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A critical analysis of base erosion and profit shifting: reflections on South Africa

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A research report submitted to the Faculty of Commerce, Law and Management, University of the Witwatersrand, in partial fulfilment of the degree of Master of Commerce specialising in Taxation.

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ABSTRACT

This research report aims to investigate if South Africa's legislation on transfer pricing is adequate and capable of limiting South Africa's tax base erosion.

With the improvement in technology as well as the global interaction of markets, global trade over the past few decades also saw an exponential increase. Consequently, parties in different jurisdictions began transacting with each other and the nature of such transactions included foreign business operations being set up in South Africa to render services to South Africa. These transactions are called inbound transactions. Similarly, South African businesses began trading in other parts of the world and these are termed outbound transactions. Inbound and outbound transactions are referred to as "cross border transactions"[1] and these include business and investment transactions, which take place across borders[2]. These transactions present an income tax challenge, as they are capable of attracting tax in more than one country. Furthermore, the interaction of tax laws of different jurisdictions has presented opportunities for businesses to order transactions in a manner that can avoid or reduce tax in the jurisdictions at play[3].

Through literature review, the research report finds that the Income Tax Act (ITA) is adequate in ensuring that South Africa safeguards its fiscus in collecting all revenue due to it and is not a catalyst for the manipulation of profits in related party transactions. This finding derives substance from the fact that section 31 of the ITA was over the years, regularly reviewed and updated to align it to the OECD recommendations. As Munyaradziwa Ratombo and Roy Blumenthal explained, section 31 is aligned to global standards and

[1] Stiglingh M., Koekemoer A, Van Schalkwyk L, Wilcocks JS and De Swardt RD. 2019 Silke: South African Income Tax 2019. LexisNexis: Durban.
[2] Supra note 1
[3] Ratombo M and Blumenthal R. 2017. The challenges faced by developing countries regarding transfer pricing. see http://www.saaa.org.za/Downloads/Publications/TAX008%20The%20challenges%20faced%20by%20developing%20countries%20regarding%20transfer%20pricing.pdf

extends the revenue authority of South Africa's "power to adjust not just the consideration but also the terms and conditions of non-arm's length transactions".[4]

Furthermore, the developments in international tax law will guide South Africa in better applying the international standards regulating transfer pricing.

Key Words:

Base erosion and profit shifting, BEPS, South African Revenue Service, SARS, South Africa, SA, treaty shopping, arm's-length principle, multilateral convention, multilateral instrument, MLI.

[4] Supra note 3

DECLARATION

I, Nyasha Philipa Maduka declare that the research work contained in this report is my own and I have developed this report of my own accord, with the exception of where otherwise indicated and acknowledged. Verbatim quotations have been used within the report and enclosed in quotation marks in acknowledgment of other authors, academics and scholars' work.

Signature of candidate: _____ Date: 27/05/2021

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27/05/21

Nyasha Philipa Maduka

ABBREVIATIONS

BEPS: Base Erosion and Profit Shifting

CFC: Controlled Foreign Company

DTC: Davis Tax Committee

EU: European Union

IP: Intellectual Property

ITA: Income Tax Act

MNEs/Multinationals: Multinational Enterprises

OECD: Organisation for Economic Co-operation and Development

SARS: South African Revenue Service

UK: United Kingdom

USA: United States of America

1 CHAPTER 1: INTRODUCTION

Over the years, global trade has increased exponentially and today people are living in a global village. The characteristics of a global village are such that national borders do not impede the flow of goods and services[5].

As a result, due to the developments in technology, parties in different jurisdictions can transact with each other. An international corporation therefore is capable of setting up operations within South Africa and/or "render services to South Africans" (inbound transactions). Such a transaction is also termed a cross border transaction. Cross border business as well as investment transactions can present challenges from an income tax perspective to the extent that they may trigger tax in more than one jurisdiction[6].

Furthermore, the interaction of tax laws of different jurisdictions often present opportunities for taxpayers to structure their business or investment transactions in a manner that results in them paying little or no tax at all[7]. Although the main objective of these so-called, aggressive tax-planning arrangements is to reduce or avoid tax in totality, the arrangements are legal to the extent that they are permitted by legislative provisions of different jurisdictions,[8] albeit the interaction of the laws of those jurisdictions maybe detrimental to a jurisdiction where the taxable income of a taxpayer is separated from the source country.

However, the moral acceptability of these structures that avoid or reduce tax obligations of businesses through aggressive tax planning mechanisms became questionable over the years, despite the practice not being illegal. These structures were more prevalent due to the nature of international corporations' business models and their ways of operation in a globalised economy[9]. As a result, the international think tank responsible for international

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[5] Daurer V. 2014 Tax Treaties and Developing Countries. Series on International Taxation. Wolters Kluwer. Law and Business Volume 44, the Netherlands.

[6] Stiglingh M. Koekemoer A, Van Schalkwyk L, Wilcocks JS and De Swardt RD. 2019 Silke: South African Income Tax 2019. LexisNexis: Durban

[7] Supra note 6

[8] Supra note 6

[9] Davis Tax Committee: Second Interim Report on Base Erosion and Profit Shifting (BEPS) in South Africa: Introduction. p.6 paragraph 1 see:

trade and the economic reforms thereof, recognised that globalisation, the gradual elimination of trade barriers and developments in technology as well as telecommunications resulted in the evolution of products and operational models, thus affecting the manner in which modern Multi-national Enterprises (MNEs) are structured and managed[10]. This change according to the Organisation for Economic Co-operation and Development (OECD) influenced "the development of global strategies aimed at maximising profits and minimising expenses and costs, including tax expenses"[11]. As an example, a significant characteristic of the new operating model by MNEs was

> "A shift from country-specific operating models to global models based on matrix management organisations and integrated supply chains that centralise several functions at a regional or global level."[12]

Accordingly, key partners within the international community including "media and civil society expressed increasing concern about tax planning by MNEs".[13] In particular, the OECD expressed that the reduction of international corporations' tax liability through the manipulation of tax laws of different countries compromises the revenue collection and administration of countries for which those taxes were due, as international corporations may have unfair competition over their domestic counterparts[14]. Base Erosion and Profit Shifting (BEPS) also presents challenges of a social nature to a country because "the tax being avoided deprives the ordinary citizens of the countries affected by such avoidance, of funds required for basic services that the government should be providing".[15]

The G20 in 2012, at its leaders' summit in Mexico turned to the OECD as the leading multi-lateral institution on international taxation to find a lasting solution for the management of

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https://www.taxcom.org.za/docs/New_Folder3/2%20BEPS%20Final%20Report%20-%20Introductory%20Report.pdf

[10] Supra note 9 p 9 paragraph 1.2

[11] Supra note 9 p 9 paragraph 1.2

[12] OECD 2013 Addressing Base Erosion and Profit Shifting see:

[13] OECD/G20 2015 Base Erosion and Profit Shifting Project. Addressing the Tax Challenges of the Digital Economy. Action 1: 2015 Final Report. October 05, 2015 see: https://www.oecd-ilibrary.org/docserver/9789264241046-en.pdf?expires=1583749912&id=id&accname=guest&checksum=4BE02FCDFCCB72BE868B7AA90F34C425

[14] Burgers I and Mosquera I 2017 Corporate Taxation and BEPS: A Fair Slice for Developing Countries? Erasmus Law Review Eleven Journals see: https://www.elevenjournals.com/tijdschrift/ELR/2017/1/ELR_2017_10_01_004

[15] Supra note 14

shifting profits through the manipulation of tax rules internationally[16]. UK's Chancellor of the Exchequer as well as the Ministers of Finance for Germany and France sought the global support of the international community to facilitate:

> "Coordinated action to strengthen international tax standards and for states to back the Organization for Economic Co-operation and Development's (OECD) efforts to identify loopholes in tax laws"[17].

As a result, the OECD commenced with a process of developing an international framework to curtail the separation of profits from the place where those profits were generated and the framework applies to member states as well as non-members of the OECD.[18].

Through these cross-border transactions, many foreign entities receive substantial support from their parent companies and shareholders. The South African entity and its foreign shareholder(s) are referred to as connected persons'.[19] The connected person relationship at times, gives rise to adjustments to profits in respect of transactions between these entities[20].

1.1 PROBLEM STATEMENT

The purpose of this research is to ascertain the adequacy of the domestic law provisions regulating transfer mispricing in South Africa, towards the shaping of a fair, effective and efficient tax system. Practical measures for development and administration of these provisions will be investigated should there be any shortcomings identified in section 31 of the Income Tax Act of 1962 (ITA). The rationale behind this paper is to ascertain the adequacy of section 31 in an effort to take advantage of the opportunity South Africa has, through the OECD project on BEPS to strengthen its corporate tax system, thereby maintaining public and private sector confidence.

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[16] Supra note 9
[17] Supra note 9
[18] Supra note 9
[19] Supra note 9
[20] Van der Zwan 2017. Transfer Pricing Adjustments: Too many layers of Tax? see: https://www.thesait.org.za/news/326196/Transfer-Pricing-Adjustments-Too-Many-Layers-of-Tax.htm

1.1 The primary research question requires identification into the gaps in the South African legal system with particular reference to section 31 of the ITA as amended and to propose how the identified challenges can be overcome.

1.2 The first sub-question is to ascertain the legal status of the "OECD BEPS Action Plan in South Africa" following South Africa's reservation and notification statement to the Multilateral Instrument.

1.3 The second sub-question is to investigate the implications of the BEPS Action Plan for South Africa with specific reference to actions 6 (seeking to address treaty abuse and the so-called "treaty-shopping" arrangements), 13 (the three tiered approach transfer pricing documentation requirements, i.e. the country-by-country report, master file, and local file) and action 15 (the MLI signed by South Africa).

1.4 The third and final sub-question requires an investigation into South Africa's way forward in implementing the BEPS Action Plan, with particular focus on the gaps identified.

