in Practice Note No. 7 to reward the functions identified under the functional analysis of the global trading organisation is discussed. In particular the use of traditional transaction methods versus profit split methods, to reward the functions of the global trading organisation, is discussed.

The study concludes that the arm's length principle should be applied when determining transfer prices for global trading transactions.

The study also concludes that it is impossible to state that traditional transaction based methods or in the alternative profit split methods should always be applied to the global trading of financial instruments as each case would need to be evaluated on its own facts.

The study further states that the choice between traditional transaction methods and profit split methods will be influenced to a large extent by the availability of reliable comparable uncontrolled transaction data and/or the degree of integration of the functions performed. If there is a lack of reliable comparable uncontrolled transaction data and/or functions are highly integrated, there will be a strong argument for the use of profit split methods. The reliability of the method would however always need to be considered.

The study also provides guidance in respect the choice of the most appropriate methods (traditional transaction methods or profit split methods) for determining an arm's length price for the each of the functions of the global trading organisation.

OORDRAGPRYSE EN UNIVERSELE HANDEL IN FINANSIËLE INSTRUMENTE

Artikel 31(1) en (2) is in 1995 in die Inkomstebelastingwet, Wet 58 van 1962 ("die Wet") ingevoeg. Die artikel verleen aan die fiskus die mag om oordragpryse aan te pas ten einde 'n arm lengte prys te reflekteer.

'n Oordragprys is die prys wat gevra word tussen entiteite binne 'n organisasie of tussen lede van dieselfde groep van maatskappye vir transaksies. Die term dui aan dat die prys binne groepsverband vasgestel is en nie in die ope mark beding is nie (met ander woorde dit is nie 'n arm lengte prys nie).

Oordragprysvasstelling word algemeen beskou as een van die belangrikste belastinguitdagings vir multi-nasionale maatskappye. Dieselfde geld vir regerings en inkomste kantore wat hul inkomste wil maksimeer.

Die uitgifte van Praktyk Nota No. 7 op 6 Augustus 1999 deur die Kommissaris vir die Suid Afrikaanse Inkomste Diens ("SAID") en die vereiste in maatskappye se inkomstebelastingopgawes (IT 14) om transaksies tussen verbonde persone te openbaar, is aanduidings dat die bepalinge van Artikel 31(1) en (2) in die toekoms strenger deur die SAID toegepas gaan word.

Tegnologiese veranderinge, die kommunikasie revolusie en finansiële deregulering het grootliks aanleiding gegee tot universele handel in finansiële instrumente. Finansiële instellings het nuwe finansiële instrumente soos afgeleide instrumente ontwikkel om te voldoen aan die universele vraag na finansiering en belegging en om die dikwels verskillende behoeftes van beleggers en leners te versoen. Finansiële instellings (hoofsaaklik banke) organiseer hul aktiwiteite om vier en twintig uur van die dag aan die vraag van beleggers na universele finansiële produkte te voldoen. Universele handel in finansiële produkte vind oor verskeie belasting jurisdiksies plaas en die aktiwiteite van universele handels organisasies is dikwels hoogs geïntegreerd. As gevolg van hierdie twee faktore hou universele handel in finansiële instrumente wesenlike oordragprys implikasies in.

Die doel van hierdie studie is om:

- oordragprysvasstelling in Suid Afrika te bespreek en te oorweeg,
- universele handel in finansiële instrumente te analiseer en te bespreek,
- oordragprysvasstellingmetodes en tegnieke toe te pas op universele handeldrywing in finansiële instrumente en

- spesifiek die gebruik van tradisionele transaksie metodes versus winsverdelings metodes vir die vasstelling van arm lengte pryse in die konteks van die universele handeldrywing in finansiële instrumente te oorweeg.

Ten einde bogenoemde doel te bereik analiseer die studie oordragprys wetgewing in Suid Afrika en aanvaarbare metodes in terme van Praktyk Nota No. 7 vir die vasstelling van oordragpryse.

Die studie bespreek ook die feitelike agtergrond, struktuur van die besigheid, besigheids strategie en die organisasie van handels aktiwiteite van 'n tipiese universele handels organisasie. Verder is 'n analise van die funksies van die universele handels organisasie gedoen. Die funksie analise het die volgende kritieke funksies van 'n universele handels organisasie geïdentifiseer: verkope en bemarking; handel en risiko bestuur; ondersteuning/"back office"; en kapitaal/risiko aanvaarding.

Die toepassing van die metodes in Praktyk Nota No. 7 om die funksies, wat deur die funksie analise identifiseer is, te vergoed word oorweeg. In besonder word die gebruik van tradisionele transaksie metodes versus winsverdelings metodes, om die funksies van die universele handelsorganisasie te vergoed, bespreek.

Die studie het bevind dat die armslengtebeginsel toegepas moet word op universele handel in finansiële instrumente.

Die studie bevind dat dit onmoontlik is om te bepaal dat tradisionele transaksie metodes of in die alternatief wins verdelings metodes altyd toegepas moet word op universele handel in finansiële instrumente, omrede elke geval op sy eie feitestel evalueer moet word.

Die studie bevind dat die keuse tussen tradisionele transaksie metodes en winsverdelingsmetodes tot 'n groot mate beïnvloed sal word deur die beskikbaarheid van betroubare vergelykbare onbeheerde transaksie data en/of die graad van integrasie van funksies. Indien daar 'n gebrek aan betroubare vergelykbare onbeheerde transaksiedata is en/of funksies is hoogs geïntegreerd, sal daar 'n sterk argument wees vir die gebruik van winsverdelingsmetodes. Die betroubaarheid van die metode sal altyd oorweeg moet word.

Die studie verskaf riglyne met betrekking tot die keuse van die mees toepaslike (tradisionele transaksie metode versus winsverdelingsmetode) vir die vasstelling van arm lengte pryse vir elkeen van die kritieke funksies verrig deur die universele handelsorganisasie.

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CHAPTER ONE

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CHAPTER ONE - INTRODUCTION

1. BACKGROUND & RESEARCH PROBLEM

1.1. Transfer pricing

Transfer pricing refers to prices for goods, services, intangibles, royalties for intangibles and cost-sharing agreements for research and development activities between related parties such as multinational enterprises¹. Multinational enterprises are generally composed of a number of associated companies/entities that operate in different countries.

Thin capitalisation refers to the practice of funding a company with a disproportionate level of debt as opposed to equity.²

As a result of the exchange control restrictions applicable to the repatriation of capital and income in South Africa, non-residents substantially manipulated prices.³

Sections 31(1) and (2) were introduced in 1995⁴ on the recommendation of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa (the Katz Commission)⁵. The Katz Commission based its recommendations on the guidelines of the Organisation of Economic Co-

¹ Van Blerck 1995 InfoTax SATR 08.5.02, Eskinazi 1996 Finansies & Tegniek 23

² Horak 1997 InfoTax SATR 10.1.10., Louw 1995 Taxforum p1.

³ Horak & Van der Walt 1995 InfoTax SATR 08.2.03, Stanley 1996 Accountancy SA p.11.

⁴ Section 23(1) Act 21 of 1995.

⁵ Katz Second Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa (1995)

operation and Development (OECD)⁶. Section 31 deals with both transfer pricing and thin capitalisation. This study is restricted to transfer pricing.

Studies have shown that transfer pricing is the most important tax issue facing multinational companies. The same goes for governments and revenue authorities, which have become more stringent in their efforts to maximise their income⁷.

Section 31(1) and (2) of the Act grant the fiscus the power to adjust transfer prices to reflect an "arms-length price". Reference to the "arm's length price" in this study refers to the price which goods or service might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's length⁸.

The Commissioner for the South African Revenue Service (SARS) released Practice Note No. 7 on August 6, 1999. The objective of this Practice Note is to provide taxpayers with guidelines on the procedures to be followed in the determination of arm's length prices taking into account the South African business environment. It also sets out the Commissioner's views on documentation and other practical issues that are relevant in setting and reviewing transfer pricing in international agreements⁹. The issue of this Practice Note by SARS may be an indication that SARS will start to enforce Section 31 more aggressively¹⁰.

Practice Note No. 7 is based on the OECD's guidelines for transfer pricing¹¹. It also states that the OECD guidelines should be followed in the absence of

⁶ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1995).

⁷ Ernst and Young 1996 InfoTax SATR 09.3.07

⁸ Section 31(2)(b)(i).

⁹ SARS Practice Note No. 7

¹⁰ Deloitte & Touche Tax News 3rd Quarter 1999

¹¹ Friedland Finance Week 23 July 1999

specific guidance in the Practice Note, Section 31 or in South Africa's double taxation agreements¹². The issue of Practice Note No. 7 by SARS stresses the increasingly important role of transfer pricing¹³.

Practice Note No. 7 sets out various methods available to establish a price which adheres to the arm's length principle. The application of these methods is complex and each one offers its own problems.

1.2. Global trading of financial instruments

It is by now a common place observation that financial markets have become increasingly globalised. This can be attributed to technological changes, the communications revolution and the spread of financial deregulation¹⁴. For example, the introduction of the Internet resulted in the world's financial sector no longer being location bound.¹⁵

Various financial institutions conduct global trading in financial instruments. However the main financial institutions involved in this trade are banks. The reason for this is that banks have developed the necessary trading expertise and capital base necessary to engage in global trading¹⁶. Note that any reference to the term global trading in this document refers to the global trading of financial instruments.

¹² SARS Practice Note no. 7

¹³ Friedland Finance Week 23 July 1999

¹⁴ OECD The Taxation of Global Trading of Financial Instruments March 1998 I; Speech to the 20th Annual Banking Conference of the Italian Chamber of Commerce, London, 2 October 1998 by Renato Ruggiero "The Global Market: the Competitiveness of European Banks and Industry"

¹⁵ De Klerk Finance Week, July 9 1999

¹⁶ OECD The Taxation of Global Trading of Financial Instruments March 1998 II-2

Financial institutions that act as financial intermediaries have played a substantial role in the efficient operations of financial markets. Traditionally financial institutions acted as intermediaries between those who wanted to invest capital and those who needed capital. However, currently financial institutions no longer simply intermediate between investors and borrowers by simply matching and offsetting transactions and taking a margin in the middle, but rather seek to earn profits by directly managing the risks from a portfolio of transactions with customers¹⁷. This pattern is well developed for businesses dealing in derivative instruments¹⁸.

One can view the business of being a derivative dealer as assuming risks that customers do not have the expertise or the desire to manage themselves or alternatively creating the means by which the customer can take on risks that it believes will complement its existing risk portfolio. The derivative's dealer makes money by managing those risks more efficiently than the customer would have.¹⁹

Derivatives are financial instruments that obtain their price and therefore their value from another instrument or the underlying security such as a debt security, equity, commodity or a specified index. The most common derivatives are forwards, futures, options and notional principle swaps, caps, floors and collars. Unlike traditional debt and equity securities, these instruments generally do not involve a return on an initial investment²⁰.

¹⁷ Fourie, Falken & Kok: A Student Guide To The South African Financial System p.7

¹⁸ Anonymous 1999 "Following the money: U.S. Finance in the World Economy"

¹⁹ OECD The Taxation of Global Trading of Financial Instruments March 1998 I

²⁰ OECD The Taxation of Global Trading of Financial Instruments March 1998 I, Ford: Mastering Exchange - Traded Equity Derivative p.X

The development of sophisticated derivative instruments has changed the nature of financial intermediation. It is no longer necessary for a financial institution to develop a single product that meets the needs of both parties to a transaction. The issuer can sell a security that has the terms demanded by the investor and then effectively modify the terms of the instrument by entering into a derivative transaction with another party (usually, the financial institution that arranged the transaction)²¹. The effect of the development of these new financial products is not limited to the market for derivative instruments as it facilitates even traditional bond offerings.

Financial intermediation now involves several business activities:

- underwriting and distributing of products on a world-wide basis,
- acting as a market-maker in physical securities (i.e. the traditional bond and equity markets) and in derivative instruments,
- acting as a broker for client transactions on stock and commodities exchanges around the world and
- developing new financial products to meet the needs of the financial institution's clients ²².

The income earned by the financial institution consist of:

- interest and dividends received with respect to the inventory which it is required to be a market-maker with respect to physical securities,
- trading gains from the sale of that inventory,
- income from notional principal contracts and other over-the-counter ("OTC") derivatives entered into with clients,
- fee income from structured transactions,

²¹ Ford: Mastering Exchange - Traded Equity Derivative p.X, OECD The Taxation of Global Trading of Financial Instruments March 1998

²² Fourie, Falken & Kok: A Student Guide to the South African Financial System p.6, OECD The Taxation of Global Trading of Financial Instruments March 1998 I

- gains from dealing in liabilities,
- income from stocklending and repo transactions and
- brokers' fees from exchange transactions executed for clients²³.

The term "global trading" refers to the capacity of these financial institutions to execute customers' orders in financial products around the world and/or around the clock²⁴. This process of global trading consists of a number of functions, which generally can be categorised into trading, sales and marketing, management and support functions. Any combination of these functions can occur at any of the locations in which global trading take place. For example, a bank's office in South Africa may structure and sell to customers a product that is booked and managed from the bank's New York office.

This global trading presents a number of challenges to traditional tax principles. This involves questions as basic as:

- when the trading activities was conducted in other countries (different time zones),
- was the activities conducted directly or through affiliates acting as agents,
- does it constitute a permanent establishment,
- how to determine the income attributable to those permanent establishments,
- how to apply traditional transfer pricing methodologies to transactions between associated enterprises involved in an integrated business, and
- basic timing issues²⁵.

²³ OECD The Taxation of Global Trading of Financial Instruments March 1998 I, Fourie, Falken & Kok: A Student Guide to the South African Financial System p.21

²⁴ Anonymous 1999 "Following the money: U.S. Finance in the World Economy"

²⁵ OECD The Taxation of Global Trading of Financial Instruments March 1998 I

1.3. Statement of the research problem

The question that arises is whether existing transfer pricing methodologies can be applied to the global trading of financial instruments and furthermore how they should be applied. A further question that arise is a whether traditional transaction based methods or profit split methods should be used to determine arm's length prices for the global trading of financial instruments.

2. THE SUBJECT OF THE STUDY

The aim of this study is to:

- 1) consider and discuss transfer pricing in South Africa,
- 2) to analyse and discuss the global trading of financial instruments,
- 3) to apply transfer pricing methodologies to the global trading of financial instruments and
- 4) to specifically consider the use of traditional transaction methods versus profit split methods for the determination of arm's length prices in the context of the global trading of financial instruments.

This aim will be achieved by analysing and discussing:

- The general principles of transfer pricing.
- South African transfer pricing legislation Section 31(1) and (2) and related legislation Section 103 and 82.
- The arm's length principle and the principles of comparability.
- The guidance provided in Practice Note No. 7 and specifically acceptable methods for the determination of arm's length prices.
- The factual background of the global trading of financial instruments.

- A functional analysis of global trading activities.
- Application of the arm's length principle to global trading of financial instruments.
- The use of traditional transaction methods versus profit split methods in the context of the global trading of financial instruments.

