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For attention: Mr Lee Corrick
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For attention: Ms Yanga Maputa
South African National Treasury

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Dear Madam/ Sir

SAICA WORK ON THE UNIFIED APPROACH

As you are aware, the Organisation for Economic Cooperation and Development's (OECD) and the G20 Nations' Inclusive Framework published a paper in January 2020. The paper named "*Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitisation of the Economy*" contains proposals that will change the global tax landscape once finalised. These proposals are largely categorised into:

Amount A - *A share of the residual profit allocated to market jurisdictions;*

Amount B - *A fixed remuneration based on the ALP for defined baseline distribution and marketing functions; and*

Amount C - *A return to cover in-country functions in excess of the baseline distribution and marketing functions.*

The Inclusive Framework has called for continued efforts to strengthen the analysis and also public views from experts necessary to support the technical design and implementation of a consensus-based solution.

The South African Institute of Chartered Accountants (SAICA), South Africa's pre-eminent accountancy body, is widely recognised as one of the world's leading accounting institutes. SAICA is a founding member of the International Federation of Accountants (IFAC), Chartered Accountants Worldwide and the Global Accounting Alliance. The Institute provides a wide range of support services to more than 50 000 members and associates who are chartered accountants [CAs(SA)], as well as associate general accountants (AGAs(SA)) and accounting technicians (ATs(SA)), who hold positions as CEOs, MDs, board directors, business owners, chief financial officers, auditors and leaders in every sphere of commerce and industry, and who play a significant role in the nation's highly dynamic business sector and economic development. SAICA's main office is located in Johannesburg, but it also has three regional offices throughout South Africa. However, with more than 8500 members outside South Africa, SAICA maintains representative offices in both the United Kingdom and Australia.

The SAICA Transfer Pricing Committee, has commenced work on the Unified Approach and what this could mean for multinational groups operating in Africa. In this regard, we are also collaborating with our sister/similar organisations in Uganda, Tanzania and Zambia. We have also consulted various African multinational companies who have operations into other African countries.

We believe these collaborations will broaden our understanding of the challenges multinationals face in the various African countries and will help inform our recommendations to ensure that the broader concerns from the African continent are addressed.

We thought it would perhaps be helpful in sharing with you the work which our committee has done thus far. The key areas that we have concentrated on are:

1. Focus on the relevance of Amount B;
2. Amount B: What are possible in-scope activities, and how to define it;
3. Amount B: What should the economic analysis to determine Amount B look like;
4. Amount B: Confirming the operation of this practically; and
5. Amount A: Confirming the likely operation of Amount A and alleviation of double tax, and the interaction with Digital Service Taxes;
6. Thoughts of dispute prevention and resolution.

Our thoughts are in the process of being refined, and, should you deem it worthwhile, we would be pleased to share more detailed input than is contained in this letter, and even meet with you to discuss this further.

1. Focus on the relevance of Amount B

At the outset we wish to state that we support simplicity (within reason), certainty, the arm's length principle, mitigation of double taxation and reduction of transfer pricing disputes.

From the constituency consulted, there is a concern about the lack of certainty in Africa especially for baseline marketing and distribution activity. In most, if not all African countries, there are no successful Advance Pricing Agreement ("APA") programs to grant certainty and the Mutual Agreement Procedure ("MAP") programs have resulted in limited resolution of double taxation than would have been expected for a continent with such a large and increasing amount of transfer pricing disputes. With the number of court cases rising (including the Nestle and Mopani cases in Zambia) and the lack of options to mitigate double taxation, the risk of double taxation and transfer pricing uncertainty of controlled transactions are high.

Our understanding is that Amount B aims to standardise the remuneration of "baseline marketing and distribution activities" (more specifically for distributors, regardless of industry), to increase simplification in the administration of transfer pricing and to enhance certainty and to limit the potential for disputes, and that Amount B would constitute an arm's length return in terms of article 9 of the OECD Model Tax convention and/ or domestic legislation or guidance. A fixed return for in-scope activities based on the arm's length principle is proposed.