1.2 UNDERSTANDING MODERN BUSINESS MODELS: TRANSFER PRICING AGGRESSIVENESS

The OECD in 2013 noted that in curtailing BEPS, countries should have an understanding of modern business arrangements and how multinational enterprises operate in a global economy[21]. Accordingly, to illustrate the different transactions or activities of multinational enterprises, which support or facilitate BEPS, this part of the research unfolds evidence from Indonesian companies. The evidence demonstrates arrangements in terms of which the distorted prices of goods and services charged between related parties to transactions, was the main mechanism used to reduce or avoid businesses' tax liability in jurisdictions they operated.[22]

[21] Supra note 7 p 9 paragraph 1.2

[22] Firmansyah A. & Yunidar A (2020) Financial Derivatives, Financial Leverages, Intangible Assets, and Transfer Pricing Aggressiveness: Evidence from Indonesian Companies. *Jurnal Dinamika akuntansi dan Bisnis,* 7(1), 1-14

The OECD in 2017 stated that, "more than 60% of the world's trade took place in multinational enterprises"[23] such that the manipulation of tax rules between related parties for pricing reasons was becoming more critical[24].

Firmansyah & Yunidar expressed that avoiding taxes through related party transactions concluded not at arm's length was quite prevalent in that income earned in a country with higher taxing rates was shifted to where the business would be liable for little or no tax at all[25].

Furthermore, mechanisms that reduce or avoid liability for taxes to revenue authorities are also due to financial derivatives transactions[26]. Evidently, from the rapid increase in volume of financial derivatives transactions in the past two decades; for example, in Indonesia, there was an increase in the volume of derivative transactions from IDR 17 472.53 billion in 2001 to IDR 60 705.55 billion in 2009[27].

Firmansyah & Yunidar submit that long-term debt is another financial instrument, which is potentially exploited for tax avoidance activities. To illustrate this submission, the authors state that,

> "The financing decision includes an alternative source of funds that the company would use to run its business. In addition, the authors express that, concerning a company's financial structure, a company is considered to use financial leverage if it uses a loan or debt as a source of financing other than its capital".[28]

Consequently, using a debt or loan to finance raises a fixed cost of interest expenses that will become due and payable at some point regardless of the level of corporate earnings. Therefore, because deductible interest from taxable income provides an incentive for the company, it is a preference by companies to fund their businesses using debt. This is because in certain instances, interest on debt can be a tax deductible. As a result, if debt transactions are concluded with related parties whose expenses or loan interest can be

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[23] Neighbour J. 2002 (corrected 2008) OECD Observer. Transfer pricing: Keeping it at arm's length. see: https://oecdobserver.org/news/archivestory.php/aid/670/Transfer_pricing:_Keeping_it_at_arms_length.html =II
[24] Supra note 22 p.2
[25] Supra note 22 p. 2
[26] Supra note 22 p. 2
[27] Supra note 22 p. 2
[28] Supra note 22 p. 2

deducted from the gross income of the company, this becomes a company's incentive for tax planning[29].

A significant observation by Firmansyah & Yunidar (2020) is that, derivatives in developing countries are used differently when compared to their application in first world countries, which have the ability to mitigate their risk exposure[30]. Accordingly, the authors state that, in developing countries, where companies use derivatives, they have the effect of devaluing a business due to unstable institutional processes as well as low liquidity for derivatives.[31].

Quoting Firmansyah & Yunidar (2020) in terms of positive accounting theory, the political costs of hypothesis reflect that the higher the cost of corporate politics, the more likely it is for corporate managers to choose accounting policies that shift profits or expenses where their corporate tax liability will be minimum or zero[32]. In essence, tax is one form of political costs that has the effect of reducing corporate profits. Another mechanism of achieving transfer pricing is through companies taking advantage of different tax rules between countries to be able to maximise profits through reducing their net income in countries where their sister companies' tax liability will be high. [33]

Notably, within the South African context, the simulation doctrine in the common law of taxation has been SARS' remedy vis-à-vis the specific and general anti avoidance provisions contained in the various tax statutes[34]. Watermeyer JA in *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd* held that, a contract cannot be a simulated one where the parties to an arrangement intended to act in accordance with the terms of the contract, irrespective of the reason for entering into the contract[35]. However, arguably the Supreme Court of Appeal judgment in *CSARS v NWK* changed the landscape of the

[29] Supra note 22 p. 2
[30] Supra note 22 p. 2
[31] Supra note 22 p. 4
[32] Supra note 22 p. 4
[33] Supra note 22 p. 4
[34] Marais AJ CA (SA) (2012) Tax avoidance in the common law
[35] *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd*

simulation doctrine[36]. The court *in casu* held that, the test should be whether the parties actually intended to give effect to the terms of the contract or whether one or both parties had an ulterior motive. The common law principle in *Randles* was used in South Africa for more than seventy years before the new test established in the *NWK* case[37].

South Africa's common law principle of simulation is supported by the doctrine of substance over form and the "sham" principle. These two principles requires the determination of the true intention of the transaction, i.e. a bona fide transaction vis-à-vis a dressed transaction[38]. Therefore, bona fide transactions are informed by the substance of the transaction rather than the form which might be a "sham"[39].

Empirical evidence exists that the use of derivative instruments positively affects transfer pricing aggressiveness. To illustrate this submission, Firmansyah & Yunidar (2020) state that the hedging instrument allows tax reductions through profit reductions and increased debt capacity. In other words, transfer pricing aggressiveness undertaken by companies using hedging transactions can result in an increase in debt, thereby reducing taxable income through interest charges. A company can therefore realise a loss or delay the realisation of its earnings through the aggressive transaction, with the result that, its taxable income, will substantially be reduced, for that relevant year of assessment[40].

It is therefore evident that derivative transactions conducted by intra group companies like multinational enterprises across borders enable the transfer of expenses or profits between countries with high or low tax rates. As an example, in Indonesia, there are no clear rules on the taxation of derivative transactions such that "derivative losses for speculative purposes would result in substantial losses due to the absence of offsetting and profit on the hedged item is also recognised to reduce taxes."[41] Consequently, the mechanism of transfer pricing

[36] *CSARS v NWK*
[37] Supra note 38
[38] Supra note 36
[39] Supra note 36
[40] Supra note 22 p. 4
[41] Supra note 22 p. 4

aggressiveness through derivative transactions may represent a more aggressive tax avoidance strategy[42].

More so, tax avoidance is possible when a company intentionally enters into derivative transactions with its subsidiaries in different tax jurisdictions. As illustration, in forward contracts, value transfers are achievable by setting a lower contract price, i.e. a higher purchase price than the estimated price that would arise at maturity[43]. As a result, a company would always encounter losses because at maturity, the company benefits from a reduced or heightened selling or buying price, depending on the relevant case in question. This is quite similar to shifting of profits due to the existence of a sale transaction to a related party, and these transactions can result in lower corporate tax profits and payments for the holding company in its jurisdiction if that jurisdiction has a higher tax rate, thus, resulting in the holding company realising a decline in tax in its jurisdiction. Furthermore, the holding company's subsidiary in a different jurisdiction, can acquire the forward contract, if the income on forward contracts in that different jurisdiction is taxable at a lower rate. There are typically two effects here: the company reduced its tax payments and delayed the realisation of its derivative profits. At the same time, there is an acceleration of a derivative loss not designated as a hedge, for accounting purposes[44].

'Positive accounting theory assumes that managers are rational' and as a result, they would opt mainly for accounting policies that are capable of meeting their interests[45]. 'Financial leverage is accordingly, one of the variables that positively affect the activities of transfer pricing aggressiveness'.[46] For instance, companies with huge borrowings result in more tax aggressive schemes than those whose borrowings are low[47]. Under the ordinary course of business, a robust debt transaction between affiliated entities is capable of generating

[42] Supra note 22 p. 4
[43] Supra note 22 p. 4
[44] Supra note 22 p. 4
[45] Supra note 22 p. 4
[46] Supra note 22 p. 4
[47] Supra note 22 p. 4

interest charges or loan charges for subsequent deduction from the company's gross income to reduce the company's profit[48].

From the above illustration of how modern business and transfer pricing aggressiveness can take place, it should be highlighted that the literature by Firmansyah & Yunidar (2020) relied on for this submission, had its own limitations[49]. The authors made a disclosure that their research was conducted using data from non-financial companies such that their submissions cannot represent an overall condition of companies in Indonesia and as a result, the conclusions of the study may be different when relying on research data from companies and sectors other than non-financial sectors and depending on the research period applicable. The authors also indicated that the sample used in their study was relatively small as they only focused on companies that had derivative transactions but did not experience losses during the studied period[50].

1.3 TAX AVOIDANCE THROUGH TRANSACTIONS RELATED TO INTANGIBLES

Another transaction, which companies often use to avoid taxes through transfer pricing aggressiveness apart from financial derivatives and financial leverage transactions, is transactions related to intangible assets[51]. Firmansyah & Yunidar (2020) advance that, 'the cost of research and development that does not have a physical form can allow companies to manipulate the magnitude of these expenses'.[52]

Transfer pricing is an establishment of a value for a transaction by corporations within a group; the value of which would not be feasible if the corporations were independent[53]. It is an observation that international corporations with operations in more than one country, may

[48] Supra note 22 p. 5
[49] Supra note 22 p. 12
[50] Supra note 22
[51] Supra note 22 p. 2
[52] Supra note 22 p. 12
[53] Davis Tax Committee. Addressing Base Erosion and Profit Shifting in South Africa. Davis Tax Committee Interim Report. Action 8: Assure Transfer Pricing Outcomes are in line with value creation with regard to intangibles. see: https://www.taxcom.org.za/docs/New_Folder/6%20DTC%20BEPS%20Interim%20Report%20on%20Action%20Plan%208%20-%20Transfer%20Pricing%20of%20Intangibles,%202014%20Deliverable.pdf

fictitiously partake in transfer pricing because of the differences in the laws of the jurisdictions they operate in. By so doing, international corporations can manipulate profits in countries where they are most likely to derive the greatest tax benefit. As such, in an endeavour to curb transfer pricing, the OECD recommends using the arm's length principle[54].

According to paragraph 1 of the OECD member states' agreement on bilateral treaties:

> "[Where] conditions are made or imposed between the two [associated] 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"[55].

Although, in many instances, the income of multinationals was effectively and efficiently allocated, among taxing jurisdictions, there were some gaps and multinationals continued to apply the rules inappropriately. In 2013, the OECD stated that:

> "In certain instances, multinationals have been able to use and/or inappropriately apply those transfer pricing rules to isolate income from the economic activities that produced the income and consequently shift it into low-tax environments[56]".