3. THE DELIMITATION

- This study will not attempt to discuss Section 31 in detail as it read prior to the amendment in 1995.
- This study will not attempt to discuss Section 31(3) and thin capitalisation.
- This study will not attempt to research the use of transfer pricing for other purposes than possible tax savings.
- This study is limited to transfer pricing methodologies that adhere to the arm's length principle as advocated by the OECD and set out in SARS Practice Note No. 7.
- The study is limited to an application of transfer pricing methodologies as set out in Practice Note No. 7 to the global trading of financial instruments, as defined in the OECD report of 1998 on this subject.
- This study only addresses the issues related to transfer pricing in relation to associated enterprises and to the attribution of income and expenses within a single legal entity, which arises when global trading is conducted in more than one tax jurisdiction.

- The study will not discuss the concepts, terminology and principles involved in the trade of financial instruments.
- The study will not discuss the VAT consequences of transfer pricing.

4. THE SIGNIFICANCE OF THE STUDY

The interpretation of the concept “arms length price” is the most significant problem arising from the application of Section 31. SARS issued Practice Note No. 7 on August 6, 1999, which provides taxpayers with guidelines about the procedures to be followed in the determination of arm’s length prices taking into account the South African business environment²⁶.

Transfer pricing is one of the most important tax issues facing multinational companies and companies seek clarity on the manner in which transfer pricing and thin capitalisation rules will be enforced by revenue authorities²⁷.

Therefore the issue of Practice Note No. 7 by SARS is extremely important as it provides practical guidance on the methodologies that SARS would find acceptable for the determination of an arm’s length transfer price. It also goes a long way to providing clarity on the manner in which transfer pricing will be enforced by revenue authorities.

The methodologies advocated by Practice Note No. 7 is in line with the OECD guidelines and would therefore be acceptable to most countries, which is important as South Africa is increasingly participating in international trade.

²⁶ SARS Practice Note No. 7

²⁷ Ernst and Young 1996 InfoTax SATR 09.3.07, Eskinazi 1996 Financial Mail 34.

The OECD published a discussion draft on the Taxation of Global Trading of Financial Instruments in 1997 and invited the business community to comment on the document. In March 1998 the OECD issued the final document on the Taxation of Global Trading of Financial Instruments.

The OECD document highlighted the significance of the Global Trading of Financial Instruments and the various problems that it poses to traditional taxation systems. The OECD document considered the application of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations to the Global Trading of Financial Instruments.

The significance of the Global Trading of Financial Instruments is evident from a small survey conducted by the U.S. Treasury Department in respect of international transactions conducted by U.S. pension funds in 1991. The survey indicated that a large portion of U.S. pension fund transactions in foreign securities had been carried out by offshore (non-resident) money managers and that there had been a significant underreporting of these transactions in the U.S. It was estimated that the underreporting amounted to approximately \$170 billion²⁸.

As is evidence from the above example countries needs to have sound transfer pricing policies in place, also in respect of the Global Trading of Financial Instruments. Due to the innovation of financial instruments operations of major financial institutions have increasingly extended beyond national borders²⁹.

²⁸ Anonymous 1999 "Following the money: U.S. Finance in the World Economy"

²⁹ Anonymous 1999 "Following the money: U.S. Finance in the World Economy"

The application of transfer pricing rules to the Global Trading of Financial Instruments has come to the forefront with the publication of the OECD's report in this respect.

Global trading entities are highly integrated, thus it is relatively easy for such entities to move profits from higher tax jurisdictions to lower jurisdictions. For example, in the case of a transaction that took place over several tax jurisdictions the expenses and losses arising from transactions entered into to hedge the risk arising from a customer transaction may be allocated against the gross profit arising from the transaction. The net profit is then recognised in the tax jurisdiction where the transaction originated i.e. where the sale to the customer took place. This allocation is unlikely to produce a result consistent with the arm's length principle³⁰.

The Global Trading of Financial Instruments was also discussed at the 1998 London Congress of the International Fiscal Association ("IFA") held on October 4 - 9 1998. Two separate case studies on the Global Trading of Financial Instruments were analysed³¹. The discussions highlighted the significance of the transfer pricing issues raised by the Global Trading of Financial Instruments.

The Global Trading of Financial Instruments and the transfer pricing issues relating to it will become increasingly important in the near future as technology develops and financial markets become increasingly deregulated.

³⁰ OECD The Taxation of Global Trading of Financial Instruments March 1998

³¹ Worldwide Tax Daily Database International Fiscal Association summary of scientific proceedings at the 1998 London Congress (reference: 98 TNI 251-53)

5. RESEARCH DESIGN AND FRAMEWORK OF THE STUDY

The research consists of a literature study. The relevant legislation, SARS Practice Note(s), OECD reports and opinions of recognised law and tax experts will be used for this purpose. The framework set out below provides a structured allocation per chapter of the subject of the study.

5.1. Transfer pricing and Section 31

In Chapter 2 the general principles of transfer pricing and the provisions of Section 31 is discussed. A thorough understanding of the general transfer pricing principles and of the provisions of Section 31(1) and (2) is essential.

5.2. Section 103 and Section 82

In Chapter 3 Section 103 the general anti-avoidance provisions in the Act and Section 82 the taxpayers burden of proof are discussed. These two sections are of importance as they are linked with Section 31 and inter acts with Section 31.

5.3. The Arm's Length Principle

In Chapter 4 the arm's length principle and the principle of comparability, which are essential for any transfer pricing review are discussed.

5.4. Methods for determining an arm's length price

In Chapter 5 the hierarchy of methods, the four-step approach for the determination of transfer prices and acceptable methods for the determination of an arm's length price as set out in Practice Note No. 7 are discussed and analysed. Each method is described and the practical problems relating to the application is discussed. Traditional transaction methods and transactional profit methods are evaluated. Advanced pricing agreements (APA's) is mentioned and briefly discussed.

5.5. Global trading of financial instruments

In Chapter 6 the factual background of the global trading of financial instruments is discussed and a functional analysis of the typical global trading organisation is performed.

5.6. Applying the arm's length principle to global trading of financial instruments

In Chapter 7 the methods discussed in Chapter 5 is applied to and considered in relation to the functions of the global trading organisation as set out in Chapter 6. Profit split methods and their application to global trading is also specifically considered. Furthermore, two case studies that illustrates global trading are considered.

5.7. Summary and Conclusion

Chapter 8 gives a summary of the findings of the study and a conclusion in respect of the research problem.

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CHAPTER TWO - TRANSFER PRICING AND SECTION 31

1. TRANSFER PRICING

1.1. A definition of transfer pricing

A transfer price is the price placed on a transaction between parts of a single organisation or between members of a group of companies. The term is a way of indicating that it is a price arranged within the same group, and not arrived at in the open market (i.e. not an arm's length price). The term is often used in condemnation because of a suspicion that the prices within an organisation are readily manipulated to avoid tax or to achieve some other ulterior motive³².

1.2. The objectives of transfer pricing

Transfer pricing is used by multinational companies in a taxation context, to exploit the differences in tax laws between countries. Profits are transferred from high to low tax jurisdictions with the object of gaining a tax advantage as a result of the differences in the tax laws of various countries³³.

³² Deloitte & Touche 1996 InfoTax SATR 09.1.07

³³ Katz Commission Report (1995); Deloitte & Touche 1996 InfoTax SATR 09.1.07

For example, if a member of a multinational company sells to a connected person resident in another country (low tax jurisdiction) at a price which exceeds the market price, the profit which the multinational earns in its country is increased. Similarly if the member of a multinational sells to a connected person resident in another country at a reduced price, the profit the multinational earns in its country is reduced³⁴.

However, tax avoidance is not the only reason for the use of transfer prices. There is significant commercial realities that justifies the use of transfer prices. For example, a company may operate in divisions which are all profit centers in their own right. These divisions are evaluated based on their performance, hence it is of importance that the transfer prices charged between divisions are not detrimental to any one division.

Other non-tax reasons for setting transfer prices are for example to avoid exchange risks, to repatriate capital or profits and to support ailing entities in a group of companies³⁵.

However, studies have shown that the maximisation of consolidated after tax profits is the most important objective in the use of transfer pricing by multinational companies³⁶.

³⁴ SARS Practice Note No. 7

³⁵ Deloitte & Touche 1996 InfoTax SATR 09.1.07

³⁶ Eskinazi 1996 Finansies & Tegniek

2. SECTION 31 OF THE INCOME TAX ACT

2.1. The objective of Section 31

The objective of the Section 31 is to address tax avoidance schemes involving manipulation of prices for goods or services in cross border transactions between connected persons³⁷.

2.2. Section 31(2)

The transfer pricing provisions of Section 31 are contained in subsection (2) that reads as follows:

“(2) Where any goods or services are supplied or acquired in terms of an international agreement and-

(a) the acquiror is a connected person in relation to the supplier; and

(b) the goods or services are supplied or acquired at a price which is either-

(i) less than the price which such goods or services might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's length (such price being the arm's length price); or

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

³⁷ Meyrowitz on Income Tax (1997-1998) 11.116; Huxam & Haupt Notes on South African Income Tax (1999) 402

then, for the purposes of this Act in relation to either the acquiror or supplier, the Commissioner may, in the determination of the taxable income of either the acquiror or supplier, adjust the consideration in respect of the transaction to reflect an arm's length price for the goods or services."

Section 31 is an anti-avoidance provision aimed at preventing the artificial removal into another jurisdiction of what would otherwise be profit subject to tax in South Africa³⁸.

The following terms used in Section 31(2) are defined in Section 31(1) of the Act: "goods", "services", "international agreement" and "arm's length price".

The term "connected persons" which is also used in Section 31(2) is defined in Section 1 of the Act.

2.3. Section 31(1) Goods

"Goods" is defined as follows in Section 31(1):

"'goods' includes any corporeal movable thing, fixed property and any real right in any such thing or fixed property".

Only tangible things and real rights are mentioned, hence other rights than real rights and intangible property (royalties, trademarks etc.) will not fall under the definition of "goods". However, these other rights and intangible property may fall under the definition of "services" as will be seen below.

³⁸ Clegg 1997 The Taxpayer 163

2.4. Section 31(1) Services

The definition of “services” in Section 31(1) is very wide and reads as follows:

“ ‘services’ includes anything done or to be done, including, without limiting the generality of the foregoing-

- (a) the granting, assignment, cession or surrender of any right, benefit or privilege;*
- (b) the making available of any facility or advantage;*
- (c) the granting of financial assistance, including a loan, advance or debt, and the provision of any security or guarantee;*
- (d) the performance of any work;*
- (e) an agreement of insurance; or*
- (f) the conferring of rights to incorporeal property.”*

As with the definition of “goods”, the legislature attempted to provide the widest possible application with the definition of services. Examples of services that would be included in the definition are management fees, royalties, patents, trademarks and franchises³⁹.

³⁹ Silke Income Tax Commentary 17.55.

2.4.1. Financial assistance

The inclusion of financial assistance in the definition of “services”⁴⁰ is relevant in cases where thin capitalisation, falling under Section 31(3), has occurred. The application of thin capitalisation rules fall outside the scope of this study.

However, Section 31(2) may also be applied in the instance where financial assistance is provided by a non-resident to a resident who is a connected person in relation to the non-resident and the consideration for the granting of the financial assistance does not reflect an arm’s length consideration. In terms of Section 31(2) the Commissioner can in the determining of the taxable income of the resident adjust the consideration in the hands of the resident to reflect an arm’s length consideration⁴¹.

The term “consideration” in this context refers to interest, related finance charges, discount or premium⁴².

As noted above,⁴³ financial assistance includes the granting of a loan, advance or debt, and the provision of any security or guarantee.

2.4.1.1. Section 31(2) & Section 31(3) applied to financial assistance

Only interest bearing financial assistance should be taken into account where Section 31(2) is applied in conjunction with Section 31(3)⁴⁴.

⁴⁰ Section 31(1) paragraph (c).

⁴¹ SARS Practice Note 2 – 14 May 1996; SARS Practice Note No. 7 – 6 August 1999

⁴² SARS Practice Note 2 – 14 May 1996; SARS Practice Note No. 7 – 6 August 1999

⁴³ Section 31(1) paragraph (c).

⁴⁴ Practice Note No. 2 – 14 May 1996

Practice Note No. 2 states that two steps should be followed where a non-resident investor has lent money to a South African borrower who is a connected person or a person in whom the non-resident has a greater than 25% stake. These steps are as follows:

1. Calculate the amount of the financial assistance which is acceptable in terms of the thin capitalisation rules (Section 31(3)), and disallow the interest on the excessive portion of the financial assistance. The excessive (disallowable) portion of the financial assistance will be the portion of the financial assistance that exceeds an amount equal to three times the fixed capital of the resident or recipient of the financial assistance (“3:1 rule”)^{45 46}.
2. The provisions of Section 31(2) should then be applied to the allowable portion of the financial assistance to determine whether the interest is based on an arm’s length consideration (interest rate)⁴⁷. Practice Note No. 2 provides the following guidance in respect of arm’s length interest rates (acceptable interest rates):
 - (i) In instances where the loan, advance or debt is denominated in Rands an acceptable nominal annual interest rate will be a rate not exceeding the weighted average of the South African prime rate plus 2 percentage points⁴⁸.
 - (ii) Where the loan, advance or debt is denominated in a foreign currency, the relevant interbank rate plus 4 percentage points will be an acceptable nominal annual interest rate⁴⁹.

⁴⁵ Practice Note No. 2 - 14 May 1996, Huxam and Haupt (1999) 20.14

⁴⁶ The study does not deal with thin capitalisation, hence the calculation is not discussed in detail.

⁴⁷ Practice Note No. 2 - 14 May 1996, Huxam and Haupt (1999) 20.14

⁴⁸ Practice Note No. 2 - 14 May 1996, Huxam and Haupt (1999) 20.14, Meyerowitz 13.20

⁴⁹ Practice Note No. 2 - 14 May 1996, Huxam and Haupt (1999) 20.14, Meyerowitz 13.20

Any interest exceeding the acceptable nominal annual rates described above will be regarded as “excessive interest” and will consequently not be allowed as a deduction for income tax purposes⁵⁰.

2.4.1.2. *Section 31(2) applied to financial assistance*

Where the thin capitalisation (Section 31(3)) rules is not applicable because the financial assistance falls within the prescribed guidelines (3:1 rule) the provisions of Section 31(2) may still be applicable. An arm’s length price in terms of Section 31(2) will be determined as explained above.

Section 31(2) refers to an arm’s length price. This raises the question if Section 31(2) would be applicable in instances where there is no consideration as is the case with an interest free loan.

According to Clegg⁵¹ a court could uphold a claim of the Commissioner to adjust an interest free loan from a South African company to a foreign subsidiary to a deemed interest consideration at market value.

This view is supported if reference is made to the interpretation rules laid down in *Glen Anil Development Corporation Ltd v SIR*⁵² in which the court stated:

⁵⁰ Practice Note No. 2 - 14 May 1996, Huxam and Haupt (1999) 20.14

⁵¹ Clegg 1997 The Taxpayer 164; Practice Note No. 2 - 14 May 1996, Huxam and Haupt (1999) 20.14

⁵² *Glen Anil Development Corporation Ltd v SIR* 1975 (4) SA 715 (A); 37 SATC 319.

"I do not understand this to mean that in no case in a taxing Act are we to give a section a narrower or wider meaning than its apparent meaning, for in all cases of interpretation we must take the whole statute into consideration and so arrive at the true intention of the legislature."

It is clear from the above that Section 31(2) will also apply to interest free loans.