Amount B can bring some certainty and failing on Amount B is failing on a key objective of Pillar I. Amount B could have the potential to simplify compliance too.

Should the Inclusive Framework not achieve consensus on Amount B, we would gladly engage to give input on a pilot project which includes African countries willing to participate in the project to achieve greater certainty with respect to what constitutes arm's length remuneration for baseline marketing and distribution activities in Africa. For such a pilot to achieve the objective of increased tax certainty the key trading partners of the countries engaging in the pilot must commit to recognise Amount B as an arm's length outcome.

Regardless, the sections below elaborate broadly on our views of what the scope of Amount B could be and how to determine it.

2. Amount B: In-scope activities

To determine whether a taxpayer performs "baseline marketing and distribution activities" for distributors, to which Amount B applies, we propose a dual test for distributors (i.e. taxpayers that buy and sell finished goods and/ or services):

- inclusion test; AND
- exclusion test.

Inclusion test:

To determine whether a tested party, and more specifically a distributor of goods and/ or services[1] would fall within an Amount B in-scope activity, we wish to propose that this is determined by a formula to determine intensity of the distributor, e.g.:

- the use of operating expenses to sales for distributors. Operating expenses would be defined as the costs between the gross profit and operating profit level per local GAAP; or

[1] This would only be applicable to associated enterprises who contractually sell to customers of the group, and are purely re-sellers.

- value adding expense to sales threshold for distributors. Value adding expenses could simply be costs or expenses incurred by the in-market "distributor" which is not external, e.g. employment costs, depreciation and other overheads, but excluding third party advertising and marketing costs and foreign exchange gains/ losses.

If the distributor's operating expenses or value adding expenses to sales ratio fall below a threshold relevant to its industry and region, it should realise a margin, being "Amount B". This proposal is based on the assumption that reliable thresholds can be determined by industry (and even by region). The relevant thresholds could be determined by either a) input from industry, or b) analysis of publicly available data in databases.

Exclusion test:

If the tested party met the inclusion test, the next step could be to apply an exclusion test to ensure that the distributor is functionally performing routine distribution activities. We propose that the distributor should be excluded from the application of Amount B if:

- There has been a significant year on year movement (e.g. 20% or more) in either its sales or uncontrolled costs, above the operating profit/ earnings before interest and tax ("EBIT") profit level (e.g. significant volatility caused by factors such as foreign exchange gains/ losses or as result of adverse or abnormal market conditions, such as depressed oil prices or COVID-19). The commercial reality is that the losses can arise (also in third party transactions) as a result of adverse market conditions. This formulaic exclusion test acknowledges this. In particular, entities suffering significant foreign exchange losses as result of dramatic currency depreciation against the US$ and Euro is a reality in the African region;

- The tested party is in its first two to three years of operation, to cater for volatility in "start-up" businesses;

- The tested party's revenue and/ or cash flow is regulated (e.g. competition law, pharmaceutical single exit price regulations, foreign exchange regulations or other regulations impeding the free flow of cash); **or**

- If the negative functional factors (initial suggestions) in the table below apply, the tested party would then fall out of the scope of Amount B.

	Functions to possibly exclude (negative factors) – not baseline marketing and distribution activity
Market	Sets, prescribes and controls market strategy, consumer value strategy for Region/ Global market; core demand creation strategy.
	Brand governance (determining brand visual, core brand messaging parameters, competitive positioning).

	Functions to possibly exclude (negative factors) – not baseline marketing and distribution activity
	Regional/ global strategic marketing/ brand roles (fulfilling DEMP functions, and not exploitation). Strategic marketing: Setting overall core marketing strategy, developing key multi-territory campaigns, defining market research priorities and driving priority campaigns for Regional or Global market. Controlling decisions regarding the defence and protection of IP.
	Product development.
Sell	Set and controls pricing strategy and maximum prices at which products can be sold in markets. No sales mandate parameters.
After-sales	Define the vision and strategy for customer service, segment customer base and define priority segments for Region/ Global market.