The affiliated corporations' ability to misappropriate rules mostly resulted "from amongst other transactions, transfers of intangibles and other mobile assets for less than the full value."[57] Furthermore, another way of misappropriating rules was the over-capitalisation of sister corporations whose tax liability was minimum and risk transfer agreements between those sister corporations. The relationship between these sister corporations enabled high

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[54] OECD/G20 2014 Base Erosion and Profit shifting Project. Guidance on Transfer Pricing Documentation and Country-by-Country Reporting Action 13: 2014 Deliverable https://www.oecd-ilibrary.org/docserver/9789264219236-en.pdf?expires=1591698456&id=id&accname=guest&checksum=E78B59C333AB2099383E4C85AE55D523

[55] OECD 2010 Review of Comparability and of Profit Methods: Revision of Chapters I-III of the Transfer Pricing Guidelines 22 July 2010 http://www.oecd.org/tax/transfer-pricing/45763692.pdf

[56] OECD 2013 Action Plan on base Erosion and Profit shifting. https://www.oecd.org/ctp/BEPSActionPlan.pdf

[57] Davis Tax Committee. Addressing Base Erosion and Profit Shifting in South Africa. Davis Tax Committee Interim Report. Action 8: Assure Transfer Pricing Outcomes are in line with value creation with regard to intangibles. see: https://www.taxcom.org.za/docs/New_Folder/6%20DTC%20BEPS%20Interim%20Report%20on%20Action%20Plan%208%20-%20Transfer%20Pricing%20of%20Intangibles,%202014%20Deliverable.pdf

risk arrangements to be moved to jurisdictions where the tax levied was low and such an arrangement would not have been feasible if entered by independent corporations[58]

Concerning the arrangements of intangible goods/services between related parties and their prices, tax regimes prior to the OECD's BEPS project, emanated from the traditional sale and transfer of products by hand and at a permanent site[59]. As a result, traditionally, business operations were concluded mostly in a specific area and in the absence of advanced technology, a company could not necessarily have operations in more than one country[60]. Where a business had representation in different countries, each operation was treated as independent of the other and would pay its rates and taxes separately in the country where it was located. However, modern technology has resulted in a business being operated, managed and controlled by the same people when the business has different branches across the globe[61]. At the same time, increased accountability faced by governments of different jurisdictions to deliver basic goods and services for their citizens, saw governments pressured to strengthen their fiscal sovereignty and to follow every piece of revenue that could be due to it.[62] Growth in intangible assets or intellectual property (IP) including patents, brand names, trademarks, copyrights and know how has influenced the change in the taxation rules in international law[63].

In order to achieve overall tax savings, groups of companies reorganise their businesses and the reorganisation takes place for every company within the group irrespective of the jurisdiction in which the company operates[64]. These types of exercises are aimed at ensuring the maximum and efficient utilisation of resources[65]. The value chain of intellectual property is therefore critical particularly due to its significance in transfer pricing[66]. Intellectual property transactions drive value for international corporations and because

[58] Supra note 51
[59] Supra note 51
[60] Supra note 51
[61] Supra note 51
[62] Supra note 51
[63] Supra note 51
[64] Supra note 51
[65] Supra note 51
[66] Supra note 51

intellectual property is capable of movement by virtue of it not having a physical geographical location, there is major significance in international law in the profit shifting associated with IP transactions[67]. The tax liability attracted by international corporations for the international exchange of intangibles is usually high; therefore, multinational companies with intellectual property intensive business models are often included in the intra-company allocation of intellectual property[68]. In addition, various jurisdictions allow varied deductions on amounts expended in the course and scope of developing or procuring intangible property[69].

As a result, since incorporeal property is capable of movement from one country to the other, more often, international corporations reduce their tax burden through agreements that seek to transfer different rights in the IP. Parties will need to conclude a licensing agreement to transfer IP rights[70]. Consequently, a taxpayer is capable of setting up a parent company overseas for the acquisition, exploitation, licensing or sublicensing of the IP titles of its sister companies in other jurisdictions.[71] Consequently, there can be a transfer of surplus income between the parent and subsidiary company with the resultant effect that the parent company will benefit a reduction in tax or will not be liable for any tax for its royalty income[72].

Income earned because of "the exploitation of the intellectual property obtained by the licensing and patent holding company, will be either exempt from tax or subject to a low tax rate in the tax haven jurisdiction".[73]

Usually, withholding taxes on royalties are charged in the jurisdiction in which they are derived and licensing together with patent holding companies are relied on to avoid high withholding taxes. A tax treaty agreement concluded by two different countries with a view to

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[67] Supra note 51
[68] Supra note 51
[69] Supra note 51
[70] Supra note 51
[71] Supra note 51
[72] Supra note 51
[73] Supra note 51 p. 3. The Davis Tax Committee quoted Arnold B The Taxation of Foreign Controlled Corporations: An International Comparison (1986) at 121. See: https://www.taxcom.org.za/docs/New_Folder/6%20DTC%20BEPS%20Interim%20Report%20on%20Action%20Plan%208%20-%20Transfer%20Pricing%20of%20Intangibles,%202014%20Deliverable.pdf

eliminate the possibility of taxing their residents twice on the same income, is capable of reducing high withholding taxes[74]. Desai MA, Foley CF and Hines JR (2006) as quoted by the DTC mentioned that, in order to derive such a reduced tax advantage, under a double taxation treaty, the multinational would establish a sister company in a country where the multinational would benefit from reduced tax for income earned from its royalties[75]. Once established, such sister company would own license rights, capable of sub-licensing to another of its affiliates[76]. The country where such affiliate will be situated must be a participant (hereinafter referred to as the participating country) in the treaties concluded and beneficial between the affiliated companies[77].

> "The second licensing company will usually be responsible for the exploitation of the licensing rights from which it would earn only a small margin on royalties and the balance would be paid to the ultimate licensor".[78]

According to Spitz & Clarke (2002) quoted by the DTC, the establishment of a sister corporation within the participating country may facilitate a movement of surplus income through a manipulation of the treaty provisions applicable to a reduction in taxes[79]. As an example, the Netherlands has been utilised for setting up sublicensing companies by using structures like the conduit company. Furthermore, Desai MA, Foley CF and Hines JR (2006) expressed that, big international firms due to their insider trading and the development of innovations often misused rules of international tax, in an effort to limit their tax liability.[80]

1.4 HISTORICAL: PROFIT SHIFTING OF INTANGIBLES

This section of the paper will below give a discussion on the most popular strategies employed by international corporations in achieving minimum tax liability at the end of a transaction involving a transfer of intangibles[81]. These common profit-shifting strategies are

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[74] Supra note 51 p. 3 The Davis Tax Committee quoted Tomsett E "Treaty Shopping and Debt/equity Ratios in the United Kingdom" Bulletin for international Fiscal Documentation (March 1990) at 48-49
[75] Supra note 51 p. 3
[76] Supra note 51 p. 3
[77] Supra note 51 p.3
[78] Supra note 51 p. 3
[79] Supra note 51 p. 3
[80] Supra note 51 p. 3
[81] Supra note 51 p. 4

termed, "the Double Irish Dutch Sandwich and the IP-holding structure using an IP-holding Box Regime."[82]

The DTC quotes Kleinbard ED (2011) who identified the "Double Irish Dutch Sandwich" scheme as one arrangement that was commonly used by the United States of America (USA) based Google and other ecommerce businesses to, inappropriately benefit from reduced tax[83]. By implication, in terms of this scheme, a parent company and its subsidiary would both have to be set up in Ireland[84]. The country of incorporation of the other conduit company would be the Netherlands. Using the USA as an example, the corporation with the licensing rights (hereinafter the holding corporation) is a direct affiliate of the USA company, which is also the controlling entity for the two companies in Ireland[85]. From an Irish perspective, the holding corporation "would usually be managed and controlled in a low tax jurisdiction such as Bermuda and therefore will be resident in Bermuda."[86] Fuest C (2013) cited by the Davis Tax Committee submits that, contrary to Irish law, the USA would treat the holding corporation as an Irish corporation on the basis that in terms of USA law, a corporation is a resident of the country in which it was established.[87] The structure of this business as advanced by the DTC citing Fuest C (2013) would consequently, result in reduced tax liability on the first exchange of the intangible as well as almost no tax in the country where the intangible is finally exploited and little tax on interest on royalties to all its affiliated companies.[88] In addition, the presence of the Irish affiliate preserves the withholding taxes on royalties within Europe, as there will be no tax levied in Ireland and in Bermuda. This is because the Bermuda resident company would collect fees and other revenue associated with the IP they hold and attend to the repatriation of funds in terms of Bermuda's laws. As for Ireland, in terms of the Irish tax regime, stamp duty is not payable on capital costs for IT goods and services procured by resident company for purposes of its

[82] Supra note 51 pp 4-5
[83] Supra note 51 p. 4
[84] Supra note 51 p. 4
[85] Supra note 51 p.4
[86] Supra note 51 p.5
[87] Supra note 51 pp. 4-5
[88] Supra note 51

trade. In addition, Ireland's legislation favours the establishment and operation of corporations especially those invested in research, development and innovation. However, to achieve reduced tax on the first transfer of the incorporeal rights thereof, the rights to exploit the incorporeal property should at the onset, be moved beyond the borders of the USA. Nevertheless, "transferring the full-fledged intangible would trigger taxation of hidden reserves and future income generated by the intangible."[89] This is in accordance with the US super royalty rule. Therefore, to transfer the intangible, the IP-Holding Company would make a buy-in payment and "conclude a cost-saving agreement on the future modification and enhancement of the IP with the US Parent Company."[90] With a partially complete intangible on transfer and deferred risk on future earnings, the challenge would be in ascertaining the arm's length price for future buyers.[91] Multinationals therefore have the pliability for price determination and the capabilities to by-pass high taxes on expatriation[92].