2.5. Section 31(1) International Agreement

Section 31(2) will only be applicable if the goods or services were supplied in terms of an international agreement. Therefore, the definition of an "international agreement" in Section 31(1) is of extreme importance.

An "international agreement" is defined as follows in Section 31(1):

" 'international agreement' means a transaction, operation or scheme entered into between-

- (a) (i) *a person who, in the case of a natural person, is ordinarily resident in the Republic or in the case of a person other than a natural person, is managed or controlled in the Republic; and*
- (ii) *any other person who, in the case of a natural person, is ordinarily resident outside the Republic or in the case of a person other than a natural person, is managed or controlled outside the Republic.; or*
- (b) (i) *a person who, in the case of a natural person, is ordinarily resident outside the Republic or in the case of a person other than a natural person, is managed or controlled outside the Republic; and*
- (ii) *any other person who, in the case of a natural person, is ordinarily*

resident outside the Republic or in the case of a person other than a natural person, is managed and controlled outside the Republic;

for the supply of goods or services to or by a permanent establishment as contemplated in section 9C(1) of either such persons in the Republic”.

Both paragraph (a)(i) and (ii) or (b)(i) and (ii) above needs to apply before an international agreement has been concluded. Thus, it is clear that Section 31 is not applicable to domestic transactions between South African residents.

Paragraph (b) of the definition makes it clear that Section 31 would apply to transactions between a permanent establishment in South Africa of a non-resident company and another non-resident company.

The Draft Revenue Laws Amendment Bill (1999)⁵³ propose the following amendment to the definition of an international agreement in Section 31(1)(b):

“Amendment of section 31 of Act 58 of 1962, as substituted by section 23 of Act 21 of 1995 and amended by section 37 of Act 30 of 1998

33. (1) *Section 31 of the Income Tax Act, 1962, is hereby amended-*

- (a) by the substitution for the word “and” at the end of paragraph (b) of subsection (1) of the word “or”; and*
- (b) by the addition to the definition of “international agreement” of the following paragraph:*

⁵³ Draft revenue laws amendment bill (1999)

- (c) (i) *a person who, in the case of a natural person, is ordinarily resident in the Republic or in the case of a person other than a natural person is managed or controlled in the Republic; and*
- (ii) *any other person who, in the case of a natural person, is ordinarily resident in the Republic or in the case of a person other than a natural person is managed or controlled in the Republic for the supply of goods or services to or by a permanent establishment as contemplated in section 9C(1) of either of such persons outside the Republic; and*
- (2) *Subsection (1) shall come into operation on the date of promulgation of this Act, and shall apply in respect of any transaction, operation or scheme entered into on or after that date."*

It is fairly certain that this proposed amendment will be incorporated in the Act. The result of the amendment would be that Section 31 would also apply to transactions between a permanent establishment in a foreign country of a South Africa resident and another South African-resident company.

The definition of an international agreement gives rise to the question of what "managed or controlled", "ordinarily resident" and "permanent establishment" mean. A discussion of these concepts follows.

2.5.1. Managed or controlled

SARS's interpretation of the meaning of "management or controlled" used in the definition of an "international agreement" is set out in Practice Note No. 7. Listed below is SARS's view as expressed in Practice Note No. 7.

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

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

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

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

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

From the above it is evident that the place from which an entity is controlled is not necessarily the place from which it is managed⁵⁴.

The SARS's interpretation as set out above supports Silke's⁵⁵ view that the legislature's choice of the word "or" rather than "and" in the phrase "*managed or controlled*", constituted an attempt to widen the scope of this section's application by effectively including a control exercising South African branch of a foreign company. If the South African branch is capable of exercising

⁵⁴ SARS Practice Note No. 7 - 6 August 1999

⁵⁵ Silke 17.57 Books on Screen

dominant control over company policy and if the controlling body within the South African branch has independence to decide how the business is managed and controlled locally, the provision could capture the local branch of a foreign entity⁵⁶.

The recent inclusion of a permanent establishment of a non-resident in the definition of “international agreement” confirms the view that a local branch of a foreign entity falls within the ambit of section 31(2)⁵⁷ (refer to para 2.4. above).

2.5.2. Ordinarily resident

The term “ordinarily resident” is not defined in the Income Tax Act. The High Court held in *CIR v Kuttel*⁵⁸ that a natural person is ordinarily resident where he has his usual or principle residence, that is, what he describes as his real home.

The question that arises is whether a person can be ordinarily resident in more than one country. Case law has as yet not provided a clear answer to this question. In *Cohen v CIR*⁵⁹ the court was of the obiter view that the term “ordinarily” referred to a persons most fixed or settled residence and that this was unlikely to be in two places.

Notwithstanding the above question and the vagueness surrounding it the Katz Commission stated in their Fifth Interim Report (at para 6.1.1)⁶⁰ that, in the context of natural persons:

⁵⁶ Silke 17.57 Books on Screen

⁵⁷ Stanley: Accountancy SA November/December 1998

⁵⁸ *CIR v Kuttel* 1992 (3) SA 242 (A); 54 SATC 306

⁵⁹ *Cohen v CIR* 1946 AD 174; 13 SACT 371

⁶⁰ Katz Commission Fifth Interim Report para 6.1.1

“6.1.1.1 The Commissioner believes that the concept currently used in our law of ‘ordinarily resident’ is well understood and, subject to the qualification in the next paragraph, should be retained.”

“6.1.1.2 Where, under rules, it is not possible to establish any one single place of residence for a natural person, it is recommended that his or her residence status be determined in accordance with the tie-break provisions as contained in the OECD Model Tax Convention. This presents a solution for an otherwise difficult problem which is both practical and internationally familiar.”

The OECD tie-break provisions are found in Article 4 of the OECD Model Double Tax Convention⁶¹ and provides as follows:

“1. For the purposes of this Convention, the term ‘resident of a contracting State’ means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any criteria of a similar nature. But this term does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:

(a) he shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (centre of vital interests);

⁶¹ OECD Model Double Tax Convention Article 4

(b) if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has a habitual abode;

(c) if he has a habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national;

(d) if he is a national of both States or of neither of them, the competent authorities of the contracting States shall settle the question by mutual agreement."

From the aforementioned it is clear that physical presence is not a conclusive test to determine if a person is ordinarily resident in the Republic. The determining factor is the manner in which a person is physically present in a particular country. The circumstances of his ordinary course of living must be examined for instance business commitments that may take him away from his settled residence for such regular and continuous periods that it may be said that he is ordinarily resident in the other country⁶².

2.5.3. Permanent establishment

In the definition of international agreement reference is made to the concept "permanent establishment" as contemplated in section 9C(1) of the Act.

In Section 9C(1) a permanent establishment is defined as follows:

"'permanent establishment' means a permanent establishment as defined from time to

⁶² Snyckers: Transfer pricing p.19

time in Article 5 of the OECD Model Tax Convention on Income and on Capital of the Organization for Economic Co-operation and Development”.

It has been said in response to the inclusion of the above definition in section 9C(1) that there is a degree of awkwardness in importing a definition of this nature verbatim into the domestic legislation of South Africa. This is due to the fact that the OECD Model Convention is a model agreement between “Contracting States”, and, accordingly the wording such as “Contracting States” could at times be inappropriate and irrelevant for domestic tax provisions.⁶³

Article 5 of the OECD Model Convention defines a “permanent establishment” as a fixed place of business through which the business of an enterprise is wholly or partly carried on, and it includes specifically: a place of management; a branch; an office; a factory; a workshop; a mine, an oil or gas well, a quarry or any other place of extraction of natural resources and a building site or construction or installation project lasting more than twelve months⁶⁴.

The definition specifically excludes: a warehouse used solely for the storage, display or delivery of goods belonging to the enterprise; and the maintenance of goods solely for the purpose of processing by another enterprise or for purchasing goods or collecting information⁶⁵.

⁶³ Van Blerck & Horak 1997 InfoTax SATR 10.2.02.

⁶⁴ Van Blerck & Horak 1997 InfoTax SATR 10.2.02., OECD Model Tax Convention Article 5

⁶⁵ Van Blerck & Horak 1997 InfoTax SATR 10.2.02., OECD Model Tax Convention Article 5

According to the OECD Commentary⁶⁶ two conditions must exist, namely:

- a “place of business” such as premises which must be fixed in the sense that i.e. is established in a distinct place with a certain degree of permanence; and
- the carrying on of business of the enterprise through these premise. This means that personnel who are dependent on the enterprise should conduct the business of the enterprise from this fixed place.

2.4.4. Partnerships

The definition of “international agreement” refers to transactions, operations or schemes entered into and between natural persons and persons other than natural persons.

Section 31 would not apply to partnerships due to the fact that the Income Tax Act does not recognise a partnership as a person⁶⁷. However, the rules will apply to the respective partners independently⁶⁸.

2.4.5. Connected person

Section 31 applies to parties who are connected persons. Hence, the definition of “connected person” in Section 1 of the Income Tax Act is significant importance. Section 1 of the Act defines a “connected person” as follows:

⁶⁶ OECD Commentary on Article 5 of the OECD Model Tax Convention

⁶⁷ Silke 17.58 Books on Screen

⁶⁸ Horak 1997 InfoTax SATR 10.1.10.

“ ‘Connected person’ means-

(a) in relation to a natural person-

(i) any relative; and

(ii) any trust of which such natural person or such relative is a beneficiary;

(b) in relation to a trust-

(i) any beneficiary of such trust; and

(ii) any connected person in relation to such beneficiary;

(bA) in relation to a connected person in relation to a trust (other than a unit trust scheme in property shares as authorised under the Unit Trust Control Act, 1981 [Act No. 54 Of 1981]), includes any other person who is a connected person in relation to such trust;

(c) in relation to a member of any partnership-

(i) any other member; and

(ii) any connected person in relation to any member of such partnership;

(d) in relation to a company-

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

(ii) its subsidiary as so defined;

(iii) any other company where both such companies are subsidiaries (as so defined) of the same holding company;

(iv) any person other than a company, who individually or jointly with any connected person in relation to himself, holds, directly or indirectly, at least 20 per cent of the company's equity share capital, members' interest or voting rights;

(v) any other company if at least 20 per cent of the equity share capital of such company is held by such company, and no shareholder holds the majority voting rights of such company;

- (vA) any other company if such other company is managed and controlled by-*
- (aa) any person who or which is a connected person in relation to such company; or*
 - (bb) any person who or which is a connected person in relation to a person contemplated in item (aa); and*
- (vi) where such company is a close corporation-*
- (aa) any member;*
 - (bb) any relative of such member or any trust which is a connected person in relation to such member; and*
 - (cc) any other close corporation which is a connected person in relation to the relative or trust contemplated in item (bb); and*
- (e) in relation to any person who is a connected person in relation to any other person in terms of the foregoing provisions of this definition, such other person."*

A discussion of this definition falls outside the scope of this study⁶⁹.

2.6. The effect of tax treaties on Section 31

Article 7 of the OECD Model Tax Convention on Income and Capital⁷⁰ provides *inter alia* for the attribution of profits to a permanent establishment of an enterprise ("business profits article"). Article 9 of the OECD Model Tax Convention⁷¹ states that the arm's length principle must be applied to commercial and financial relations between associated companies residing in contracting states ("associated enterprises article"). These two principles are embodied in each of South Africa's treaties. Tax treaties cannot impose tax liability, they merely allocate existing tax liabilities between countries⁷².

⁶⁹ See Meyerowitz 12.23 for a general discussion of the meaning.
⁷⁰ OECD Model Tax Convention on Income and Capital Article 7
⁷¹ OECD Model Tax Convention Article 9
⁷² SARS Practice Note No. 7

The “business profits” and “associated enterprises” articles in the tax treaties do not indicate priorities as to the methods to be used to determine the attribution of profits or an arm’s length price. The Commissioner holds the view that the treaties do not restrict or limit the application of Section 31 of the Act, regardless of the method selected to determine an arm’s length consideration. The Commissioner also takes the view that no inconsistency exists between domestic law and the tax treaties, as both embody the arm’s length principle⁷³.

2.7. The Commissioner’s discretionary powers

Section 31 enables the Commissioner to adjust the consideration in respect of a supply or acquisition of goods or services in terms of an international agreement between connected persons. The Commissioner may adjust the consideration, for tax purposes, if the actual price is either less or greater than the price that would have been set if the supply or acquisition of goods or services had occurred between independent parties on an arm’s length basis. The Commissioner may use the amount so determined, in the determination of the taxable income of either of the parties to the transaction⁷⁴.

The amount that has been adjusted or disallowed could be deemed to be a dividend for purposes of Secondary Tax on Companies (STC) and STC will be imposed on such an amount in terms of section 64C(3)(e)⁷⁵. However, this only applies if the “recipient” in relation to any company is:

⁷³ SARS Practice Note No. 7

⁷⁴ SARS Practice Note No. 7

⁷⁵ Horak & Van Der Walt 1995 Infotax SATR 08.2.03.; Huxam & Haupt (1999) 20.14

- any shareholder of such company;
- any relative of such shareholder; or
- any trust of which such shareholder or relative is a beneficiary⁷⁶.

The deemed dividend rule thus only applies to specific cases. For example, if a company sells goods to a connected party abroad who is not a shareholder of the company, the adjustment under Section 31 would not be treated as a dividend. It should be noted that the definition of "shareholder" in Section 1 of the Act is very wide and includes any person who is entitled to all or part of the benefit of the right of participation in the profits or income attaching to a share⁷⁷.

Any discretion exercised by the Commissioner is subject to objection and appeal⁷⁸. At first glance it seems that the onus falls upon the taxpayer to prove that the transaction was conducted at an arm's length price⁷⁹.

3. DOCUMENTATION REQUIREMENTS

Documentation sections in the Income Tax Act⁸⁰ also apply to transfer pricing investigations. There is no explicit statutory requirement to prepare and maintain transfer pricing documentation. However, adequate documentation should be kept in order to demonstrate that prices are arm's length.

If a taxpayer does not keep such documentation:

- the Commissioner will examine transfer pricing issues in detail and

⁷⁶ Section 64C(1).

⁷⁷ Snyckers: Transfer pricing p.28

⁷⁸ Section 81.

⁷⁹ Section 82.

⁸⁰ Section 74, 74A, 74B, 74C, 74D and 75

- if an alternative arm's length amount is substituted, the lack of documentation will make it difficult to challenge the adjustment made by the Commissioner.

The income tax return for companies (IT14) requires specific information regarding transaction between connected persons. It would not be possible for a taxpayer to comply with these requirements if the taxpayer has not addressed the question of whether its dealings comply with the arm's length principle.

If a transfer pricing file is kept which properly documents pricing, the Commissioner is more likely to conclude that the transfer pricing practices are acceptable.

A taxpayer is not expected to go to such lengths that the cost of documentation is disproportionate to extent of the taxpayer's international transactions.

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

- International agreements between connected persons
- Nature and terms of all relevant transactions
- Functional analysis
- Comparables
- Method selection of appropriate transfer pricing method and reasons
- Information relied on to arrive at arm's length terms⁸¹.

⁸¹ SARS Practice Note No. 7

CHAPTER THREE

SECTION 103 AND SECTION 82

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CHAPTER THREE - SECTION 103 AND SECTION 82

1. SECTION 103 AND TRANSFER PRICING

An analysis of Section 103(1) makes it clear that the existence of a motive to avoid or postpone liability for taxation is required for the provisions of Section 103(1) to take effect⁸².