Note, that if a distributor is excluded from Amount B, it does not necessarily imply the existence of an intangible or premium in excess of Amount B. It is just an indication that the arm's length nature of controlled transactions should be determined in accordance with the OECD Transfer Pricing Guidelines (Amount C).

Applying the above criteria would likely exclude regulated businesses and multinational groups operating on a decentralised basis, e.g. banks, insurance companies, regulated fund managers, mobile and fibre telecommunications companies.

3. <u>Determining Amount B</u>

To arrive at Amount B we recommend the following analysis to arrive at a reliable Amount B for baseline marketing and distribution activities, in Africa specifically, given the lack of comparable data in Africa:

- Consider performing a global TNMM benchmarking search (at both the EBIT and profit before tax ("PBT") profit levels) and segment results by industry and region (at both country level, region and developing and developed market level). Operating expense and value-adding expense data should also be observed, if available, to inform the inclusion test;

- Corroborate the above, for Africa, by considering a deductive approach, using an appropriate database, and/ or the additive approach to select MNEs, with publicly available data, who largely operate in Africa, to sense check the margins identified through the search above. The publicly available data for businesses in Africa are usually of listings on African stock exchanges. These businesses have off course a greater functional profile than one would expect of a distributor subject to Amount B. In the absence of reliable comparables in Africa, when stress testing an appropriate margin for distributors subject to Amount B, to evaluate the margins of "all in risk groups"[2] operating in Africa could be supportive of an arm's length margin for Amount B in Africa. Surely distributors cannot earn more than all-in risk entities/ entrepreneurs. This data can frame broad profitability, i.e. be indicative of a ceiling of returns; and

- Corroborate the above, for Africa, by considering alternative PLIs, for example Return on Working Capital. Further work should be done to consider the impact of funding on distributors in Africa.

We would welcome the opportunity to refine recommendations on:

- whether returns should be capped though with reference to group profitability. Should distributors in the industry have low profitability, this would reflect in the benchmarking study performed;
- the impact of fragmentation or of functions in separate distributors. Some groups could have longer supply chains or multiple subsidiaries in one country with shared functions, which could result in the "split" of functions and margins;
- whether the ultimate target margin should be Operating (EBIT) or Net (EBIT/ PBT) profit. The benefits of PBT as a margin would be more simplicity and certainty, given the variable interest rates and variable accounting of foreign exchange gains/ losses in Africa (above and below the EBIT level);
- the economic impact to a market jurisdiction if the target margin for Amount B is too high; and
- whether there should be a rebuttable presumption that Amount B for baseline marketing and distribution activities shall prevail, unless it can be refuted by reliable internal comparables.

4. The Operation of Amount B

We wish to also confirm the operation of Amount B and highlight the implications of achieving a target margin at the end of the relevant year of assessment.

[2] Multinational Enterprises (MNEs) that carry on a consolidated basis all the functions, assets and risks of the value chain within that economic unit.

We would recommend that the target margin be achieved at the end of the year of assessment (as contained in the local statutory audited annual financial statements), to mitigate the exposure to secondary adjustments, withholding tax and customs duty.

Distributors should have the freedom to choose which inter-company transactions could be used to achieve the target margin (e.g. through the pricing of goods/ services or intellectual property charges, where appropriate).

Should this not occur, we recommend harmonisation of other taxes with Amount B, for example, thought should be given to the knock-on impact of transfer pricing adjustments on customs duty, VAT and withholding taxes.

We recommend that the test for Amount B be in local GAAP (as opposed to group GAAP), regardless of tax accounting or specific tax rules.

For Amount B to achieve desired success, we believe that the above, in respect of Amount B, could be reconciled to the arm’s length principle and not necessitate changes in either local legislation or double taxation agreements.

We would, however, support the codification of Amount B in a multilateral competent authority agreement to give the required certainty in local law on what Amount B would be.

We further recommend that Amount B be reviewed every three years, and its success be evaluated through a peer review mechanism, akin to other peer review mechanisms.