With respect to the structure resulting in the no-payment of taxes, in the jurisdiction where the incorporeal was finally exploited, the Irish affiliate would generate significant income from exploiting the incorporeal.[93] Evidently, in the country of final consumption, there will be no continuous existence because in Google's case, the Irish subsidiary's main business is to advertise and it portrays itself as having contractual relationships with customers outside the US.[94] Within international corporations, low-risk enterprises within the group are allocated the responsibilities to deliver and market goods and services, while the corporation's suppliers operate on a marginal fee basis to maintain the tax base at a minimum in the jurisdiction where the intangible will be finally exploited.[95] Furthermore, profits earned from customer sales by the Irish affiliate/subsidiary are taxed in Ireland.[96] However, because the Irish affiliate pays high tax-deductible royalties for use of the incorporeal to the parent entity,

[89] O'Sullivan C. 2019 Modernising Ireland's transfer pricing rules. Budget 2020 and current tax developments. See: https://home.kpmg/ie/en/home/insights/2019/10/taxing-times-budget-2020-modernising-irelands-transfer-pricing-rules.html
[90] Supra note 51
[91] Supra note 51
[92] Supra note 51
[93] Supra note 51
[94] Supra note 51
[95] Supra note 51
[96] Supra note 51

the tax base of the Irish entity is close to nil.[97] But for Ireland recently changing its legislation on pricing between related entities, to incorporate the 2017 OECD Transfer Pricing Guidelines, which became effective on 01 January 2020, most companies were before then capable of eroding the Irish tax base, by paying heftily on royalties for agreements concluded prior to 1 July 2010.[98] This was achievable prior to 1 January 2020, by using the "Double Irish Dutch Sandwich" for contracts and contractual terms concluded before 1 July 2010.

In addition, as a result of the existence of the Dutch conduit corporation no withholding tax on royalties would leave Europe. This is because royalties paid to the parent corporation pass through the affiliate entity in the Netherlands given that the conduit company sublicenses the incorporeal and the Netherlands, in itself has no royalty tax.

More so, because the Dutch Conduit Company does not perform any economic activity, it is inter-posed. The reason behind is that, the IP-Holding Company is a Bermuda resident for Irish tax purposes and Ireland levies withholding tax on royalty payments to Bermuda. Consequently, Irish resident companies are entitled to a 20% withholding tax on patent royalties to non-residents companies and individuals.

Following that business structure, there would be a complete circumvention of withholding taxes, because the movement of royalties by an Irish resident to the Netherlands is not taxable under applicable tax treaties. Furthermore, by virtue of EU's Interest and Royalties Directive, royalties from Ireland can be exempt from a source deduction paid between related entities, on interest or dividends. Related entities are whereby one company bears direct control of approximately a quarter percent voting rights in the other or at least a quarter percent voting rights of both companies is held by a 3rd party. At the same time, there is no withholding tax on royalties levied by Netherlands because the residence state of the receiving company is not a factor when the Netherlands imposes withholding tax on

[97] Supra note 51
[98] Supra note 83

royalty payments. The affiliate entity in the Netherlands pays a 10% levy on the patent box regime under the Dutch tax system. The formula for calculating the 10% is 10/25.5 of the total net earnings coming out of the intangible asset as allocated to the patent box. The said total net earnings constitute taxable profit at a rate of 25.5, being the regular tax for companies.[99]

Lastly, the parent entity is not taxed in both Ireland and Bermuda because it is not resident in Ireland and there is no corporate tax in Bermuda; hence, profits earned in Europe would virtually exit Europe without being taxed. On the other hand, the US only taxes non-US income if it is dividends and the income falls outside subpart F income. Subpart F income is:

> "Movable income earned by a CFC, i.e. income from the performance of services by or on behalf of a related person (foreign base company services income, income from the purchase and sale of personal property involving a related person (foreign base company sales income) and investment or passive income such as dividends, interest, rents, royalties (foreign personal holding company income), taxable to the US Shareholders in the year earned even though it is not distributed."[100]

However, for US tax purposes, the Irish entity and its Dutch affiliate by election, will be deemed as one Irish entity, with a combined income. Consequently, the royalties paid between the two Irish entities will not be considered and only income received from consumers will be considered. The transactions with customers typically falls outside of Subpart F, due to certain exclusions thereunder.

The IP-Holding Structure using an IP Box is the second prominent IP planning scheme, which multinationals have been using to reduce their tax liability[101]. For ease of reference, an IP Box is an intellectual property box regime or an innovation box which is a low corporate tax regime used by most countries to incentivise research and development. The regime taxes patent revenues differently from other commercial revenues. An illustration: the IP-

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[99] TBA and Associates Tax Business Advisors Ltd. 2020. The Dutch Intellectual Property (IP) Tax Planning Through the Netherlands. see: https://www.tba-associates.com/global-solutions/intellectual-property/incorporating-in-netherlands-bv-licensing-company/

[100] Brager Tax Law Group. 2014 Overview of subpart F income. Slide 6 p.7 see: https://www.bragertaxlaw.com/files/lbl_doc_13.pdf

[101] Davis Tax Committee. December 2014 Addressing Base Erosion and Profit Shifting in South Africa. Davis Tax Committee Interim Report. Action 8: Assure Transfer Pricing Outcomes are in line with value creation with regard tointangibles.p6see: https://www.taxcom.org.za/docs/New_Folder/6%20DTC%20BEPS%20Interim%20Report%20on%20Action%20Plan%208%20-%20Transfer%20Pricing%20of%20Intangibles,%202014%20Deliverable.pdf

Holding Company can be relied on to minimise taxes by transferring the IP to an IP-Holding Company resident in a country that offers a special IP Box Regime such as Luxemburg, Belgium or the United Kingdom. Generally, the Operating Company will be resident in any EU Member State and locating it in a country that is not strict on the application of the arm's length principle facilitates an increase for profits shifted.[102]

The IP-Holding structure requires that the movement of the incorporeal should not result in increased levies on expatriation and therefore no rules relating to artificial deferral of taxes by affiliated companies in the Parent Company's country of residence should apply. The resultant effects of the structure are the deliberate escape from the tax liability on royalty payments due to Europe's Interest and Royalties Directive and there will be low tax levied on the royalty payments to the parent entity. Royalty payments to the parent entity are made directly by the Irish entity. Europe's Interest and Royalties Directive applies because the parent entity is an EU Member State. Thus, the interposition of a conduit entity to avoid withholding tax will not be necessary. Similarly, the parent entity's liability on royalties will be very minimum, "as IP Box Regimes either exempt or offer reduced taxes for such income."[103]

The consequence of the tax-planning structures described above are a renunciation of an entity's residence status for tax purposes due to the absence, alternatively, the ineffectiveness of Controlled Foreign Company (CFC) rules; conflicting definitions of tax residence for varying jurisdictions, generally marginal tax levies as well as tax regulations or practices of an exceptional nature like intellectual property Boxes.[104]

Furthermore, the DTC quoted Fuest C (2013) who said the above intellectual property arrangements lead to no tax or minimum tax being levied at source because there is no taxes on royalties retained in Europe and with third countries.[105]

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[102] Supra note 51
[103] Supra note 51
[104] Supra note 51
[105] Supra note 51 p. 7

In addition, Fuest C (2013), as referenced by the DTC identified that the intellectual property boxes schemes cause

> "Difficulties in the valuation of IP and relating royalty payments and the absence of taxable presence of multinationals doing business via the internet in customers' residence countries[106]."

1.5 METHOD USED IN CONDUCTING THIS RESEARCH

"The methodology used in this research is a literature review. A literature review is a critical evaluation of what has been published on a topic by accredited scholars and researchers."[107]

Accordingly, as a secondary source of information, a literature review "will not report on any new or original experimental work."[108]

The intended outcome from a literature review includes inter alia, 'avoiding fruitless approaches, seeking new lines of inquiry, seeking support for grounded theory, distinguishing what has been done from what needs to be done and relating ideas and theory to applications'.[109]

1.6 LIMITATIONS

For a stretched period, exponential transformation of rules regulating shifting of profits has taken centre stage at international level. Transfer pricing, as a subject is very comprehensive and complex and international law developments in this realm since 2010 have not simplified the subject. In as much as the focus of the BEPS project has been to strengthen the different jurisdictions' taxing rights and ensuring transparency by establishing uniform global transfer pricing practices; some jurisdictions had to amend their domestic legislations to align "with the OECD transfer pricing guidelines" while maintaining the pulse on understanding the

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[106] Supra note 51 p. 7

[107] Taylor, D. n.d. The Literature review: a few tips on conducting it. See: https://libguides.unisa.ac.za/literature_review.

[108] Supra note 93

[109] Justus J. 2009 A Guide to Writing the Dissertation Literature Review *Practical Assessment, Research and Evaluation*. A peer reviewed electronic journal. Volume 14, Number 13, June 2009 ISSN 1531-7714.see: https://pareonline.net/pdf/v14n13.pdf

changing course and the implications thereof to respective domestic law trends. Determining how the changes influenced the research topic was not always possible as expert interpretation would be required and because the wheels of the subject would be turning so quickly, not many authors will have written articles with particular reference to the primary research question, to aid the development of the report.

2 CHAPTER II: BACKGROUND TO BASE EROSION AND PROFIT SHIFTING (BEPS)

A prestigious international forum for economics known as Group of Twenty (G20)[110] in 2012, at its leaders' summit in Mexico turned to the OECD as the leading multi-lateral institution on international taxation to find a lasting solution for the management of tax manipulation by international corporations, across jurisdictions.[111]

In response to the developments on the international front, the South African Minister of Finance set up a tax review committee in 2013 for purposes of inter alia, reviewing issues about the movement of profits out of South Africa by international corporations, in as far as they relate specifically to corporate income tax.[112]

2.1 THE DEFINITION OF BASE EROSION AND PROFIT SHIFTING (BEPS)

"Base Erosion and Profit Shifting (BEPS)" describes arrangements whereby international corporations move surplus income from countries where the activities generating such surplus income took place to a country where reduced tax attaching to those profits is achieved or the profits will not be taxed at all.[113] The movement of this surplus income to where it gets taxed minimally or goes untaxed at all is a form of tax avoidance that takes place through manipulating tax rules of different countries.[114]

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[110] G20 2020 What is the G20? https://g20.org/en/Pages/home.aspx
[111] Supra note 51
[112] Supra note 51
[113] Supra note 51
[114] Supra note 51

It should be noted that, tax avoidance resulting in low or no tax attaching to income is not in itself the cause of BEPS[115] and is not in itself illegal.

Furthermore, in *Inland Revenue Commissioner v Duke of Westminster* (1936), the court held that:

> "Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Act is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however inappropriate to the Commissioner of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax."[116]

Evidently, a clear distinction should be drawn between what constitutes an illegal obstruction of the revenue authority's duty to collect taxes and a manipulation of an application of the law to derive benefits through a fictitious transaction. Thus, escaping tax through non-compliance with tax legislation because of actions such as the misrepresentation of information on one's tax returns, with the purpose of influencing the results of one's tax assessment, to either attract a reduced or no tax liability is inconsistent with the law and therefore illegal.[117]

However, the OECD explained that, low or no tax due to an arrangement by a taxpayer would be the cause of BEPS where the arrangement results in artificially segregating excess earnings from the country where they were generated.[118]

Accordingly, following global consensus that the movement of profits due to mispricing and other aggressive transactions was a threat to every country's fiscal sovereignty, the OECD cited that the practice was being necessitated by the international corporate tax system, which was not coordinated.[119] The pronouncement saw the advent of the OECD's report named, "Addressing base erosion and profit shifting".