Section 31 does not contain such a requirement. In terms of Section 31, if the Commissioner has established that goods or services has been transferred at a non-arm's length price, he may adjust the consideration to reflect an arm's length price. As a consequence, the taxpayer cannot defend an abnormal price on the grounds that it is abnormal for reasons other than obtaining a tax benefit⁸³.

However, if the Commissioner attacks a transfer price set by a taxpayer in terms of Section 31, the taxpayer may argue that the abnormal price is in fact arm's length, and only appears otherwise due to circumstances which are unrelated to taxation⁸⁴. Thus, if the taxpayer is able to show that special circumstances, unrelated to the fact that the purchaser is a connected person, account for the variation, he may be able to establish that the price is, in the circumstances, an arm's length price.⁸⁵

As illustrated above the focus of the Section 31 and Section 103(1) differs significantly. Section 31 would appear to have a wider application.

⁸² Section 103(1)(c).

⁸³ Van Blerck 1995 InfoTax 08.2.02.

⁸⁴ Van Blerck 1995 InfoTax 08.2.02.

⁸⁵ Van Blerck 1995 InfoTax 08.2.02.

However, a transaction that passed the test in Section 31 may still be attacked in terms of the provisions of Section 103(1). Section 103(1) will also apply where a scheme is entered into to avoid the application of Section 31.⁸⁶

2. SECTION 82

Section 82 reads as follows:

“The burden of proof that any amount is exempt or not liable to any tax chargeable under this Act or is subject to any deduction, abatement or set-off in terms of this Act, shall be upon the person claiming such exemption, non-liability, deduction, abatement or set-off, and upon the hearing of any appeal from any decision of the Commissioner, the decision shall not be reversed or altered unless it is shown by the appellant that the decision is wrong.”

The section requires that it must first be established that there is an “amount” which the taxpayer claims to be tax exempt, or subject to tax deduction. It does not require that the taxpayer should establish the existence of such an amount and it follows that the tax authorities should undertake this task⁸⁷. This view was supported by the Appellate Division in *CIR v Butcher Bros (Pty) Ltd*⁸⁸ where the following was said:

“it is essential for the Commissioner, in order to support his assessment, to show that some “amount” accrued to or has been received by the company by virtue of such rights ...”

⁸⁶ Horak 1997 InfoTax SATR 10.1.10.

⁸⁷ Van Blerck 1995 InfoTax SATR 08.2.02.

⁸⁸ *CIR v Butcher Bros (Pty) Ltd* 1945 AD 301; 13 SATC 21 at 39.

"If the Commissioner could show that any specified "amount" accrued to or was received by the company it may be that he would be entitled to include such amount in an assessment against the company..."

Therefore, although the onus is on the taxpayer to show that any "amount" is not subject to tax, the Commissioner should first prove that there is an amount⁸⁹. The Commissioner should be able to ascertain this relatively easy in the taxpayer's financial statements or tax return. The taxpayer would then carry the *onus* to prove that the amount is deductible or not subject to tax.⁹⁰

In the context of transfer pricing the tax authorities would have to prove that a non-arm's length price was used, since only by doing so can they prove there is an "amount" which the taxpayer regards as being tax deductible or exempt. Since the section entitles the Commissioner to "adjust" as to reflect an "arm's length price" it may be concluded that the onus is also on the Commissioner to prove the arm's length price⁹¹.

⁸⁹ Van Blerck 1995 InfoTax SATR 08.2.02.

⁹⁰ Van Blerck 1995 InfoTax SATR 08.2.02.

⁹¹ Van Blerck 1995 InfoTax SATR 08.2.02.

CHAPTER FOUR

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CHAPTER FOUR - THE ARM'S LENGTH PRINCIPLE

1. THE ARM'S LENGTH PRINCIPLE

1.1. What is the arm's length principle

From the wording of Section 31(2) it is clear that South Africa adopted the arm's length principle, which is the international norm. The Commissioner is of the opinion that application of this internationally accepted principle will minimise the potential for double taxation⁹².

Section 31(2)(b) describes the term arm's length price as the price which goods or services might be expected to fetch if the parties had been independent persons dealing at arm's length⁹³.

Practice Note No. 7 refers to the definition of the arm's length principle in the OECD Guidelines. These guidelines define the arm's length principle as follows: ⁹⁴

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

⁹² SARS Practice Note No. 7

⁹³ Section 31(2)(b)

⁹⁴ OECD Guidelines G-1

The determination of an arm's length consideration is not an exact science but requires judgment on the part of both the taxpayer and the Commissioner. Accordingly, taxpayers and the Commissioner need to approach each case, having due regard for the unique business and market realities applicable to each individual case⁹⁵.

An arm's length price does not necessarily constitute a single price, but a range of prices and the facts of each case will determine where, within that range, a specific arm's length price will lie⁹⁶.

Practice Note No. 7 provides broad guidelines about the business and economic concepts that serve to indicate what information, data and other evidence would support a contention that a transaction has occurred at arm's length. These guidelines will be discussed later on in this document.

1.2. The separate entity approach

The arm's length approach treats members of multinational enterprises as separate tax entities by seeking to adjust profits with reference to the conditions which would have existed between independent parties. Accordingly the members of multinational groups are treated as separate entities rather than inseparable components of a single unified business. This has the result that attention is focused on the nature of the transactions between the members⁹⁷.

⁹⁵ SARS Practice Note No. 7

⁹⁶ SARS Practice Note No. 7

⁹⁷ OECD Guidelines I-3, Deloitte and Touche 1996 InfoTax SATR 09.1.07.

This separate entity approach strives to ensure that equitable results are achieved and minimises the risk of unrelieved double taxation in instances where two different tax bases exist, i.e. a source tax base in one country and a residence tax base in another. The arm's length approach ensures that these separate entities deal with each other at arm's length to restrain them from setting special conditions within the group that would not exist had they been dealing in an open market.⁹⁸ As a result growth of international trade and investment is promoted since associated enterprises and independent enterprises are placed on an equal footing⁹⁹.

2. PRINCIPLES OF COMPARABILITY

2.1. Introduction of the principles of comparability

Comparability is fundamental for the application of the arm's length principle. The preferred arm's length methods are based on the concept of comparing the prices/margins achieved by connected persons in their dealings to those achieved by independent entities for the same or similar dealings. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be highly comparable¹⁰⁰.

For transactions to be comparable there must be no difference between the transactions compared, or it must be possible to make reasonable accurate adjustments to eliminate any differences. The assets employed and the risks

⁹⁸ OECD Guidelines P-2.

⁹⁹ Snyckers: Transfer pricing p.32

¹⁰⁰ SARS Practice Note No. 7

assumed by parties must also be taken into account¹⁰¹.

Since precise calculations cannot be made and the application of any method involves elements of judgment, there is, depending on the circumstances of the particular case, a need to avoid making adjustments to account for minor or marginal differences in comparability¹⁰².

The objective of comparability is to always seek the highest practical degree of comparability, recognising though that there will be unique situations and cases where it is not practicable to apply methods based on a high degree of direct comparability¹⁰³.

The practical standard of comparability will be determined by the amount of data on which comparisons with uncontrolled situations and dealings in a particular case can be based. Comparisons with controlled dealings by other taxpayers cannot be regarded as arm's length comparisons¹⁰⁴.

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

- 1) the characteristics of goods and services;
- 2) the relative importance of functions performed;
- 3) the terms and conditions of relevant agreements;
- 4) the relative risk assumed by the taxpayer, connected enterprises and any independent party where such party is considered as a possible comparable;
- 5) economic and market conditions; and
- 6) business strategies¹⁰⁵.

A discussion of each of these factors follows.

¹⁰¹ Deloitte and Touche 1996 InfoTax SATR 09.1.07

¹⁰² SARS Practice Note No. 7

¹⁰³ SARS Practice Note No. 7

¹⁰⁴ SARS Practice Note No. 7

¹⁰⁵ SARS Practice Note No. 7

2.2. Characteristics of goods or services

Differences in the characteristics of property or services often account for differences in their value. For example:

- in the case of property, its physical features, quality and reliability;
- in the case of services, their availability, nature and extent; and
- in the case of intangibles, the form of the transaction, the type of property and the duration of the transaction¹⁰⁶.

2.3. Functional analysis

In determining whether transactions are comparable, analysis of the functions undertaken by the entity is necessary. Such functional analysis is defined as the identification and comparison of the economically significant activities and responsibilities undertaken by independent and associated enterprises respectively.

The functions that may need to be compared include design, manufacturing, assembling, research and development, servicing, purchasing, distribution, marketing, advertising, transportation, financing and management. The economic significance of such functions is important when comparing independent entities with controlled entities.

Account should be taken of the assets used and risks assumed by the respective entities. The party's conduct is the best evidence concerning the true allocation of risk. Whether the allocation of risk claimed by the taxpayer would be the rational in arm's length transactions should also be

¹⁰⁶ SARS Practice Note No. 7, Deloitte and Touche 1996 InfoTax SATR 09.1.07

considered¹⁰⁷.

In Practice Note No. 7 Annexure A¹⁰⁸ SARS sets out the characteristics of a functional analysis. In the concluding comments of the Annexure the Commissioner for SARS states the following:

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

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

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

2.4. Terms and conditions of relevant agreements

The contractual terms, whether contained in a written agreement, in correspondence, or simply deduced from the parties conduct, usually define how the responsibilities, risks and benefits are to be shared by the parties. These terms should form part of the functional analysis.

¹⁰⁷ SARS Practice Note No. 7, Deloitte and Touche 1996 InfoTax SATR 09.1.07

¹⁰⁸ SARS Practice Note No. 7 Annexure A

In controlled situations the degree of adherence to the terms of the contract should be examined¹⁰⁹.

2.5. Economic and market conditions

For transactions to be comparable, the markets in which they are undertaken must be similar or where there are differences appropriate adjustments must be capable of being made. The factors in determining market comparability include geographic location, size, competition, availability of substitute goods and services, supply and demand, consumer purchasing power, production costs, whether wholesale or retail, timing of the transaction and government regulations¹¹⁰.

2.6. Business strategies

A market penetration strategy may dictate lower prices or higher marketing costs to expand on existing market shares. Such strategies need to be taken into account¹¹¹.

¹⁰⁹ SARS Practice Note No. 7; Deloitte and Touche 1996 InfoTax SATR 09.1.07

¹¹⁰ SARS Practice Note No. 7; Deloitte and Touche 1996 InfoTax SATR 09.1.07

¹¹¹ SARS Practice Note No. 7; Deloitte and Touche 1996 InfoTax SATR 09.1.07

CHAPTER FIVE

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CHAPTER FIVE - METHODS FOR DETERMINING AN ARM'S LENGTH PRICE

1. BACKGROUND

In Practice Note No. 7 the Commissioner sets out the methods that it would generally seek to use for the determination of an arm's length consideration. These methods will be discussed below.

It is important to note that these methods are in line with the methods advocated by the OECD and that the OECD guidelines should be followed in the absence of specific guidance in the Practice Note, Section 31 or South Africa's double taxation agreements¹¹².

SARS recognises in Practice Note No. 7 that transfer pricing is not an exact science and that applying the appropriate method/s will often result in a range of justifiable arm's length prices. The Practice Note suggests that in the absence of persuasive evidence for selecting a particular point in the range of prices, SARS may select the midpoint. The Practice Note has deviated from the OECD guidelines in this regard.

Choosing the midpoint of a range is contradictory to the arm's length principle. There are no grounds for SARS to use the midpoint within a range, except if the facts and circumstances of the case indicate that the midpoint is in fact the arm's length price. Therefore SARS should reconsider their

¹¹² SARS Practice Note No. 7

approach in using the midpoint of the range¹¹³.

2. THE HIERARCHY OF METHODS

The Practice Note states that SARS does not have a preference for any specific method, but that the method used should be the one that provides the most reliable results and requires the least and most reliable adjustments. In determining which method to use, the taxpayer needs to assess the reliability of the data it has available¹¹⁴.

The standard transfer pricing methods recognised by the OECD Guidelines and endorsed by SARS in Practice Note No. 7¹¹⁵, are:

- 1.) the comparable uncontrolled price method (CUP method);
- 2.) the resale price method (RP method);
- 3.) the cost plus method (CP method);
- 4.) the transactional net margin method (TNMM); and
- 5.) the profit split method.

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

SARS specifically states in Practice Note No. 7 that they do not have a preference for any specific method. The Practice Note does however provide the following guidance in respect of the hierarchy of methods:

¹¹³ Deloitte & Touche Tax News 3rd Quarter 1999

¹¹⁴ SARS Practice Note No. 7; Deloitte & Touche Tax News 3rd Quarter 1999

¹¹⁵ SARS Practice Note No. 7; OECD Guidelines

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

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

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

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

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

Where a taxpayer has considered a number of methods, it may be appropriate to document the reasons for discarding some of those methods. The availability of data is likely to be very important in a taxpayer's choice of method. South Africa is a small market and under certain circumstances this means reliable comparables may be difficult for taxpayers to locate."

3. THE FOUR-STEP APPROACH

In Annexure B of Practice Note No. 7 SARS sets out a so-called four step approach which is a practical approach for determining transfer prices that adheres to the arm's length principle¹¹⁶. In summary the four steps are as follows:

Step 1: Understand the cross-border dealings between connected parties in the context of the business. This step includes amongst other things the preparation of a functional analysis¹¹⁷.

Step 2: Select the pricing method or methods. The choice of method would depend on:

- the degree of comparability between the uncontrolled transactions used for comparison and the controlled transactions of the taxpayer;
- the completeness and accuracy of the data relied on;
- the reliability of all assumptions;
- the sensitivity of any results to possible deficiencies in the data and assumptions.

Step 3: Application of the pricing method or methods.

Step 4: Arriving at the arm's length amount and introducing process to support the chosen method. The taxpayer will be required to document and demonstrate how its data has been used in the application of its chosen pricing method to determine an arm's

¹¹⁶ SARS Practice Note No. 7 Annexure B

¹¹⁷ Refer to Chapter 4 Part 2.3 for a discussion of term functional analysis

length amount.

This four-step approach provides extremely useful guidance in terms of the process that should be followed for the determination of a transfer price that adheres to the arm's length principle.

4. ACCEPTABLE METHODS

4.1. Traditional transaction methods

4.1.1. Comparable uncontrolled price method (CUP)

4.1.1.1. *Description & Application*

The CUP method is described as follows in Practice Note No. 7¹¹⁸:

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

¹¹⁸ SARS Practice Note No. 7

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

The CUP method is the most direct and reliable way to apply the arm's length principle where it is possible to locate comparable uncontrolled transaction data¹¹⁹.

4.1.1.2. Practical Problems

The difficulty with this method is that controlled and uncontrolled transactions would rarely be comparable. Furthermore, it may be difficult or impossible to make reasonably accurate adjustments to eliminate the effect on the price of differences between the controlled and uncontrolled transaction¹²⁰.