5. Operation of Amount A

We understand that what is proposed is that a designate group company of an MNE (“the paying entity”), would pay income tax in its country (i.e. the country of tax residency of the paying entity) on Amount A (if any), with allocations to relevant countries or markets’ Revenue Authorities. The tax authority collecting the tax on Amount A would distribute the tax to the relevant countries or markets’ Revenue Authorities. Consequently, Amount A is a notional calculation, and is not determined by actual inter-company transactions or tax registrations in market jurisdictions. Consequently, there is no need to consider customs, withholding tax or deductibility of charges for domestic corporate tax purposes.

It can happen, conceivably, that Amount A could be subject to tax already in the market jurisdiction by virtue of the residual profit being realised in the market where a multinational enterprise operates on a decentralised basis, or if for example Amount B has been exceeded for whatever reason. Notably, this can occur on highly decentralised consumer facing businesses, e.g. professional service firms and telecommunication service providers. In this case, we wanted to confirm and support that relief from double taxation should be considered either through credits or exemptions in the paying jurisdiction, or market jurisdiction. We propose that a credit (or exemption) in the paying jurisdiction be given in the calculation of taxes to be paid on Amount A. This should be the most efficient, especially given that group accounts are often finalised before local statutory accounts.

In the alternative, the double taxation should be eliminated through a credit (or exemption) in the market jurisdictions, when the market jurisdiction tax return is filed, on the basis that the group has a presence in the market.

Where an MNE has no presence and tax obligation in a country, there should probably be no double taxation, unless withholding taxes are applicable.

It would be important that the “paying entity” be tax resident in a country that has signed up to any possible ensuing multilateral competent authority agreement.

We wish to note that our concern about the burden that Amount A would cause on certain taxpayers in Africa which would be subject to Amount A. For instance, the tax functions of South African listed groups are often not as sizable as larger global MNEs. The burden to comply with Amount A would be a concern. The extent of the administrative requirements to comply with Amount A is uncertain. We welcome further debate on the Amount A threshold to ensure that the compliance burden does not outweigh the Amount A objectives.

We welcome further debate on regional differentiation in the determination of Amount A, even within Africa. Profit profiles can differ widely from one market to another in Africa, e.g. while end-to-end system profit could be high in country A, it would not necessarily be so in country B.

Many MNEs function on a regional basis due to the heterogeneity of the regions, with regional management developing marketing, sales and after-sales strategies that are aimed at acquiring and retaining consumers in the respective regions (e.g. the marketing strategy applied across the MNE group is not a one strategy for all regions). In such situations, determining Amount A with reference to a Group’s consolidated financial statements, which contains regional segmented financial information, could be more appropriate. Determining Amount A with reference to only the Group consolidated financial statements of the ultimate holding company (without regional segmentation) would not result in a fair allocation of taxing rights to market jurisdictions.

While some MNEs may have reasonably homogenous profits, there will be many MNEs that have differing margins by business segment and market. Market profitability may differ substantially (i.e. achieve healthy profits in one region versus losses in another region) due to the impact of specific market conditions and cost infrastructures relevant only to that specific geographical region.

6. Dispute prevention and resolution mechanisms

Having said the above though, we appreciate the balance that would have to be achieved between complexity, simplicity and certainty. We hope that we can play a role to liaise with MNEs operating in Africa to solicit further views to ultimately achieve certainty on Amount A and B.

Further, for the unified approach to be successful in Africa, there should be a deliberate action on the part of the OECD/ inclusive framework to ensure that Revenue Authorities are not incentivised by assessment targets. This can hamper the successful implementation of the unified approach.

Lastly, we support binding mandatory arbitration although we appreciate the legal and political complications that binding mandatory arbitration may bring. However, we sincerely wish that work could be undertaken to resolve possible complications, especially around the size of arbitration panels, selection of arbitrators, and their powers.

We look forward to hearing from you.

Yours sincerely

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Chairperson: Transfer Pricing Subcommittee

Pieter Faber
Senior Executive: Tax

The South African Institute of Chartered Accountants