Following an increasing relocation by taxpayers of their surplus income to tax havens, there were numerous amendments to different jurisdictions' domestic laws in order to curb tax

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[115] Supra note 51
[116] *Inland Revenue Commissioner v Duke of Westminster*
[117] Oguttu AW. 2015 Tax base erosion and profit shifting in Africa-part 1: what should Africa's response be to the OECD BEPS Action Plan? *Comparative and International Law Journal of Southern Africa* Mar 2015 Vol 48 Issue 3 p.518
[118] Supra note 51
[119] Supra note 105 p.517

avoidance. As an example, the European Union (EU) issued a report with recommendations aimed at prohibiting the transfer of investments to low-tax jurisdictions. In addition,

> "The EU Council of Economic and Financial Ministers identified a package of measures that would tackle harmful tax competition as a mechanism to reduce distortions in the single market and to preserve the EU's tax revenue."[120]

Similarly, "in 1998 the OECD issued a report on Harmful Tax Competition." The report expressed that tax havens together with "harmful preferential tax regimes had harmful tax practices that could lead to the depletion of other countries' tax bases and distorted financial and investment flows between countries".[121]

Simultaneously, the OECD recommended certain anti-avoidance rules, which countries could adopt to protect themselves from these harmful practices.[122]

In 2013, the OECD introduced a project plan to regulate strategies set to escape tax liability through profit shifting.

According to the DTC, the project plan's core purpose was that of resolving inbound activities involving foreign MNEs, investing in a country and failing to pay an equitable corporate income tax share to that country.[123] There is however, a relationship between the plan cementing rules for CFCs and inbound concerns.

Although there are fifteen action points contained in the OECD's plan, this paper will focus mainly on actions 6, 13 and 15. With the exception of action 15, the G20 Development Working Group Domestic on Resource Mobilisation for Developing Countries, identified these measures as the highest priority actions whose impact is significant for developing economies[124].

2.2 TREATY SHOPPING: A SOURCE OF BEPS CONCERNS

[120] Supra note 105 p.521
[121] Supra note 105 p.522
[122] Supra note 105 p.522
[123] Supra note 51
[124] Oguttu AW. 2016- Tax base erosion and profit shifting-part 2: a critique of some priority OECD action points from an African perspective-preventing excessive interest deductions and tax treaty abuse p.131

Historically, bilateral agreements were concluded by many jurisdictions to avoid taxing the same income twice as well as to do away with inappropriate restrictions on global business and the movement of assets plus people. The use of these agreements evidently gave rise to "treaty shopping arrangements", being the indirect and improper use of a treaty entered into by two jurisdictions for one's benefit, (jurisdiction 1 and 2 for ease of reference), without being a resident of either of those jurisdictions. Treaties are designed to provide relief when an amount is taxed in both jurisdictions either as a result of the recipient being deemed to be a resident of both jurisdictions (1 and 2) (residence/residence conflict) or residence/source conflict, i.e. where the recipient is taxed on his or her world-wide income by virtue of being tax resident in country 1 and the income emanated from country 2 (the source).[125] As a result, treaty shopping undermines the tax sovereignty of jurisdictions, as a person would have claimed a tax benefit, which in the ordinary course of events such person would not be entitled to as a resident of that jurisdiction, thereby depriving jurisdictions of tax revenues. One of the findings during the BEPS project was that, treaty abuse is undesirable because entitlements reserved for residents of parties to a DTA were inappropriately being exploited by other jurisdictions' residents who may not be party to the treaty and this impacts on "the principle of reciprocity and the balance of concessions for the relevant parties to the treaty" are altered. Furthermore, in such cases, income may not be taxed at all or may be inadequately taxed and the jurisdiction of the person who would have claimed the tax benefit unduly (the underserving party), due to its residents being able to obtain tax benefits indirectly from the jurisdiction of source, without the undeserving party having to extend reciprocal benefits.

Evidently, South Africa had anti-avoidance rules before the OECD's action point 6, which rules have the effect of disregarding a transaction where the core aim of the respective parties' arrangement lay in enjoying minimal or zero tax liability. An in-depth discussion on BEPS Action Plan 6 will be held later in this report.

[125] Olivier L and Honiball M. 2011 International Tax: A South African Perspective Fifth Edition

3 CHAPTER III: EXISTING LAWS IN SOUTH AFRICA TO CURTAIL BEPS

The Davis Tax Commission acknowledged that South Africa has been aggressive in putting measures in place to curtail BEPS and compared to other developed jurisdictions, South Africa's efforts in this realm are commendable.[126]

South Africa's efforts in strengthening its domestic tax laws dates back to 1997 when the legislature introduced the Revenue Laws Amendment Act 59 of 2000, to bring into force the residence basis of taxation.[127]

The introduction of the residency principle aided to preserve the tax base of South Africa and facilitated its passage of re-entry on the international economic arena post 1994.[128]

Specific anti-avoidance provisions intended to curtail shifting of profits in South Africa, include section 9D of the ITA rules, the provisions of section 31 of the ITA, sections 34 to 39 of the Tax Administration Act 28 of 2011 (hereinafter TAA)and sections 225 to 233 of the TAA[129]

More so, Double Tax Agreements (DTA) concluded between South Africa and other countries contain provisions that mitigate tax treaty manipulation by residents of countries that are not party to those treaties. An example of such provisions is the 'beneficial ownership provision.'[130]

The introduction of the Taxation Laws Amendment Act 23 of 2018 (Act 23 of 2018) was aimed at tightening SA's domestic law pertaining to profit shifting and disclosure requirements; thereby empowering the South African Revenue Authority with the requisite provisions that guide the administration of tax matters.[131]

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[126] Supra note 51

[127] Davis Tax Committee. 2014 Addressing Base Erosion and Profit Shifting in South Africa. Davis Tax Committee Interim Report p.37 see: https://www.taxcom.org.za/docs/New_Folder/1%20DTC%20BEPS%20Interim%20Report%20-%20The%20Introductory%20Report.pdf

[128] Supra note 115 p. 37

[129] Stiglingh M., Koekemoer A, Van Schalkwyk L, Wilcocks JS and De Swardt RD. 2019 Silke: South African Income Tax 2019. LexisNexis: Durban

[130] Supra note 117

[131] Wiesener C. February 2019 #Budget2019: Can transfer pricing help increase tax collections? https://www.bbrief.co.za/2019/02/18/budget-2019-can-transfer-pricing-help-increase-tax-collections/

3.1 SOUTH AFRICA'S MAIN LEGISLATIVE PROVISION AIMED AT ADDRESSING TRANSFER MISPRICING

This research report seeks to investigate if there are any gaps in section 31 of the ITA as it currently stands. The report will consider whether the section is sufficient as is and/or whether the section requires some enhancements in its application to curb treaty-shopping arrangements, mitigate the challenges which may arise from the documents which ought to be submitted by a taxpayer, who is an international corporation, for transactions concluded with its affiliates, as required by the international transfer pricing guidelines. In addition, the research report aims to clarify how section 31 should be applied in light of the MLI.

Section 31 is the main legislative provision for South African law on shifting of profits through mispricing and accordingly, the section prescribes tools to mitigate risks associated with arrangements concluded between affiliated corporations, which may have the potential to unduly benefit these related corporations from tax liability.[132] Additionally, section 31 empowers the revenue authority to adjust the price agreed on by the affiliated corporations to bring it in line with what the price would have been if the transaction was between unrelated entities[133].

Where there are differing terms and conditions in a transaction between connected persons and a supposedly similar transaction between independent persons, then "the taxpayer is required to calculate their taxable income based on the arm's length terms and conditions of the affected transaction."[134]

In ascertaining whether there are any gaps in section 31 of the ITA as amended, the provisions of section 31 will be tested against section 23M[135] of the ITA dealing with

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[132] Republic of South Africa Revenue Service. 1999 Practice Note 7 Section 31 of the Income Tax Act, 1962 (the Act): Determination of the Taxable Income of Certain Persons from International Transactions: Transfer Pricing. see: https://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-PrN-2012-11%20-%20Income%20Tax%20Practice%20Note%207%20of%201999.pdf

[133] Supra note 121

[134] Sizwe Ntsaluba Gobodo. 2013 Transfer pricing 2256 Section 31 Further Analysis November 2013- Issue 170. https://www.saica.co.za/integritax/2013/2256._Section_31_û_Further_analysis.htm

[135] National Treasury 2020Reviewing the tax treatment of excessive debt financing, interest deductions and other financial payments. National Treasury. 26 February 2020. Reviewing the Tax Treatment of Excessive Debt Financing, Interest Deductions and Other Financial Payments see:

deductions of interest on loans. It should however be noted that, section 23M is currently under review by National Treasury as part of the alignment to the "OECD recommendations on the treatment of excessive debt financing, interest deductions and other financial payments because it is National Treasury's view that rather than the existing interest limitation rules specifically those in section 23M of the ITA, adopting the OECD approach will provide a more uniform standard to all interest payments flowing out of the country, regardless of which country the loan emanates from."[136] Evidently, the current review shows that National Treasury has a more stricter approach to excessive debt financing, which is a significant departure from the judgment in "*Ticktin Timers CC v The Commissioner for Inland Revenue*"[137], in which Hefer J held that,

> "There can be no objection in principle to the deduction of interest on loans in suitable cases [given] that loan capital is the life blood of many businesses [and] the mere frequency of its occurrence does not bring about that this type of expenditure requires different treatment."[138]

During 2014, National Treasury heightened its focus on finance transactions between international corporations and their potential to further the movement of surplus income across jurisdictions with the resultant effect of escaping tax liability.[139]

Consequently, this focus on cross border financing resulted in National Treasury introducing into South African law, provisions restricting interest deductions emanating from financial transactions between international corporations.[140]

The introduction of section 23M of the ITA followed developments at international law.[141]

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http://www.treasury.gov.za/documents/national%20budget/2020/Tax%20Treatment%20of%20Excessive%20Debt%20Finance.pdf

[136] Supra note 126

[137] Weber S. 2019 Inbound interest bearing loans – section 31 versus section 23M of the Income Tax Act. see: https://www.ensafrica.com/news/detail/1820/inbound-interest-bearing-loans-section-31-ver/

[138] *Ticktin Timers CC v The Commissioner for Inland Revenue* (1999) (4) SA 939 (SCA)

[139] Supra note 127

[140] Supra note 128

[141] Supra note 126

Where a creditor has majority control in its debtor and advances a loan to such debtor, "section 23M provides for a limitation on the deduction of interest incurred."[142] In such a setting, a controlling relationship is in existence.