4.1.2. Resale price method (RP)

4.1.2.1. Description & Application

The resale price method is described as follows in Practice Note No. 7¹²¹:

"The resale price method is based on the price at which a product, which has been purchased from a connected enterprise, is resold to an independent enterprise. The resale price is then reduced by an appropriate gross margin, to cover the reseller's

¹¹⁹ SARS Practice Note No. 7

¹²⁰ SARS Practice Note No. 7

¹²¹ SARS Practice Note No. 7

selling and other operating costs, and to provide an appropriate profit, depending on functions performed, assets used and risks assumed by the reseller. The balance may be regarded as the arm's length price before other adjustments in respect of, for example, customs duties."

The RP method differs from the CUP method in that it does not require as close a physical similarity between the products that are being compared. With the RP method the comparison is made between the mark-up charged by the associated company and the mark-up charged by the companies dealing at arm's length. Because minor product differences are less likely to have an effect on the accuracy of the RP method, fewer adjustments would be necessary than with the CUP method.

The reliability of the RP method might be affected if there are material differences in the ways associated enterprises and independent enterprise carry out their business. The RP method also depends on comparability of functions performed¹²².

4.1.2.2. Practical Problems

The most important difficulty with the RP method is to determine a resale gross margin. It is difficult finding a transaction between independent enterprises that is similar to a controlled transaction and where differences do not have a material effect on the margin¹²³.

The application of the RP method sometimes requires access to segregated product data. This information will usually be available in respect of the controlled entity being examined, but not in respect of uncontrolled entities

¹²² Deloitte and Touche Infotax SATR 1996 09.1.07

¹²³ SARS Practice Note No. 7

used as benchmarks¹²⁴.

4.1.3. Cost plus method (CP)

4.1.3.1. Description & Application

The cost plus method is described as follows in Practice Note No. 7¹²⁵:

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

The costs that are taken into account are limited to the costs to the supplier of the goods or services. This method is mostly used in instances where semi-finished goods are sold between related parties for additional manufacturing, assembly or the addition of trademarks prior to distribution¹²⁶.

As with the CUP and RP methods, the CP method relies on a comparable uncontrolled transaction data to determine the arm’s length price. Two transactions would be comparable if the differences between them would not materially affect the cost plus mark-up in an open market or if the material differences can be eliminated by adjustments¹²⁷. As with the resale price method, close physical similarity of the goods is not a requirement.

¹²⁴ SARS Practice Note No. 7

¹²⁵ SARS Practice Note No. 7

¹²⁶ Deloitte and Touche Infotax SATR 1996 09.1.07

¹²⁷ OECD Guidelines II-11

4.1.3.2. *Practical Problems*

The application of the cost plus method presents the following difficulties:

- The determination of cost, as some companies are more effective than others and will incur lower costs.
- Furthermore, comparable mark-ups and comparable costs must be found. Therefore differences between controlled and uncontrolled transactions that affect the amount of the mark-up must be analysed to determine which adjustments are necessary. In this respect it is essential to consider differences between the levels and types of expenses such as direct costs, indirect costs, operating expenses, non-operating expenses and administrative expenditure. In most cases the cost plus method would use margins computed after taking into account only direct and indirect costs of production.
- There may be no discernible link between the costs incurred and the market price.
- The application of the cost plus method sometimes requires access to segregated product data. This information will usually be available in respect of the controlled entity being examined, but not in respect of uncontrolled entities used as benchmarks¹²⁸.

4.2. Transactional profit methods

According to the hierarchy of methods in Practice Note No. 7 transactional profit methods should be applied as a last resort¹²⁹.

¹²⁸ SARS Practice Note No. 7

¹²⁹ Refer Chapter 5 Part 2 for a discussion on the hierarchy of methods

The transactional profit methods examine the profit arising from controlled transactions between associated enterprises. When applying these methods the extent and reliability of the data must be assessed and the basic arm's length principle of comparability must be adhered to. These methods must be applied in a manner that approximates arm's length pricing, which requires that the profits from a controlled transaction must be compared to the profits from a comparable uncontrolled transaction.

4.2.1. Transactional net margin method (TNMM)

4.2.1.1. Description & Application

The TNMM is described as follows in Practice Note No. 7¹³⁰:

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

TNMM operates similarly to the cost plus and resale price methods. With the transactional net margin method the net profit margin realised from a specific base, such as sales or assets, is examined and not the gross profit.

As with the cost plus and resale price methods, the net margin method must be applied in such a way that the net margin of the taxpayer in a controlled transaction is similar to the net margins that the same taxpayer earns in comparable uncontrolled transactions. Alternatively the net margin of an

¹³⁰ SARS Practice Note No. 7

independent comparable transaction may be used. Comparability is established by performing a functional analysis of the associated enterprises and the independent enterprise¹³¹.

Care must be taken when selecting a comparable transaction, because should a comparable uncontrolled enterprise be used, a high degree of similarity of the relative cost structures are required as TNMM is calculated on net margin i.e. operating expenses is included in the calculation. For this reason TNMM is considered less reliable than the traditional transaction methods¹³².

The advantage of the net margin method is that net margins, such as returns on assets or operating income to sales, are less affected by transactional differences than prices. Net margins may also be less affected by some functional differences than gross profit margins. This is the case when differences in functions are reflected in variations of operating expenses while still earning more or less the same net margins. With the net profit margin it is not necessary to examine each of the associated enterprises in the transaction. Consequently it is not necessary to allocate cost to each participant, which simplifies the application.¹³³

4.2.1.2. Practical Problems

The following practical problems arise with the use of TNMM:

- The net margin can be affected by factors that do not have an influence on the price or gross margins, thereby reducing the reliability of the results of TNMM.

¹³¹ Snyckers: Transfer pricing p.42

¹³² SARS Practice Note No. 7

¹³³ OECD Guidelines III-10.

- Information required to apply TNMM may not be readily available in respect of the controlled and uncontrolled transaction.
- As with the CP and RP methods, the TNMM is a one sided analysis, as it does not consider the effect of the determined price on the other party to the transaction. As operating expenses affect the calculation of TNMM it is likely to be less reliable than CP and RP¹³⁴.

4.2.2. The profit split method

4.2.2.1. *Description & Application*

The profit split method is described as follows in Practice Note No. 7¹³⁵:

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

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

The situation sometimes arises that transactions are so integrated that they cannot be split in order to be evaluated separately. Independent enterprises in similar situations might agree to split the profit or form some sort of partnership.

¹³⁴ SARS Practice Note No. 7

¹³⁵ SARS Practice Note No. 7

The purpose of the profit split method is to eliminate the effect of special conditions on profit in a controlled transaction or alternatively in controlled transactions which may appropriately be view as one composite transaction. This is achieved by attempting to determine the amount of profit that independent enterprises would have expected to realise had they engaged in the same transaction or transactions¹³⁶.

The first step in applying the profit split method is to identify the combined profit arising from a controlled transaction between associated enterprises. Practically this entails a calculation of the sum of the profits realised by the parties to the transaction. The combined profit will then be attributed to the parties to the transaction by using one of the methods discussed below.

Two profit split approaches are outlined in Practice Note No. 7. These approaches are as follows:

- **Residual profit split analysis**

The residual profit split approach divides combined profits or losses in two stages. The first stage ensures that that the participants to the transaction are given a sufficient allocation of profits to provide them with a basic return relating to the functions performed, but would generally not account for the return that would be generated by any unique and valuable assets of the participants. The second stage allocates any residual profit or loss in accordance with manner in which this would have been allocated between independent enterprises based on an analysis of the facts and circumstances.

¹³⁶ Snyckers: Transfer pricing p.41

- **Contribution analysis**

Under the contribution analysis approach, the combined profit (profit before interest and tax) or losses are divided according to the relative value of the functions performed by each of the participating associated enterprises.

The Practice Note provides further detail in respect of the application of these two approaches, which is not discussed in this document.

The Practice Note refers to the OECD Guidelines and states that these two approaches are not necessarily exhaustive or mutually exclusive and that there may be other ways to split a profit to achieve a reliable arm's length price.

The advantages of the profit split method are that it does not require closely comparable transactions. The profit split method may be used where unique intangibles or specialised products are present, since the allocation of profit is based on the functions of each division of the associated enterprise and the comparison with independent enterprises is undertaken to determine the value of contributions and not the profit itself. Furthermore, both parties to the controlled transaction are evaluated with the result that the profit division is fair to both parties and will be considered as such by tax authorities¹³⁷.

4.2.2.2. *Practical Problems*

The main problem with the profit split method is its potentially arbitrary nature in that it does not rely heavily on independent comparable data,

¹³⁷ OECD Guidelines III-3

especially in the absence of external market criteria¹³⁸.

Further problems that arise in the application of the profit split method is:

- Difficulty for both tax administrations and taxpayers to obtain information from foreign affiliates.
- Differences in the accounting treatment and financial comparability in affiliates may cause problems when attempting to measure the combined profit and expenses of all the associated enterprises involved in a transaction¹³⁹.

It must be borne in mind that most of these problems are also experienced with the other available methods and are not exclusive to the profit split method.

4.3. Evaluation of the traditional transaction methods and transactional profit methods

The most important question to be asked is whether the method, be it a traditional transaction method or a transactional profit method, will provide a reliable approximation of the arm's length price in the particular circumstances.

The transactional profit methods offer a viable alternative to the traditional transaction methods in cases where the latter cannot be reliably applied. This will occur in instances where insufficient data is available on uncontrolled transactions or where this data is unreliable due to the specific nature of the business. The reliability of the transactional profit methods should also be considered before they are applied. Occasionally the transactional profit

¹³⁸ OECD Guidelines III-4

¹³⁹ OECD Guideline III-4

based methods may be applied in conjunction with the traditional transaction based methods.

The use of transactional profit based methods in the instances of global trading of financial instruments may be more appropriate than it would be in other industry sectors. This is because global trading businesses are often organised similarly to joint venture profit sharing arrangements of a type, which can be found between independents in the financial sector.

5. ADVANCE PRICING AGREEMENTS (APA'S)

An advance pricing agreement is a process whereby the setting of transfer prices in respect of controlled transactions may be agreed with tax administrators in advance of the transaction being undertaken and reported¹⁴⁰.

The greatest problem with the arm's length approach for taxpayers is the uncertainty that it creates. The Katz Commission recommended in its first report¹⁴¹ that the transfer pricing rules in South Africa should make provision for advance pricing agreements between the taxpayer and Revenue authorities.

Practice Note No. 7 states that the APA process will not be made available to South African taxpayers in the foreseeable future¹⁴². This is disappointing as APA's are one way of providing greater certainty to taxpayers regarding the tax implications of their actions¹⁴³.

¹⁴⁰ SARS Practice Note No. 7

¹⁴¹ Katz Commission Report (1994) 232

¹⁴² Katz Commission Report (1994) 232

¹⁴³ Snyder: 1995 The Tax Lawyer 1068-1069

Advantages of advance pricing agreements are as follows:

- It provides opportunity for both tax administrations and taxpayers to consult and co-operate in an environment that is less adversarial.
- It may prevent costly and time-consuming examinations and litigation.
- It may improve knowledge and understanding of the highly technical and factual circumstances in which multinational enterprises operate.

The disadvantages of APA's are as follows:

- Unilateral advance pricing agreements may be problematic for both taxpayers and the tax authorities of other countries and it may even lead to double taxation and greater administrative burden.
- APA's necessitate more detailed information and the potential misuse of this information and related confidentiality issues presents further problems.

The OECD is of the view that APA's may be successful if care is taken to determine a proper degree of specificity based on critical assumptions together with proper administration and adequate safeguards¹⁴⁴.

¹⁴⁴ Snyckers: Transfer pricing p.45

CHAPTER SIX

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CHAPTER SIX - GLOBAL TRADING OF FINANCIAL INSTRUMENTS

The first step in the determination of an arm's length transfer price is to understand the cross border transactions of the entities involved¹⁴⁵. This involves amongst others obtaining an understanding of the factual background of the transactions and a functional analysis. To this end a discussion of the business background, factors affecting the structure of the business, the organisation of global trading activities and a functional analysis follows.

1. FACTUAL BACKGROUND OF THE GLOBAL TRADING OF FINANCIAL INSTRUMENTS

1.1. Business background

Technological changes, the communications revolution, and the spread of financial deregulation and liberalisation have driven financial markets to globalise. Financial firms have developed innovative financial instruments, such as derivatives, to meet the global demand to finance trade investment and to reconcile the often different demands of borrowers and investors¹⁴⁶.

The development of these innovative financial instruments and new digital technologies created a fully integrated global market of astonishing scope.

¹⁴⁵ Refer to Chapter 5 Part 3

¹⁴⁶ OECD News Issue - Paris 18 February 1997; Fabozzi Foundations of Financial Markets and Institutions p.9

The average daily value of foreign exchange transactions grew from \$15 billion in 1973 to \$1.2 trillion in 1995, and daily foreign exchange transactions now exceed total global currency reserves. International capital flows exceed trade flows by a 60 to 1 margin¹⁴⁷.

It is clear from the above statistics that the use of derivative instruments in particular has expanded significantly. The reason for this is that these instruments allow parties to a transaction to tailor their risk exposure.

1.2. Factors affecting the structure of the business

It is difficult to make generalisations about the structure of a global trading business, because the manner in which the business is conducted is influenced by the type of institution doing the trading, the product being traded and the institution's business strategy¹⁴⁸. These three factors are discussed below.

1.2.1. Type of financial institution

Many types of financial institutions conduct global trading in financial instruments. However, the main financial institutions involved in this trade is commercial and investment banks, the reason being that these entities have developed the necessary trading expertise and capital base necessary to engage in global trading¹⁴⁹.

A strong capital base and credit rating are particularly important in the case of trading in over-the-counter ("OTC") derivatives (OTC derivatives are derivatives that are not traded on an exchange, but rather directly between

¹⁴⁷ ODC Commentary - Managing the International Economy in an Age of Globalisation

¹⁴⁸ OECD The Taxation of Global Trading of Financial Instruments March 1998 II - 2

¹⁴⁹ OECD The Taxation of Global Trading of Financial Instruments March 1998 II - 2

parties). In this respect banks enjoy a distinct advantage as they usually conduct their business in branch form. As a result, every transaction is backed by all of the bank's assets¹⁵⁰.

Transactions conducted by branches of a foreign company in South Africa and by a branches of a South African company in a foreign country could fall within the ambit of Section 31¹⁵¹.

1.2.2. Type of product

It is now possible to buy almost any financial product, including most currencies, many debts instruments (particularly government securities) and some equities and commodities, at any hour of the day and night. The level of global trading in products varies widely, with the deepest world-wide markets found in certain currencies and derivative instruments and the markets for equities being the most localised.

Derivatives are financial instruments that obtain their price and therefore their value from another financial instrument, the underlying security such as a debt security, equity, commodity or a specified index. The most common derivatives are forwards, options, futures, and notional principle swaps, caps, floors and collars. Unlike traditional debt and equity securities, these instruments generally do not involve a return on an initial investment¹⁵².

It is appropriate to consider what some of these derivatives entail.

¹⁵⁰ OECD The Taxation of Global Trading of Financial Instruments March 1998 II - 2, Ford: Mastering Exchange - Traded Equity Derivatives p.X-XI

¹⁵¹ Refer to Chapter 2 Part 2.4 for a discussion of agreements covered by Section 31

¹⁵² Ford: Mastering Exchange - Traded Equity Derivatives p.X

Forward Foreign Exchange (FX) Contracts:

An outright forward FX deal is a firm and binding contract to buy or sell a given amount of currency at some future date, at a rate of exchange which is agreed between the parties at the time of dealing. No money changes hands until settlement date¹⁵³.