Similarly, a limitation will also apply if the creditor borrowed finance from a third party who has control over the debtor.[143]

However, an interest deduction limitation of this nature will only apply if the interest amount is not taxable in the hands of the recipient or is not included in the net income of a controlled foreign company and furthermore, is not disallowed under the provisions of section 23N of the ITA, which deals with the limitation of interest deductions in reorganisation and acquisition transactions.[144]

Generally, "section 23M of the ITA applies to cross-border inbound bearing loans advanced by foreign holding companies to their subsidiaries in South Africa."[145] In such a case, "the interest income derived by the foreign company would usually not be subject to tax in terms of the provisions of the ITA, especially where loans are advanced from creditors who are resident in Luxemburg, Cyprus and Netherlands because of the double tax agreements concluded by and between South Africa and these respective countries."[146]

However, notably section 31 of the ITA applies to loans between a South African debtor and an international creditor,[147] because the section applies to "affected transactions". In turn, in its definition section, the ITA defines an "affected transaction" as an arrangement concluded between connected persons and the parties are a South African resident and a non-resident respectively.[148]. Furthermore, the test for an affected transaction is, the contractual

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[142] Supra note 128
[143] Betts M. 2015 Limitation on the deductibility of interest see: https://www.sataxguide.co.za/limitation-on-the-deductibility-of-interest/
[144] Supra note 135
[145] Supra note 128
[146] Supra note 128
[147] Supra note 128
[148] Supra note 128

arrangement should have been similar if the parties were independent and transacting at arm's length.[149]

In addition, section 31 (2) indicates that:

"The taxable income of the person who derives the tax benefit must be determined as if the transaction had been concluded on terms and conditions that would have existed between independent persons dealing at arm's length."[150]

Therefore, where there is a discrepancy in the terms and conditions of an arrangement between connected parties vis-a-vis an arrangement between independent parties', the taxpayer should not include interest on the loan when making a determination of the tax it has to pay to the revenue authority, on the basis that this constitutes what is called a primary adjustment[151]. An example of independent parties in this scenario would be a bank and a third-party borrowing.[152]

In section 31 (3), the ITA provides that, where in determining one's tax liability, certain income varies, resulting from an application of the arm's length standard, the varying amount is deemed a dividend in specie declared by the person liable to pay tax. The implication of this provision is that, the 20% dividends tax will be levied on the interest income under the ITA's "section 64E (1) read with section 64 EA (b)."[153]Quoting Simon Weber, "the question arises as to which of these provisions must be applied first in a situation where they both apply to the same in-bound loan?"[154]

In light of the aforementioned illustration,

> "Any adjustment in terms of section 31 of the ITA gives rise to both the primary and secondary adjustment, while the application of section 23M of the ITA results in a lesser allowable interest deduction, which has the same effect as the primary adjustment."[155]

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[149] Supra note 128
[150] Weber S. 2019 Inbound interest bearing loans-Section 31 vs Section 23M of the Income Tax Act. see: https://www.mondaq.com/southafrica/Tax/845280/Inbound-Interest-Bearing-Loans-Section-31-Versus-Section-23M-Of-The-Income-Tax-Act
[151] Supra note 128
[152] Supra note 128
[153] Supra note 128
[154] Supra note 93
[155] Supra note 128

When interpreting legal provisions, South African courts focus mainly on the intention with which a specific provision was established. To illustrate this point, Cliffe Dekker Hofmeyr (CDH) quotes the respondent's attorney in the *CSARS v Airworld CC and another case*, who said the intention of the legislature when the statute was drafted should be given effect to.[156]

Furthermore, CDH refers to the *S v Zuma and Others* case, in which the court endorsed the purposive approach in interpreting the Constitution of the Republic of South Africa[157].

In light of the cases supra and in keeping in principle with the purposive approach to interpretation, where sections 23M and 31 of the ITA apply to the same in bound loan, the two sections should be harmonised and be read together[158].

Notably, the provisions of section 23M apply a statutory formula with the result being a limitation on the deduction of interest. In other words, the test in section 23M is on factual matters, meaning it may be applied where a loan was advanced by a creditor holding more than 50% of the equity shares or voting rights in the debtor or in the absence of a controlling relationship between the two, where the creditor obtained the funding which became the debt, from a person who is in a controlling relationship with the debtor. There is a proviso that states that the interest deduction limitation only applies if the interest is neither subject to tax in the hands of the recipient nor included in the net income of a controlled foreign company and is not disallowed under section 23N of the ITA.[159]

Section 23M (1) defines "adjusted taxable income as an amount of interest incurred and which has been allowed as a deduction from income."[160] Arguably, this could mean any interest incurred which was disallowed as a deduction under section 31(2) of the ITA.[161]

According to section 31, there are two considerations namely, the existence of a tax benefit and whether the terms and conditions of the loan were at arm's length.[162]

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[156] Cliffe Dekker Hofmeyr 2011 General Issue 147 - November / December 2011 2008. Purposive interpretation of tax statutes https://www.saica.co.za/integritax/2011/2008._Purposive_interpretation_of_tax_statutes.htm
[157] Supra note 148
[158] Supra note 142
[159] Supra note 142
[160] Supra note 142
[161] Supra note 142

Consequently, consideration will be made to the quantum and interest rate of the loan and in the event the said terms of the loan were not at arm's length and a tax benefit exists, then the taxable income of the borrower will be calculated as if the loan transaction was entered into on arm's length terms. In accordance with this approach, the borrower's taxable income will already have been reduced by the application of the statutory formula in section 23M and this aspect will need to be taken into account in applying section 31 of the ITA.[163]

In summing up, where sections 23M and 31 of the ITA respectively apply to the same in bound loan, the initial approach should be an attempt to read the two sections together by first applying the statutory formula in section 23M. The input from section 31 would be the amount of interest incurred and which will have been allowed as a deduction from income.[164]

Secondly, section 31 (2) should then be applied to the same loan but there is need to establish if there was a tax benefit and whether the terms of the transaction constitute an "affected transaction."[165] In this regard, a further adjustment to the taxable income may become necessary in terms of section 31(2) of the ITA.[166]

In *Natal Joint Municipal Fund v Endumeni Municipality*, the SCA held that as a point of departure, in interpreting legislation, one should consider the document in question read in context taking into account the purpose of the provision as well as the background to the preparation and production of the document. As a result, since sections 23M and 31 aim to restrict base erosion and profit shifting, it clearly could not have been the intention of the legislature to prefer the application of one provision to the exclusion of the other.[167]

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[162] Supra note 142
[163] Supra note 142
[164] Supra note 142
[165] Supra note 142
[166] Supra note 142
[167] Supra note 142

Furthermore, in the *Endumeni* case, "the SCA held that where a person is faced with two or more possible interpretation of a statute, the one which gives rise to impractical, unbusiness like or oppressive consequences must be avoided."[168]

4 CHAPTER IV: THE INTERNATIONAL TEST SET TO MITIGATE THE MANIPULATION OF PROFITS FOR THE SALE OF GOODS AND SERVICES BETWEEN RELATED PARTIES

Up until 2018, there was no South African law precedent on the application of section 31 of the ITA as far as the "arm's length" principle is concerned.[169] Therefore, as referenced by Brink J, the court *in Crookes Brothers case* pronounced on how some provisions of section 31 of the ITA should be applied.[170] However, the court in its findings fell short of providing insight into the "arm's length" principle, yet the principle forms basis of every transfer pricing assessment.[171]

Seeing that in the *Crookes Brothers,* the court did not give meaning to the "arm's length principle", South Africa in making assessments in terms of section 31 may from time to time need to consider the developments in international law on transfer pricing.

During 2016, the vigorous work of international organisations provided state of the art perspectives regarding the development of systems or initiatives for moving profits amongst different countries.[172] Through the several projects, which were undertaken in this realm, the Multinational enterprises and tax administrations directives were communicated in 2010. The OECD TPG amendments were to give effect to the outcome of the 2015 final reports of the project[173]. At the same time, the European Union undertook a vast number of different enquiries into inappropriate mispricing practices of many countries that could be deemed illegal state aids.[174] Amongst others, the United Nations (UN) redrafted its transfer-pricing

[168] Supra note 142
[169] Brink J. 2018 South Africa's first transfer pricing case? see: https://www.golegal.co.za/tax-law-transfer-pricing/
[170] Supra note 162. The full citation of the case referred to is *Crookes Brothers Ltd v Commissioner for the South African Revenue Service* [2018] ZAGPHC 311
[171] Supra note 162
[172] Lang M, Storck A and Petruzzi R. 2017. Transfer Pricing Developments around the World. Wolters Kluwer
[173] Supra note 165
[174] Supra note 165

guide for emerging nations (UN TPM) to align with international transfer pricing progressions. Further guidance for developing countries in assessing circumstances of mispricing was provided by the World Bank Group (WBG) with the publication of a handbook titled, 'Transfer Pricing and Developing Economies: A handbook for policy makers and practitioners.'[175]

In addition, the International Monetary Fund (IMF), the OECD, UN and the WBG provided toolkits which were organised under the Platform for collaboration on tax, as suggestions and practical solutions to transfer pricing related topics for low-income countries.[176]

All the work by the various international bodies highlighted above, had an impact on different countries' legislation including South Africa, international administrative tax guidelines and the world's jurisprudence. The new trends in international tax also influenced South Africa's legislation and administrative tax guidelines.[177] The ITA's amendment to section 31 by the Taxation Laws Amendment Act, 24 of 2011, introduced a third updated version of the section.[178] This amended section became operational from 1 April 2012. [179]

The OECD report on action points 8 to 10, named, "Aligning transfer pricing outcomes with value creation" gave direction on how the "arm's length principle" should be applied in general and specifically to agreements in contract, incorporeal transactions, certain intra-group services and cost contribution practices.[180].

The transactional profit split method (hereinafter the profit split method) if applied properly is capable of aligning profits in accordance with the arm's length principle, particularly where a transaction's features makes the use of an alternative pricing method problematic[181].

Revised guidance on how to apply the transactional profit split method was communicated in 2018. The revised guidelines are not prescriptive but they provide clarity and significantly

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[175] Supra note 165
[176] Supra note 165
[177] Supra note 165
[178] Edward Nathan Sonnenbergs. 2012 Transfer Pricing 2044 New Rules. March 2012 Issue 150 see: https://www.saica.co.za/integritax/2012/2044._New_rules.htm
[179] Supra note 171
[180] OECD 2015 Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports see:
[181] Supra note 173

expand the circumstances upon which the method will be the most preferred. The guidelines suggest that to apply the method:

(1) There should be unique and valuable contributions made by each respective party;
(2) The parties' operational environment should be so inter-connected such that it will be impractical to separate an individual evaluation of the one party's inputs from his other party's; and
(3) The parties should share business risks of significant economic value or they should independent of one another, assume risks that are immensely connected.[182]

Evidently, while an absence of comparables is not adequate to justify the use of the profit split method, where appropriate comparables exist, the method may be the most appropriate.[183]

Furthermore, revised guidelines illustrate the manner in which the method should be used, as well as how to determine relevant profits to be split and the appropriate profit splitting factors. The revised guidelines suggest that, "the transactional profit split method seeks to establish arm's length outcomes or test reported outcomes for controlled transactions in order to approximate the results that would have been achieved between independent enterprises engaging in a comparable transaction or transactions."[184]

Accordingly, the profit split application initially identifies the profits capable of being shared from the controlled transactions and thereafter in a commercially prudent manner, divides the related enterprises' surplus income to be an estimated equivalent of possible profit sharing between unrelated parties.[185] In addition, the guidelines suggest that, the profit split method is specifically useful when the reparation to the related enterprises can more reliably be valued

[182] OECD/G20 2018. Revised Guidance on the Application of the Transactional Profit Split Method. Inclusive Framework on BEPS: Actions 10. June.p. 9 http://www.oecd.org/tax/transfer-pricing/revised-guidance-on-the-application-of-the-transactional-profit-split-method-beps-action-10.pdf
[183] Supra note 175
[184] Supra note 175 p.11
[185] Supra note 175

by reference to the relative shares of their contributions to the profits emanating from the transaction than by a more direct estimation of the value of their respective contributions.[186]

Notably, where the profit split method is determined to be the most appropriate method, it should generally and in the same way apply regardless of whether the transaction between the related parties concerned resulted in a profit or loss. There is a caveat to the revised guidelines which states that, "asymmetrical splits of profits and losses, i.e. where the parties apply different considerations depending on the results of the transaction, might be arm's length but must be treated with caution and should be appropriately documented."[187]

The revised guidelines carry sixteen examples illustrating the different principles illustrated in the document and demonstrating practical ways of using the profit split application. The strength and weaknesses of the method also form part of the said guidelines. It should be noted that the guidelines are not exhaustive in terms of how the profit split method may be applied but their application will depend on the facts and circumstances of each case as well as the available information. The key objective should always be to, as closely as possible, estimate the split of profits that would have been realised were the parties independent.

In addition, the OECD's BEPS Action Plan 13, "Transfer Pricing Documentation and Country by Country Reporting", published standardised documentation for MNEs. The standardised documentation aims to "enhance transparency in the way tax payers arrange their transfer pricing policies and implement them in practice."[188] The BEPS Action Plan 13 final report suggested a three-tiered approach to transfer pricing as follows:

(1) A master file with details on the high-level information of MNE's global business operations coupled with the MNEs' transfer pricing policies.

(2) A local file setting out materially significant related party transactions, the amounts involved in such transactions and an analysis of the transfer pricing determinations the company has made in relation to those transactions.

[186] Supra note 175
[187] Supra note 175 p.12
[188] Supra note 175

(3) A country-by-country report with annual information on the amount of revenue, profit before income tax, income tax paid and accrued number of employees, stated capital, retained earnings and tangible assets for each tax jurisdiction in which the MNE does business.[189]

MNEs should indicate each entity within the MNE group and the nature of each entity's business activities in any particular tax jurisdiction.[190]

In addition, to facilitate the implementation of the CBC reporting standard, the OECD provided a CBC reporting implementation package in 2010. The package consists of three model competent authority agreements and model legislation, for use in obtaining a CBC report from the parent company of an MNE group and for purposes of requesting the said parent company to disclose its jurisdiction of residence as well as back up filing requirements.[191] The three Model Competent Authority Agreements facilitate the exchange of CBC reports based on the Multilateral Convention on Administrative Assistance in Tax matters, the bilateral tax conventions and the Tax Information Exchange Agreements (TIEAs). However, the OECD clearly expressed that, in as much as the master file and local file are useful tools to understand an MNE's transfer pricing policy, the CBC report should primarily serve as a risk assessment tool. That being the case, reading the master file and local file together is the recommended approach. As Raffaele Petruzzi submits, the documentation requirements suggest a more transparent environment that could positively influence the behaviour of both taxpayers and tax administrators.[192]

4.1 THE OECD GUIDELINES ON THE INTERNATIONAL TEST

The ITA does not explicitly provide for the application of the OECD Transfer Pricing Guidelines. However, the application of the OECD guidelines is provided for in Practice Note No. 7, which although it is not law, is based on the OECD guidelines.

As mentioned earlier on, the court in the *Crookes Brothers* case supra did not provide guidance on the application of the "arm's length" principle. The ITA similarly does not provide

[189] Supra note 175
[190] Supra note 51 page 8
[191] Supra note 51
[192] Supra note 175

guidance on the application of the "arm's length principle" and as a result, developments in international law are likely to be relied on by the South African tax administrators and courts in applying the principle.

Collins P refers to the *Glencore Investment Pty Ltd v FCT [2019] FCA 1432* judgment where it was held that, in assessing the transaction, the evaluation should be a comparative one on the price or other term of the actual agreement compared to a "real world" consideration of non-related parties.[193]

Davies J in the court supra, rejected the Australian revenue authority's argument on the "flexible comparative analysis" in an earlier case, expressing that possible transaction reconstructions should be limited to the OECD guidelines. In particular, the Australian court expressed that the OECD recommendation on "exceptional circumstances", should be restricted to transactions where the agreement's terms and structure are not aligned. Alternatively, the "exceptional circumstances test should be applied where the structure and terms of the agreement are the same but where the holistic view of the agreement in totality differ from the terms of an agreement by independent enterprises and the actual substance precludes tax authorities from making a proper determination of the transfer price.[194]

Furthermore, the analysis of the transaction being challenged cannot be between metaphysical independent parties and the taxpayer's attributes has to form the basis of the assessment in the comparable agreement."[195]

In as much as the take away from the Glencore judgment is a clarification of the functionality of Australia's transfer pricing legislation, the judgment is a possible international law reference for South African courts because it reduces uncertainty and it limits the risk of

[193] Collins P. Dec 2019/Jan 2020 *Glencore v FCT*: transfer pricing decision. Academic Journal. *Taxation in Australia* Vol. 54 Issue 6, p332-334
[194] supra note 186
[195] supra note 186

double taxation. Furthermore, the judgment is also a manifestation of the Australian legislation's alignment to international standards, i.e. the OECD guidelines.[196]

5 CHAPTER V: THE GLOBAL AGREEMENT TO PREVENT BASE EROSION AND PROFIT SHIFTING AND ITS SIGNIFICANCE FOR SOUTH AFRICA

Through the publication of its fifteen BEPS measures, the OECD set in motion the project of fighting tax avoidance mechanisms which exploited inconsistent laws in the tax systems of various jurisdictions, by introducing a coordinated approach through new agreed to international rules.[197] Hogan Lovells quotes the DTC's recommendation in relation to the developments at international law, which stated that, should the OECD's action points' application call for the amendments of South Africa's Double Tax Agreements (DTAs), the financial implications and other difficulties arising out of re-negotiating those agreements are capable of being avoided through an endorsement of the Multilateral Convention to Tax Treaties Related Measures to Prevent Base Erosion and Profit Shifting (MLI), as per BEPS Action 15.[198] Consequently, the endorsement of the MLI constitutes a concurrent re-negotiation of all the signatories' DTAs. [199] The MLI emanates from the OECD's action point 15 on base erosion and profit shifting, which was designed to fast track the OECD strategies affecting tax treaties by eliminating the hassle of signatories having to bilaterally re-negotiate treaties between them.[200] As at 28 February 2020, ninety-four (94) jurisdictions had signed the MLI, with another four (4) jurisdictions having expressed their intention to sign the convention.[201]

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[196] supra note 186

[197] Lourens P.2018 Hogan Lovells Publications. What is the "MLI" and why is it important in the context of the South African tax system? see: https://www.hoganlovells.com/en/publications/what-is-the-mli-and-why-is-it-important-in-the-context-of-the-south-african-tax-system

[198] Supra note 188

[199] Supra note 188

[200] Supra note 188

[201] OECD 2020 Signatories and Parties to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting. Status as of 28 February 2020. http://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf

5.1 THE SIGNIFICANCE OF THE MLI

Rather than having to consult and interpret a number of different agreements, agreed to international principles and exceptions will be codified in the MLI, hence the international tax measures will be transparent and readily ascertainable.[202] The instrument provides flexibility to signature countries of mechanisms for basic principles of preventing misuse of treaties and resolving disputes. There are exceptions to signing the MLI and the exceptions are such that a signatory can indicate provisions which it does not want to be part of should the signatory view the provision as not being a basic principle of base erosion and profit shifting[203]. That signatory is still allowed to accept that basic principle at a later stage.[204] Signatories can apply optional provisions to curtail BEPS, where there are a number of ways to address it.[205] There are however conditions for the MLI to be in a position to amend a DTA.[206] As such, to amend a DTA using the MLI, both countries to the DTA should have endorsed the MLI and should have identified relevant DTAs falling under the MLI and their position on certain MLI articles in discussion should be the same.[207] In general, there must be consensus on the application of the relevant MLI article by both countries. The parties must be *ad idem*. Accordingly, the modification of a particular DTA can be blocked where either of the parties have raised an exception to an MLI article or where the other party has not raised an exception to the MLI article for which the other party did.[208] It should be clear that the variations to the DTA will be blocked only for the MLI article for which an exception was raised. Where both countries agree to the same position for amendments of that same DTA by other MLI articles, the amendments will be valid and of effect.[209]

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[202] Supra note 188
[203] Supra note 188
[204] Supra note 188
[205] Supra note 188
[206] Supra note 188
[207] Supra note 188
[208] Supra note 188
[209] Supra note 188

South Africa's position on the MLI articles together with seventy-six (76) DTAs to which the MLI extends was outlined by the country's treasury in 2017. [210] The OECD also created a useful link referred to as the MLI Matching Database (the Matching Database), which provides insight into whether a DTA is capable of amendment and the manner in which it can be amended using the multilateral instrument, "by matching information provided by the MLI signatories on their stated positions in respect of the articles of the MLI"[211].