Options:

A traded option is an agreement between a buyer (holder) and a seller (writer) giving the buyer the right, but not the obligation, to buy or sell an asset on or before a given date, at a specific price in return for a consideration¹⁵⁴. An option can be looked at as a deposit securing either the purchase or the sale price of the underlying asset/security. There are two classes of options namely call and put.

Futures:

A future can just like an option, also be looked at as a deposit securing either the purchase or the sale price of the underlying asset/security. However, with futures contracts there are no call or put contracts to determine whether the investor wishes to buy or sell the underlying asset/security. Instead, if the investor thinks the underlying asset/security (for example FT-SE 100 Index) will rise, he buys a futures contract (he is going long on the future) and if he believes the index will fall he sells the future (going short)¹⁵⁵.

Derivatives can be trade over-the-counter ("OTC") i.e. directly between the financial institution and the customer or on an exchange (this works similar to a stock exchange). Examples of derivative exchanges is the London Traded Options Market ("LTOM"), the London International Financial Futures and

¹⁵³ Roth: Mastering Foreign Exchange & Money Markets p.256

¹⁵⁴ Ford: Mastering Exchange - Traded Equity Derivatives p.102

¹⁵⁵ Ford: Mastering Exchange - Traded Equity Derivatives p.107

Options Exchange ("LIFFE") and the South African Futures Exchange ("SAFEX").

Derivatives are the financial instrument in which the most trade globally takes place. For example, evidence suggests that more US dollar notional principal contracts are written in London than in the United States¹⁵⁶.

The most global trading takes place in spot and forward contracts¹⁵⁷ in the most heavily traded foreign currencies. This is a natural result of the increasing globalisation of trading markets and the resulting need for foreign currency. Hedging such foreign currency exposures is an ordinary and increasingly important part of running an international business.

A financial institution acts as a derivative dealer by entering into executory contracts with customers. In OTC derivative contracts, the "product" is created when the financial institution enters into the derivative contract with the end user. The financial institution remains a party to the transaction until the transaction matures or the financial institution assigns its rights and obligations to a third party or enters into an agreement with the counterparty to terminate the transaction¹⁵⁸.

1.2.3. Business strategies

Difference in business strategies, even among those institutions that market and trade financial instruments, may affect where and how business is conducted and therefore the comparability analysis for purposes of determining an arm's length price.

¹⁵⁶ OECD The Taxation of Global Trading of Financial Instruments March 1998 II - 2

¹⁵⁷ Refer to aforementioned definition of Forward Foreign Exchange (FX) Contracts

¹⁵⁸ OECD The Taxation of Global Trading of Financial Instruments March 1998 II - 2

Institutions also differ in respect of the amount of risk, which they are willing to accept. Some institutions may hedge most of their transactions making their profits on the dealer "spread" between bid and ask prices. Other institutions may earn their income from taking unhedged, proprietary positions to generate significant trading gains. Regulators are willing to allow securities dealers to incur a higher level of unhedged risks that they are willing to tolerate in the case of banks and insurance companies, which have obligations to retail depositors or policyholders¹⁵⁹.

Institutions also differ in their choice of instruments to market and trade in.

1.3. Organisation of trading activities

Most trading activities conducted by a global trading business can be classified into one of the following trading modules:

- Integrated trading module
- Centralised product management module
- Separate enterprise trading module

The trading modules are defined only by reference to the organisation of the trading and risk management activities. The classification of a particular global trading business under one of the modules above does not therefore mean that other activities, such as marketing and support, are organised in the same manner as the trading and risk management activities¹⁶⁰.

¹⁵⁹ OECD The Taxation of Global Trading of Financial Instruments March 1998 II - 2, MV Kelly: Financial Institutions in South Africa Chapter 12

¹⁶⁰ OECD The Taxation of Global Trading of Financial Instruments March 1998 II - 3

The typical characteristics of these modules as described in the OECD document on the taxation of global trading in financial instruments are listed below¹⁶¹.

1.3.1. Integrated trading module

Traders in each trading centre (generally London, New York, Tokyo or Hong Kong) set prices and trade off a portfolio of positions called a "book" while the market is open in that location.

While ownership is retained in one entity, when the market close in a particular location responsibility for the "book" is passed to the next trading location where the open positions form the starting point of trading. Traders in the new location may close positions passed to them and open new ones. This process is called "book passing". A variation of this process is the instance where traders in one location are trading at the same time and from the same book as traders in another location.

A committee in the institution sets overall trading limits but does not centrally manage the trading operations which are independent. Each location has a head trader who polices the trading limits set by the financial institution.

Foreign currency options are often traded in this manner¹⁶².

¹⁶¹ OECD The Taxation of Global Trading of Financial Instruments March 1998 II - 3

¹⁶² OECD The Taxation of Global Trading of Financial Instruments March 1998 II - 3

1.3.2. Centralised product management module

All market risk of a particular product is centralised and managed in one location. An example would be if all gilts were managed by the London branch and all trading in US treasuries were managed by the US branch.

Commercial considerations e.g. market liquidity, ease of hedging, competition, business strategy, location of customers and skilled staff would determine where the centralised trading location is.

The financial institution will rely on marketing operations in its other trading centres but will require the marketing location (originating office) to transfer responsibility for managing the risk to the centralised trading location. The transaction can be booked directly with the centralised trading location or the marketing location can reverse the transaction with a trader in the centralised trading location through an inter-branch (or inter-company) transaction, thus referring the market risk to that location.

Physical securities (for example bonds, gilts and treasuries bills) appear to be most often trade under a centralised product management approach. However, certain derivatives could also be traded under this approach¹⁶³.

1.3.3. Separate enterprise trading module

Each trading location, whether in subsidiary or branch form, operates as if it were a separate profit centre, with its own marketers, traders and its own books that reflect products sold by that location. Different locations pursues

¹⁶³ OECD The Taxation of Global Trading of Financial Instruments March 1998 II - 3

different trading strategies and in fact may enter into trades with other locations. As a result different branches of a bank may end up with opposite positions, perhaps as a result of retail transactions and may seek to close such positions by transactions with other parts of the same legal entity. A central committee would set overall trading limits for each location but does not control trading that is within the prescribed limits.

Many banks organise their trading in spot and forward transactions of the most heavily traded currencies on a separate enterprise basis¹⁶⁴.

1.3.4. Dynamic and flexible nature of global trading

A bank may use a combination of the models described above for different parts of its operations. For instance, its foreign exchange book may be based on a separate enterprise approach while its trading in physical securities may be based on a centralised product management approach.

The trading activities of all enterprises will not necessarily fall within any of the above models. Furthermore, the way in which a product is traded may change over time. For example, a financial institution may grant limited trading authority for the product to traders located outside the original centralised trading location in order to satisfy customer demand during non-business hours in the centralised trading location. In practice the other trading locations may often begin by fulfilling a “nightwatch” function.

¹⁶⁴ OECD The Taxation of Global Trading of Financial Instruments March 1998 II - 3

It should be remembered that global trading firms could use a variety of legal structures and forms to carry out its business. Some trade exclusively through branches, others through separate legal entities (which may act in their own right or as dependent agents of other entities), whilst others use a combination of branches and separate legal entities. This diversity can be found in all trading models. For example, firms that only use separate legal entities to conduct global trading can still organise their activities by reference to any of the three models or a hybrid of them¹⁶⁵.

2. FUNCTIONAL ANALYSIS

A functional analysis is part of the first step in the process of the determination an arm's length transfer price¹⁶⁶.

In the global trading context, the carrying out of a careful function analysis is particularly important because of the wide range of significant functions potentially involved, the variety of risks that can be assumed or transferred, the global dispersal of the performance of many functions and the wide variation in business structures and organisation.

This section describes in detail the functions of global trading businesses starting with functions performed by the personnel of the firm - "people functions" - then moving on to consider the role of capital¹⁶⁷.

¹⁶⁵ OECD The Taxation of Global Trading of Financial Instruments March 1998 II -

¹⁶⁶ Refer to Chapter 4 Part 2.3 for a discussion of the principles of functional analysis

¹⁶⁷ OECD The Taxation of Global Trading of Financial Instruments March 1998 II - 4

2.1. People functions: sales and marketing

Sales and marketing personnel are responsible for all contact with customers. Usually, staff is assigned to a particular geographic area and, within that area they may specialise in clients in a particular industry.

The organisation of sales and marketing personnel is determined by the need to be accessible to the firm's clients and thus is largely independent of the structure of the trading modules described in Chapter 6 paragraph 1.4. In contrast to the trading function the trend is towards decentralisation of sales and marketing functions.

Sales and marketing personnel unlike traders are not allowed to price or trade in products directly. Sales and marketing personnel do however have the responsibility of ensuring that the product meets the client's needs.

Usually general sales staff plays little part beyond introducing the trade whilst the marketer is responsible for "running" the deal, including that the transaction receives all the necessary clearances within the financial institution. Clearances may be required from the following departments: regulatory, compliance and credit department. New structures may require extensive consultations with the risk management department to ensure that it is possible to hedge the transaction in a cost effective manner.

The trader determines the price at which he is willing to take a deal onto his books, but the marketer is frequently responsible for negotiating the price with the customer.

One of the marketer's most significant contributions is determining the price that the client is willing to pay¹⁶⁸.

2.2. People functions: trading and risk management

Global trading involves dealing (that is making a market) and taking and managing proprietary positions. Marketers are only involved in the dealing aspect of the business whilst traders are involved in all of the above mentioned activities. Traders provide marketers with the prices at which transactions will be entered into with customers and are responsible for the management of the market risk¹⁶⁹ that arises from those transactions once they are entered on the institution's books. All reference to risk in this section relates to market risk. Traders and risk managers are generally not responsible for managing credit risk¹⁷⁰.

In order to manage the risk arising from a derivative transaction, the transaction must be "unbundled" into separate risk components so that they can be assigned to the appropriate trading books. In this process the risk from a single transaction may be assigned to several books. For example, a financial institution may purchase a Deutschmark-denominated note paying 5%, the principal amount of which is tied to performance of the German stock market index, DAX. This note involves fixed-income risk (the risk that Deutschmark interest rates will go up, reducing the value of the note), equity risk (the risk that the value of the DAX will decrease) and, depending on the institution's functional currency, possible currency risk (the risk that the Deutschmark may devalue in relation to financial institution's functional currency).

¹⁶⁸ The analysis of sales and marketing is based on the OECD Report on The Taxation of Global Trading of Financial Instruments March 1998 II - 4(1)

¹⁶⁹ Market risk is the risk of realising a loss due to changes in market conditions.

¹⁷⁰ Credit risk is the risk of a borrower or the financial institution itself not being able to meet its obligations.

These risks must be allocated to the appropriate books, usually by entering into inter-desk transactions negotiated by the traders. Accordingly, a sophisticated derivatives operation may require numerous inter-desk (and inter-branch) transactions simply in order to assign risks to the appropriate trading book.

Once the risks are entered into the appropriate books, it may be up to the traders to increase the financial institution's profit on the transaction by managing the risk, thus generating "trading profits" which are distinct from the initial "dealer spread" on the transaction. Throughout the life of the transaction the trader must decide whether and when to hedge the aggregate market exposure from a transaction, after netting all the other risk positions in the book.

A trader's discretion in the management of risk is limited to a greater or lesser degree by the market risk limits that are imposed by the financial institutions.

Most financial institutions with a significant trading presence calculate market risk exposure on at least a daily basis. This is done by calculating the potential exposure to losses based on current market conditions. The calculation of the amount of a financial institution's market risk exposure is generally verified by an administrative group separate from the trading function as it is an important control over the trading business.

Trading and risk management functions described in this section are usually carried out by the same person (a trader). However, these functions can also be performed by different people or by different parts of the global trading business¹⁷¹.

¹⁷¹ The analysis of trading and risk management is based on the OECD Report on The Taxation of Global Trading of Financial Instruments March 1998 II - 4(2)

2.3. People functions: support

Marketers and traders who are generally identified as “front office” rely on a number of other departments within the financial institution. The functions performed by these other offices have traditionally been called “back office” functions. However, many institutions now designate some of the departments particularly funding, credit, accounting, research and intangibles development as “middle office” functions in recognition of their increased importance in the context of global trading.

The business dynamic for most support functions is towards centralisation in order to reduce cost, especially where they are capable of being performed without direct involvement of front office staff.

Some of these support functions will now be discussed in more detail¹⁷².

2.3.1. Treasury

The treasury function is the back office function that is most similar to the general trading activities of a financial institution. The task of the treasury book traders are to ensure that the financial institution has sufficient cash to meet its payment obligations but does not have excess cash which could adversely affect profitability.

¹⁷² The analysis of support functions is based on the OECD Report on The Taxation of Global Trading of Financial Instruments March 1998 II - 4(3)

The task of the treasury book traders is complex because the cash needs of the institution fluctuate a great deal. The volatility in cash resources results in part from the use of exchange-traded contracts and securities to hedge OTC positions. The cash needs of a particular book (and therefore the business) will depend on whether the exchange-traded or the OTC contracts are in the money.

Many institutions view the treasury function as a separate profit centre and hire traders for the specific purpose of managing the institution's funding costs. If this scenario applies the treasury desk share in the bonus pool on the basis of the "profits" of the book, measured by the difference between the institution's outside funding costs and the "interest" and other "income" or expense arising from transactions with other trading books.

Inter-desk interest is nationally earned by the treasury book that functions as clearinghouse in matching cash needs of certain books with the excess cash generated by other trading books. Other "income" and "expenses" arise from the treasury desk's internal hedging transactions. Treasury desk traders are generally more comfortable managing short-term risk than long term risk. Hence the treasury desk trader will enter into transactions with other trading books to convert long term risk to short term risk.

The treasury desk is generally permitted to enter into hedging transactions with other entities. However, treasury desks are usually encouraged by management to enter into transactions with the institutions own trading desks in order to maximise net hedging within the institution, thus lowering overall hedging costs.

2.3.2. Accounting/Product control

This department is usually responsible for financial and regulatory accounting and for specialised accounting for the trading business. This generally involves preparing daily trading revenue and market risk reports, the preparation of which requires the process of reconciling the positions shown in computer-generated reports with trade tickets entered during the course of the day's trading.

The existence of reliable product control capabilities was critical for the development of complex trading and risk management strategies that fostered explosive growth in global trading, particularly global trading in derivatives.

2.3.3. Systems development/intangibles

Computer systems are critical for the proper functioning of a global trading operation. The valuation of products, the development of new products, the processing and settlement of trades, the real time global risk management of the portfolio, the management of credit and corporate accounting and reporting are all dependent on the availability of sophisticated computer-based systems.

2.3.4. Credit

The credit departments primary responsibility is to analyse new customers and establish appropriate credit limits, monitor the credit exposure of a particular transaction and review the total credit exposure in terms of the

established credit limit. Many institutions have centralised the credit function so that the total credit risk from all the institution's dealings with a particular party can be managed in one location.

In the case of derivatives credit exposure will change over the life of the transaction as the market value changes. As market rates changes during the life of such a transaction one party is "in the money" and has credit exposure to the counterparty to the extent of the inherent gain in the transaction.

Credit limits imposed by regulators or by the institution's directors may limit the ability of the institution to write new business. As credit limits become more severe, some institutions may dictate traders to eliminate those transactions with relatively lower profit margins to allow the institution to engage in higher margin transactions, thus ensuring maximum profitability.

2.3.5. Other support functions

The back office also performs various other functions, the relative importance of which varies depending on the type of business conducted. Some of the other departments are: operations, compliance and legal.

2.4. Other functions: role of capital and assumption of risk

For a global trading firm to be successful it needs skilled employees capable of successfully performing the wide range of functions described above. However, it is also necessary that the firm has sufficient capital in order to fund its cash needs and to be able to assume the variety of risks arising from its global trading operations.

The most commonly identified risks are credit risk and market risk, there are however many other types of risk in addition to the aforementioned. The role of the treasury function has already been described above. Bear in mind that the treasury function can not operate successfully without the necessary capital base and access to credit lines, bank borrowings etc.

Regulatory authorities are also concerned that financial firms under their control adequately evaluate their risk exposure and have enough long term capital to cover those risks. To this end regulatory authorities also impose limits on the minimum amount of resources that an institution must have available¹⁷³.

¹⁷³ The analysis of other functions: role of capital and assumption of risk is based on the OECD Report on The Taxation of Global Trading of Financial Instruments March 1998 II - 4(4)

CHAPTER SEVEN

APPLYING THE ARM'S LENGTH PRINCIPLE TO GLOBAL TRADING OF FINANCIAL INSTRUMENTS

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CHAPTER SEVEN - APPLYING THE ARM'S LENGTH PRINCIPLE TO GLOBAL TRADING OF FINANCIAL INSTRUMENTS

The OECD special session on the global trading of financial instruments unanimously agreed that the arm's length principle in the OECD Transfer Pricing Guidelines should be followed in global trading cases¹⁷⁴.

South Africa's transfer pricing guidelines are based on the arm's length principle¹⁷⁵. Furthermore, SARS indicated in Practice Note No. 7 that their guidelines are based on the OECD's transfer pricing guidelines and that the OECD guidelines should be followed in the absence of guidance in the Practice Note. Therefore, it follows logically that South Africa will also apply the arm's length principle to the global trading of financial instruments.

In the discussion that follows the following will be discussed:

- Various important global trading functions¹⁷⁶ will be analysed and recommendations will be made regarding the appropriate method(s),¹⁷⁷ which should be used to determine an appropriate arm's length price for each particular function.
- The application of profit split methods in particular.
- Case studies illustrating the global trading of financial instruments.

The use of the Transactional Net Margin Method (TNMM) to determine an arm's length price for the various functions will not be discussed. The reason

¹⁷⁴ OECD The Taxation of Global Trading of Financial Instruments March 1998 III-1

¹⁷⁵ Section 31(2)

¹⁷⁶ Refer to Chapter 6 Part 2 for a discussion of these functions

¹⁷⁷ Refer to Chapter 5 Part 4 for a discussion of acceptable methods available

for this is that:

- TNMM is fairly similar to the cost plus (CP) and resale price (RP) methods, except that TNMM examines net profit instead of gross profit.
- The CP and RP methods are preferred to TNMM in terms of Practice Note No. 7.
- TNMM is fairly similar to the CP and RP methods and are thus likely to pose the same difficulties as CP and RP.

1. ANALYSIS OF GLOBAL TRADING FUNCTIONS

The various important global trading functions described in Chapter 6 Part 2 will be analysed in more detail and recommendations will be made on the appropriate method(s) to be applied for the determination of an appropriate arm's length price for the particular function.

1.1. Sales and marketing

In transactions between unrelated parties, the amount and type of the reward would depend on the level of services provided, which may be related to the type of product and the functions performed. This can be illustrated with the following examples:

- General sales personnel that merely act as brokers in respect of standardised products would be rewarded by a simple fee or commission. Their reward would not depend on the profitability of the particular deal.
- On the other hand some marketers are highly specialised and closely involved in the process of developing and structuring products so that they insist on a share of the total trading profits and losses.

The two examples listed above are the two extremes. In the middle of this spectrum are those marketers who act as more than simple brokers but are

not involved in the structuring of products.

In a controlled situation i.e. a transaction that falls within the provisions of Section 31(2) it is necessary to first evaluate the exact functions performed by the marketer.

If the controlled transaction is in respect of general sales functions, market data is likely to be available so that the CUP method, usually in the form of commission can be applied.

If complex sales and marketing functions are performed, often the data between independent parties will relate to basic sales functions, which raises the question if reasonably accurate adjustments can be made for the extra functions performed. Adjustments can potentially be made by increasing the level of commission reward, if comparable data is not available. If comparable data is unavailable and reasonably accurate adjustments can not be made, the CUP method should not be used.

Another possibility would be to use the resale price method. A careful comparison of the risks assumed under the controlled and uncontrolled transaction would be required. The value added by the marketer may in certain instance be measured by reference to the difference between the price at which a trader would undertake a transaction with a customer and the price obtained by the marketer. The calculation is best illustrated by the following example:

Price Charged by Marketer	R100
Price Charged by the Trader	<u>R 80</u>
Value added by Marketer	<u>R 20</u>

The relevant information for this analysis may be obtained from transactions which the trader undertakes with independent marketers. Alternatively

information may be available from other institutions. Care must be taken that rewards attributable to the trader and marketer correctly reflect functions performed.

The cost plus method would probably not be appropriate in this instance as data relating to mark-up's for comparable uncontrolled transactions would be hard to obtain. Furthermore, the cost structure of institutions and products involve could potentially differ significantly.

In order to make reasonably accurate adjustments under the traditional transaction methods to account for difference between controlled and uncontrolled transactions it may be appropriate to look at independent data concerning reasonably comparable marketing functions outside the global trading field. For example, the search for comparable data for derivatives need not be restricted to derivative markets. Third party data for the marketing of other products (for example bonds, shares, loans or insurance) can be considered. The possibility for accurately accounting for the differences in the nature of the products would depend amongst other things on the extent to which the various differences affect the nature and performance of the marketing function.

There will be instances where it would be impossible and/or inappropriate to apply traditional transaction methods, in these instances profit split methods would have to be considered. It is not unknown in the financial sector for trading firms to motivate independent marketers by allowing them to retain a portion of the profits on the deals. This would strengthen the case for applying a profit split method.

If it is decided in a particular case that a profit based commission is appropriate, the question arises as to the profits on which the commission should be based. In general it should be limited to the initial profit on the

customer transaction rather than the overall trading profit of the institution. This would be the case if the contribution of sales personnel is limited to bringing in the customer, hence there is no justification for them to receive a share in overall trading profits.

The solution for any case would depend on the particular facts and circumstances as revealed by the comparability analysis. There would undoubtedly be some problems in finding appropriate comparables, but the possibility of making appropriate adjustments should always be considered¹⁷⁸.

1.2. Trading and risk management

In the discussion that follows the most appropriate method for the determination of an arm's length price applicable in the case of each of the three basic trading models of global trading namely: separate enterprise, centralised product management and integrated trading¹⁷⁹ will be considered.

1.2.1. Separate enterprise model

Where trading is conducted in the separate enterprise model traditional transaction methods would usually be the most appropriate. This is due to the fact that each location should earn the appropriate overall profit provided that all trading and hedging transactions, whether with third parties, intra-company, inter-branch or inter-company, are undertaken under arm's length conditions. It should be fairly straight forward to test this, because of the availability of comparable transactions with unrelated parties.

¹⁷⁸ The analysis of sales and marketing is based on the OECD Report on The Taxation of Global Trading of Financial Instruments March 1998 III - 2(1)

¹⁷⁹ Refer to Chapter 6 Part 1.4 for a discussion of these models

In many cases the CUP method can be applied by reference to market data, without the need for any adjustments because there are no material differences in the manner in which controlled and uncontrolled transactions are carried out.

1.2.2. Centralised product management model

In theory there should be few problems in evaluating trading or risk management functions under this model, because the centralised location is taking the full responsibility for trading and hedging. Therefore it receives the profits attributable to those activities largely as a result of trading and hedging transactions with independent parties and most of the controlled transactions with other locations are in connection with the provision of services other than trading, such as sales and support functions.

Problems can arise if more complex functions are carried out away from the central location, so that the organisation structure moves more towards the integrated trading model. This poses the question of how to reward the trading function that takes place outside the central location. A similar question arises if risk management is centralised in a different location from the trading location. There is a problem in deciding whether a location which starts to undertake some kind of limited trading or risk management activity under the control of the central location, can still be appropriately rewarded with traditional transaction methods, as opposed to receiving a share of the overall profits. The problems in using traditional methods such as CUP or cost plus are similar to those described under the sales and marketing function. The use of profit based methods should be considered as a last alternative.

Market data is often only available for routine trading functions where little or no discretion or judgement is required. The question is whether it would be possible to make reasonably accurate adjustments to this data to reflect the different and more complex functions performed under the controlled conditions or whether it is necessary to use profit based methods.

1.2.3. Integrated trading model

In the integrated trading model as with the separate enterprise model each location has the ability to perform the full range of trading and risk management activities necessary to conduct the business. The difference between the models are that in the integrated model the trading and risk management functions may be split between locations, whereas in the separate enterprise trading model the trading occurs in the same location as the marketing of the transaction.

Trading or risk management in integrated form is unlikely to be found between independents and it may not be possible to make reasonably accurate adjustments to make data comparable. In an integrated trading model, locations can not act independently. Therefore, it may not be possible to evaluate any transactions in isolation so that traditional transaction methods could be applied reliably. Profit split methods may well be the only viable method in this instance.

1.2.4. Conclusion

In reality actual trading or risk management operations may be a hybrid that does not fall completely within one of the above models. It is more likely that traditional methods for example cost plus method could be reliably applied the closer the trading organisation is to centralised product management or

separate enterprise than integrated trading. Also bear in mind that the manner in which global trading is conducted may change over time¹⁸⁰.

1.3. Support or back office

The first step is to determine if the traditional transaction based methods could result in a reasonably accurate arm's length price.

In some cases it may be difficult to find a comparable uncontrolled price for all the support or back office functions as these functions typically take place within the same enterprise. However, many support functions such as settlement are provided for between independent parties, hence comparable uncontrolled prices should be available, even without the need to make reasonably accurate adjustments. In other cases adjustments may be needed to reflect differences in the functions performed.

Activities of some key back office staff such as product control staff (sometimes called "middle office" staff) play significant roles in the determination of the overall profitability of the whole operation. Comparable uncontrolled prices may not be available as reliable benchmark to evaluate the contribution by such staff but one possible measure of the contribution of such activities would be the compensation paid to key staff, especially to the extent that the compensation is performance related. The cost plus method may be applicable in these situations.

Given the wide range of functions falling under the category "middle office" and "back office" it would best to evaluate each case on its own and then reach a decision regarding the appropriate method to be used for the

¹⁸⁰ The analysis of trading and risk management is based on the OECD Report on The Taxation of Global Trading of Financial Instruments March 1998 III - 2(2)

determination of an arm's length price. However, given the nature of most support functions (Refer Chapter 6 Part 2) it would usually be possible to use the traditional transaction method to arrive at a reliable arm's length price. The most likely instance where the traditional methods could not be applied reliably, is where the particular back office function is so integrated with the other functions that it is impossible to evaluate it on a separate basis as required by Practice Note No. 7.

Should a profit split method be used it would be important, on a case by case basis, to ensure that each party to the transactions proportionate share of the overall contributions to the arrangements is consistent with the party's proportionate share of the overall expected benefits to be received under the arrangement¹⁸¹.

1.4. Role of capital/risk assumption

A functional analysis is an analysis of functions performed (taking into account assets used and risk assumed). The people's functions of a global trading organisation has been discussed above. What remains to be analysed is the assets used and the risk assumed, both of which relate to the capital of the global trading organisation. This analysis involves a separate evaluation of the role of the capital provider.

In many cases there will be no need to measure the function of the capital provider as all the capital of the global trading organisation, which underpins the assumption, bearing risk and management of risk, is centralised in the one enterprise where the risk management and trading takes place. The other enterprises in the group which performs other functions e.g. sales will require

¹⁸¹ The analysis of support or back office is based on the OECD Report on The Taxation of Global Trading of Financial Instruments March 1998 III - 2(3)

capital, but this is likely to be insignificant compared with the capital necessary to undertake dealing, trading and risk management functions.

However, where the capital function is spread, or where it is centralised but separated from the people's function of trading and risk management, it will be necessary to separately measure it in order to arrive at an arm's length reward for this function.

When undertaking a functional analysis of the capital/risk assumption function it will be important to check that the controlled transaction and uncontrolled transactions being compared are similar with respect to the capital situation or the risks assumed, or if not, that reasonably accurate adjustments can be made for any differences. Financial markets are familiar with the concept of the assumption of risk and so, for many transactions, data may be available to make adjustments for the influence of capital, in the form of fees charged for assuming particular types of risk, for guaranteeing financial transactions or for enhancing credit worthiness. Such data may also be used as a comparable to evaluate the reward for a capital provider for an entity that assumes the credit risk associated with a transaction.

A possible approach for making adjustments in capital or risk assumption between controlled and uncontrolled conditions, or to evaluate the reward for the provider of such attributes, could be to use an adapted form of the cost plus method, based on the capital assets "used" or "put at risk" in the transaction. Financial institutions need to have enough capital on hand to cover the risks which they assume, there is a cost associated with the maintenance of this capital. The more risky a transaction is the more capital needs to be set aside to cover it and the price for entering into the transaction should correspondingly also be larger. Often such data may be available from independents or the taxpayer may bring forward its own data on the basis that it has been created for business and management purposes and has been

validated by the regulatory authorities. Revenue may not accept the taxpayer's own data as this may not be reflective of an arm's length price.

The facts and circumstances surrounding the provision of capital should be evaluated in order to determine exactly what function is being undertaken. If the capital provider is merely lending money the function can be rewarded by use of the CUP method to determine an arm's length interest rate. If on the other hand the capital provider is acting as an entrepreneur by underwriting all the risks of the activity it would require a large share of the profits (a transactional profit based method would be appropriate). The two aforementioned examples are extremes in between which there are capital providers whose function may be more that of an intermediary or a portfolio investor and where it may be possible to apply traditional transaction methods reliably.

In some circumstances reliable adjustments would not possible in which case profit split methods can be used as a last resort. In such cases third party data may be available to help decide how profits should be split.

It is necessary to consider in addition to the functions performed, a variety of other factors that may affect the transaction, such as the economic circumstances of the particular market, the business strategy of the taxpayer, the risk profile, and the type and nature of the product.

The influence of capital is likely to be more important for products that are complex and innovative and where the duration of the contract is long rather than short¹⁸².

¹⁸² The analysis of the role of capital/risk assumption is based on the OECD Report on The Taxation of Global Trading of Financial Instruments March 1998 III - 2(4)

1.5. Integration of functions

In some of the centralised product management models and in all the integrated models, a fee or commission, calculated on the basis of a separation of the trading and marketing functions, may not fully reflect the co-operation between the marketers and traders which is essential in order to produce the profits from global trading. This raises two problematic issues.

- Firstly how should the benefits of integration be allocated? This problem is not unique to global trading. The OECD guidelines states the following in this regard: *“There are, however, no widely accepted objective criteria for allocating the economics of scale or the benefits of integration between associated enterprises.”*¹⁸³
- Secondly how should the level of integration in respect of particular transactions be evaluated? The behavior of the parties may help in this analysis. The question of integration should be dealt with on a function by function basis. The fully integrated trading model is defined only by the level of integration of trading and risk management functions – there is no reason why the integration of these functions means it should not be possible to separately evaluate the other functions, such as support, under a similar type of trading model.

It may be possible to deal with the aforementioned problem by making reasonably accurate adjustments to the fee. For example, the analysis could identify a comparable commission for performing a basic sales function which could then be increased to reflect the additional functions performed by the marketer who is more integrated into the global business. The adjustment could also be made by the trader receiving a share of the reward given to the marketer and vice versa (both rewards being determined by the traditional

transaction methods), rather than both of them sharing in the profits.

The business strategy of the taxpayer should be taken into account and the functions should be looked at on a case by case basis.

A number of tax authorities believe that in some global trading cases that they have examined there has been such a high level of integration between the various locations and functions that traditional transaction methods could not reliably be applied to particular functions, because the conditions of the controlled transactions differed so much from those in transactions between independent enterprises. Therefore, it was not possible to make "reasonable accurate adjustments" so that a valid comparison could be made or the degree of integration between the functions and the consequent interrelation between the transactions was such that it was not possible to evaluate the transactions on a separate basis.

Tax authorities have found that the majority of cases where a profit split method would be appropriate are in the case of integrated trading modules and in some cases a hybrid between the integrated and centralised product management model. An example of such a hybrid is where some functions such as risk management is completely centralised and others such as trading authority is delegated outside the central location to some extent¹⁸⁴.

¹⁸³ The OECD Guidelines on Transfer Pricing paragraph 1.9

¹⁸⁴ The analysis of integration of functions is based on the OECD Report on The Taxation of Global Trading of Financial Instruments March 1998 III - 2(5)

2. PROFIT SPLIT METHODS

As illustrated in the above analysis it may be appropriate especially where operations are highly integrated and where there is a lack of uncontrolled comparable data to apply profit split methods to determine an arm's length price for a global trading transaction. Practice Note No. 7 sets out two profit split approaches namely the residual profit split analysis and the contribution analysis¹⁸⁵.

Practice Note No. 7 makes it clear that the profit split approach will only be acceptable if the factors used to allocate the combined profits or losses produce a result consistent with that what would have been realised if the parties were independent.

Before any one of the abovementioned approaches can be applied it is essential that the functions necessary to earn global trading profits are included, valued and appropriately rewarded.

There is a belief that the residual profit method may be particularly applicable to global trading of financial instruments because of the wide range of complex functions that are performed. Under the residual profit split analysis the first step would be to reward the less integrated functions and more routine functions such as sales and some of the back office functions. The type of function would determine the reward, but often it would be determined by a traditional transaction method, such as an arm's length service fee. This fee is when deducted from the total profit and the remaining residual profit would be attributed to the global integrated functions.

¹⁸⁵ Refer to Chapter 5 Part 4.2 for a discussion of these methods.

The residual profit would be split between the various locations by means of factor formula. The choice and application of the profit split method must depend on the facts and circumstances of each case. In particular, care must be taken not to apply a factor formula developed for one product line to other products where the factual situation differs.

The supporters of the residual profit split method argue that it is more likely to lead to an arm's length reward for each individual function because routine functions will be rewarded accurately by reference to comparable data, leaving the more complex functions for which it is difficult to find comparables, to share in the residual profit or loss. They also believe that this approach is more likely to produce a result in accordance economic theory as the routine functions will receive a lower but more certain return, whilst the more complex functions will receive a potentially higher but more volatile return, with the real risk of making a loss, as well as the possibility of making large profits in one year.

Other believe that the residual method may not adequately capture the integration of functions found in global trading operations and that the contribution analysis method is better because it ensures that all significant functions that contribute to the earning of the global profit are included in the profit split.

Interest in factor formulas to deal with difficult global trading cases was stimulated in April 1994, when the US Internal Revenue Service issued Notice 94-40 which described in general terms its early experience with APA's concluded with taxpayers engaged in fully integrated global trading. The APA's described in the Notice used a profit split method based on the contribution method that utilised factors intended to ensure that profits were divided according to the economic activity of each location and its

contribution to the overall profitability of the global business.

The Notice identified three general types of factors that represent the contribution of various functions to the global profits in the case of a fully integrated trading operation:

- (1) the relative value of the trading location (“the value factor”) which was measured with reference to the compensation paid to traders at the location
- (2) the risk associated with the trading location (“the risk factor”) which measures the potential risk to which a particular location exposes the capital of the global organisation and
- (3) the extent of activity of each location (“the activity factor”) which was measured by reference to the compensation paid to key support people or the net present value of transactions executed at a trading location.

The Notice provides a useful starting point for identifying and analysing allocation factors that have to be considered when profit is split¹⁸⁶.

Practice Note No. 7 also provides guidance in respect of the application of profit split methods. This guidance should also be considered.

It should be noted that Practice Note No. 7 expressly authorise the use of both the residual profit split analysis and the contribution analysis.

¹⁸⁶ The discussion of profit split methods are based on the OECD Report on The Taxation of Global Trading of Financial Instruments March 1998 III - 3

3. CASE STUDIES

Global trading and its implications for tax purposes was considered in Seminar C of the International Fiscal Association's ("IFA's") London congress in October 1998. Seminar C of the congress dealt specifically with 24 hour global trading by considering two case studies which highlights the difficulties that arise from global trading. These two case studies and the findings of the IFA are discussed below¹⁸⁷.

3.1. Case study no. 1 (centralised product management model)

3.1.1. Facts

General

Global Co. conducts business in internationally traded securities - say its domestic Government bonds e.g. bonds of the country in which Global Co is incorporated and located.

Global Co's customers will require the ability to purchase and sell securities in their own time zone, although they accept that settlement procedures will be tied to the domestic market. Global Co's operations take place from the Home Market location (centralised location) and formal contractual relationships are entered into from there.

¹⁸⁷ International Fiscal Association London Congress October 7, 1998 Seminar C on Global Trading - Tax Analyst Database Reference 98 TNI 251-51

Financing

Financing of long positions takes place through debt (both secured and unsecured) and equity. Financing of short positions takes place through stock loans, repos and buy/sells.

The financing is arranged by Global Co domestically.

Trading

To maintain control and to reflect the importance of the domestic market, Global Co maintains responsibility for the trading book in its "Home Market" location (centralised location).

Selling

To meet the customers' requirements Global Co maintains a branch or has an affiliate in the "Foreign" locations, which have discussions with customers as to whether, and what they wish to buy or sell. The salespeople cannot price transactions. To the extent that time zones with the Home Market location (centralised location) overlap, salespeople will require the authorisation of trader in the Home Market (centralised location). Where time zones do not overlap a senior salesperson may be granted limited authority to agree transactions with customers within defined parameters set each day at the close of the Home Market (centralised location). The salesperson will typically conduct the transaction by phone and formal confirmation will be forthcoming from the Home Market (centralised location).

Recognition of profits from global trading activities

Global Co recognises all the profit and loss arising from the trading, but pays a commission to its branch or affiliate in each foreign location for the provision of its marketing services.

3.1.2. Findings

The delegates attending Seminar C agreed that the above model would normally require analysis of the appropriate transfer price under Article 9(1) of the OECD Model Tax Treaty. This would normally involve a functional analysis and the use of comparable pricing information.

It was noted that practical difficulties often arise in relation to finding suitable comparable information. This would be the one of the main determining factors influencing the choice of the appropriate method for the determination of an arm's length price.

The delegates attending Seminar C did not reach a conclusion in respect of the appropriate method (traditional transaction method versus profit split method) that should be used.

It is the author's view based on the facts of the case study that it is likely that comparable transaction data would be available and as a result traditional transaction methods should be used.

3.2. Case Study no. 2 (integrated trading model)

3.2.1. Facts

General

Global Co conducts business in international financial markets - say foreign currency options.

In providing a market to its worldwide customer base, Global Co deals with these customers from its locations in Europe, Japan and the US. Customers will require the ability to transact in their own time zone, but accept that settlement procedures may be consolidated by Global Co in one location worldwide.

Trading

The activity is undertaken by Global Co to maintain control. However, responsibility for the trading of the books will be “passed” between traders in the locations noted above so as to provide 24 hour coverage of the markets.

The activity is managed in one of two ways:

- Full discretion for all the books is passed completely between locations. Overall trading limits are set centrally by Global Co’s management, but the operations in each jurisdiction are independent.
- Each trader worldwide has responsibility for particular books. The prime responsibility resides with one trader only, but limited discretion is granted to traders in other jurisdictions to transact without further reference to the trader with prime responsibility only within prescribed parameters.

Selling

Global Co will market its foreign exchange products in each of the “Foreign” locations in which it operates, whether through a branch or an affiliate. As in Case Study No.1 the salespeople will hold discussions with customers as to whether and what they wish to buy or sell, but they will not be able to price a trade without the authorisation of a trader. Unlike Case Study No.1, a trader with responsibility will be on hand in the jurisdiction (unless the local trader has only been given limited discretion and the trade is outside the parameters set). The salespeople will typically conduct the transaction by phone and

formal confirmation of the transaction will be forthcoming from the operational support location for Global Co.

Recognition of profits from global activities

Global Co recognises all of the profit and loss arising from the trading, but allocates profit to its branches, or pays a profit related commission to its affiliates, in the foreign locations for their contribution.

3.2.2. Findings

The delegates attending Seminar C indicated that the case study illustrates the difficulties that arise when an integrated securities or derivatives trading business is conducted in a number of jurisdictions. One of major problems encountered in practice is identifying a suitable method for allocating fairly the profits to the entities in the jurisdictions involved (whether under Article 7 or 9 of the OECD Model Tax Convention).

The degree of integration of functions will be critical in determining which method would result in a reasonably accurate arm's length price.

The delegates attending Seminar C did not reach a conclusion in respect of the appropriate method (traditional transaction method versus profit split method) that should be used.

It is the author's view based on the facts of the case study that it is unlikely that comparable transaction data would be available and as a result profit split methods would need to be used.

CHAPTER EIGHT

SUMMARY AND CONCLUSION

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CHAPTER EIGHT - SUMMARY AND CONCLUSION

The aim of the study was to consider:

- 1) transfer pricing in South Africa,
- 2) to analyse and discuss the global trading of financial instruments,
- 3) to apply transfer pricing methodologies to the global trading of financial instruments and
- 4) to specifically consider the use of traditional transaction methods versus profit split methods for the determination of arm's length prices in the context of the global trading of financial instruments.

A summary and a conclusion in respect of each aspect of the subject of the study follows.

1. TRANSFER PRICING IN SOUTH AFRICA

The South Africa's transfer pricing legislation as set out in Section 31(1) and (2) of the Act and the guidance provided in Practice Note No. 7 were discussed in some detail.

South Africa's transfer pricing legislation supports the arm's length principle, this is in line with OECD guidelines on transfer pricing. The study found that the arm's length principle should be applied when determining transfer prices for global trading transactions.

Practice Note No. 7 sets out a four-step approach for the determination of an arm's length price. The four-step approach is as follows:

- Step 1: Understand the cross-border dealings between connected parties in the context of the business.
- Step 2: Select the pricing method or methods.
- Step 3: Application of the pricing method or methods.
- Step 4: Arriving at the arm's length amount and introducing process to support the chosen method.

The study concludes that this four-step approach should be followed when determining an appropriate arm's length price for global trading transactions.

Practice Note No. 7 provides practical guidance in respect of acceptable methods that may be used for the determination of an arm's length price.

These methods are as follows:

- 1) the comparable uncontrolled price method (CUP method);
- 2) the resale price method (RP method);
- 3) the cost plus method (CP method);
- 4) the transactional net margin method (TNMM); and
- 5) the profit split method.

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

The Practice Note specifically states that it does not impose a hierarchy of methods. It does however state that the traditional transaction methods are preferred to transactional profit methods. This is consistent with the guidance provided in the OECD guidelines on transfer pricing.

2. ANALYSIS OF THE GLOBAL TRADING OF FINANCIAL INSTRUMENTS

The concept global trading of financial instruments were considered in detail. The factual background, structure of the business, business strategies and organisation of trading activities of a typical global trading organisation were discussed.

3. TRANSFER PRICING AND THE GLOBAL TRADING OF FINANCIAL INSTRUMENTS

A functional analysis of a typical global trading organisation was performed. The following critical functions of a global trading organisation were identified and discussed:

- Sales and marketing
- Trading and risk management
- Support or back office
- Capital/Risk assumption

The application of the various methods set out in Practice Note No. 7 to reward the functions listed above was considered. In particular the use of traditional transaction methods versus profit split methods to reward the functions of the global trading organisation.

4. TRADITIONAL TRANSACTION METHODS VERSUS PROFIT SPLIT METHODS

The suitability and reliability of any method used to determine an arm's length price will depend on the facts and circumstances of each case and the most reliable method will be the one that requires fewer and more reliable adjustments. Therefore, it is impossible to conclude and state that traditional transaction based methods or in the alternative profit split methods should always be applied to the global trading of financial instruments.

However, the study found that the choice between traditional transaction methods and profit split methods will be influenced to a large extent by the availability of reliable comparable uncontrolled transaction data and/or the degree of integration of functions. If there is a lack of reliable comparable uncontrolled transaction data and/or functions are highly integrated there will be a strong argument for the use of profit split methods. The reliability of the method would however always need to be considered.

In conclusion the choice of the most appropriate methods (traditional transaction methods or profit split methods) for determining an arm's length price for each of the aforementioned functions of a global trading organisation are listed below. Note that the conclusion is based on the analysis performed in respect of a typical global trading organisation and that it is intended to be a general guide which will not apply in all instances.

Sales and marketing; Support or back office; and Capital/risk assumption

The most appropriate method for the determination of an arm's length price to reward these functions will be determined on a similar basis. Hence, the

conclusion in respect these functions are discussed together.

In general reliable comparable uncontrolled transaction data should be available or reliable adjustments should be possible in respect of these functions. Thus, the application of traditional transaction based methods should result in reasonably accurate arm's length prices.

An exception to the above would be if reliable comparable uncontrolled transaction data is not available. This will often be the case if the functions are highly integrated with the trading and risk management functions. The use of profit split methods should then be considered.

Profit split methods should also be applied if the functions are rewarded by the global trading organisation internally, based on profit share.

Trading and risk management

One of the most important functions of the global trading organisation is arguably trading and risk management. Three possible trading structures were discussed namely:

- Integrated trading
- Centralised product management
- Separate enterprise trading

These three trading models present three extremes. Often the trading structure of the global trading organisation would consist of a combination of these models.

It appears from the functional analysis performed and the consideration of appropriate methods to reward the trading and risk management function that:

- sufficient reliable comparable uncontrolled transaction data would be available for global trading organisations whose trading activities are organised according to the separate enterprise trading model or
- a combination of the separate enterprise model and the centralised product management model.

As a result of the availability of reliable comparable uncontrolled transaction data, traditional transaction based methods should be applied in this instance.

On the other hand if a global trading organisation conducts its trading according to the integrated trading model or a combination of the integrated trading model and the centralised product management model it may be more appropriate to use profit split methods. The reason for this would be a general lack of reliable comparable uncontrolled transaction data.

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