Amendments to DTAs capable of amendment will only come into effect once ratified by the parties to that DTA, in their respective countries' jurisdictions.[212] In addition, for the MLI to come into effect in South Africa, it needs to be ratified by Parliament or its equivalent in other jurisdictions and thereafter it will come into effect after the expiration of a quarter of a year, from the date South Africa will have deposited its ratification protocol with the OECD. As at 13 May 2020, South Africa had not yet endorsed the multilateral instrument[213].

Although the MLI offers flexibility in that it provides countries globally with a uniform standard for amending their treaties, be they modelled on the OECD or the United Nations convention, the instrument does not come without criticisms and concerns. In general, the criticism is that

> "Developing countries (beyond the major emerging economies in the G20) had little or no involvement in its development and that it does not reform the underlying source-residence split in international tax rules (BMG, 2016)."[214]

Furthermore, there are some concerns regarding the effectiveness of the MLI because of the exceptions raised by signatories to the MLI. Oguttu submits that the MLI is a complex tool

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[210] Supra note 188
[211] OECD 2020. Signatories and parties to the Multilateral Convention to implement tax treaty related measures to prevent base erosion and profit shifting. Status as of 13 May 2020 see: www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf
[212] Supra note 188
[213] Supra note 188
[214] Oguttu AW. 2018 Should Developing Countries Sign the OECD Multilateral Instrument to Address Treaty Related Base Erosion and Profit Shifting Measures? Centre for Global Development Policy Paper 132 November 2018. see: https://www.cgdev.org/sites/default/files/should-developing-countries-sign-oecd-multilateral-instrument-address-treaty-related.pdf

whose implementation in practice and the comprehension of its provisions for application purposes, should greatly concern developing countries.[215]

5.2 BEPS ACTION PLAN 6

Action point 6 is a basic principle for treaty shopping which the BEPS Inclusive Framework members consented to. Action point 6 provides pre-requisites in jurisdictions' tax systems, which require resolution prior to each jurisdiction deciding to enter into a tax agreement.[216]

Action point 6 aims at preventing a misuse of treaties and setting up fundamental principles on how jurisdictions can design their domestic rules in a manner that ensures that they do not extend treaty benefits in inappropriate circumstances.[217] Following a March 2014 preliminary OECD report and reviews on the report from interested parties, the OECD published its second paper in this realm in September and November 2014 with a subsequent report.[218] The final report on action point 6 was published in 2015 and was referred to as a final package of measures.[219]

In order to mitigate disputes when concluding tax treaties, the OECD advises that countries should bear the burden of preserving their respective countries' internal anti-avoidance rules.[220]

Against this OECD recommendation, the South African tax legislation provides anti-avoidance principles of general application in sections 80A to 80L (GAAR) and the Commissioner of revenue in South Africa is empowered through enforcement of these anti-

[215] Supra note 205
[216] OECD 2019 Action 6 Prevention of tax treaty abuse. Minimum Standard. https://www.oecd.org/tax/beps/beps-actions/action6/
[217] Deloitte Africa. 2015 Global Tax Reset: The changing world of tax. A detailed overview of the BEPS Action points see: https://www2.deloitte.com/content/dam/Deloitte/za/Documents/tax/ZA_BEPS_Tax_191015.pdf
[218] Supra note 208
[219] Supra note 208
[220] Supra note 208

avoidance regulations to hold taxpayers accountable for any anti-avoidance schemes and for arrangements concluded on or after 2 November 2006.[221]

An "impermissible avoidance" is defined in section 80A and in turn, section 80B contains the revenue authority's competences concerning an "impermissible avoidance arrangement.[222] Section 80L defines "arrangement", "avoidance arrangement", "impermissible avoidance arrangement", "party" as well as "tax benefit" when applying the General Anti-Avoidance Rules (GAAR).[223]

As Van der Zwan Pieter expresses, an arrangement for which its core or only reason for existence was to derive an advantage from one's taxable income and which was concluded for reasons or under circumstances, which would ordinarily not exist between independent parties can be viewed as impermissible in tax.[224] In addition, to be impermissible, an agreement should lack business sense and it should create rights as well as obligations which would normally not arise had the parties concerned been operating independently, leading to the inappropriate use of tax legislation. Sections 80D and 80E provides situations that can indicate that an arrangement was concluded purely for a tax benefit.[225]

Against this background and with reference to action point 6 regulating treaty shopping, the Davis Tax Committee recommended that in its DTAs, South Africa's general anti-avoidance provisions should be safeguarded. Keith Jordaan submits that the GAAR's "main purpose" requirement equates to the OECD's Principle Purpose Test (PPT). Accordingly, Keith Jordaan suggests that South Africa should apply its anti-avoidance principles in mitigating tax fraud by arrangements seeking to manipulate its domestic provisions. Furthermore, as quoted by Keith Jordaan, the DTC in addition recommends that South Africa should work towards renegotiating its previous DTAs or conclude agreements amending the opening

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[221] Jordaan K. n.d. 2018/19 General anti-avoidance rule (GAAR) South African Tax Guide. see: https://www.sataxguide.co.za/general-anti-avoidance-rule-gaar/
[222] Supra note 213
[223] Supra note 213
[224] Van der Zwan P 2014 Analysis: Arm's length pricing between connected persons see: https://www.accountancysa.org.za/analysis-arms-length-pricing-between-connected-persons/
[225] J Supra note 213

statement of those DTAs in a manner that expressly reflects that parties to such treaty do not have the permission to facilitate the non-payment or the payment of reduced taxes be it by way of evading or avoiding liability, including through treaty shopping. This will be necessary where older treaties do not reflect as such.

6 CHAPTER VI: CONCLUSION

This report concludes that the South African tax legal framework is adequately sound in ensuring a transparent, effective and efficient tax system; particularly with reference to the developments in South Africa's tax legislation since 2012. These developments were being influenced and took into account developments in international law. The 1995 introduction of section 31 of the ITA aided to protect South Africa's fiscus sovereignty because there were now tools for managing mispricing and the movement of profits between countries.[226] Section 1 of the ITA defines a "connected person", as a determinant in establishing if a party to an agreement falls within the confines of section 31.[227] In 1999, the South African Revenue Authority issued guidelines known as Practice Note 7 and the Commissioner of Revenue's approach was that the Practice Note was drafted to be non-prescriptive and to be non-exhaustive guidelines to all profit shifting cases likely to arise.[228]

Although there are weaknesses with Practice Note 7, the document was modelled on *inter alia* the international standards on the movement of surplus income designed by the OECD. For South Africa, these international standards "are acknowledged as an important, influential document that reflects unanimous agreement amongst the member countries, reached after an extensive process of consultation with industry and tax practitioners in many industries"[229] and therefore international best practice.[230] Furthermore, the provisions

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[226] EYGM Limited 2019. EY Worldwide Transfer Pricing Reference Guide South Africa.2018-19 Tax Authority and Relevant transfer pricing regulation or rulings. see: https://www.ey.com/Publication/vwLUAssets/ey-worldwide-transfer-pricing-reference-guide-2018-19/$FILE/ey-worldwide-transfer-pricing-reference-guide-2018-19.pdf

[227] EYGM Limited 2019. EY Worldwide Transfer Pricing Reference Guide South Africa.2018-19 Tax Authority and Relevant transfer pricing regulation or rulings. see: https://www.ey.com/Publication/vwLUAssets/ey-worldwide-transfer-pricing-reference-guide-2018-19/$FILE/ey-worldwide-transfer-pricing-reference-guide-2018-19.pdf

[228] Supra note 220

[229] Supra note 121 p. 6 paragraph 3.2.1

[230] Supra note 220

of section 233 of the Constitution of the Republic of South Africa states that, "when interpreting any legislation, every court must prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law"[231], therefore the OECD developments are key to South Africa's domestic tax law.

Pricing transactions is a critical managerial, accounting and tax-reporting tool in connected firms. This is because pricing between related parties inform how income generated by an international corporation is distributed within the said corporation.[232]As a result, pricing transactions are of commercial significance globally, such that a sound understanding of global business models and global standards is of paramount importance.

Concerning the BEPS Action Plan, since 2014, South Africa is a mere OECD participant[233] and it has membership in the OECD BEPS Committee. Notwithstanding that the OECD international standards on shifting of profits and mitigating erosion of tax bases have not been introduced into Parliament and signed into law by the President of South Africa, the courts have applied the standards.[234] Oguttu AW makes reference to the ITC 1503 case which held that the interpretation of a treaty should be in accordance with the common law rules for interpreting statutes and the OECD Commentary.[235] Accordingly, as suggested by the Davis Tax Committee (DTC), it is paramount that South Africa co-operates with the international players to develop a comprehensive strategy to thoroughly address BEPS. [236]

Although the DTC's recommendations are in favour of South Africa accepting the developments of the new rules in international tax, it is highly unlikely that there will be a

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[231] Oguttu AW 2009 Resolving the conflict between 'controlled foreign company' legislation and tax treaties: a South African perspective. The Comparative and International Law Journal of Southern Africa, Vol. 42, No. 1 (March 2009) p.111 see: https://0-www-jstor-org.innopac.wits.ac.za/stable/pdf/23253214.pdf?refreqid=excelsior%3A4c347b467a8bba825cf13e12ddf8c451

[232] Supra note 161

[233] Davis Tax Committee. 2014 Addressing Base Erosion and Profit Shifting in South Africa. Davis Tax Committee Interim Report page 18

[234] Supra note 214 p.112

[235] Supra note 214 p.112

[236] Davis Tax Committee: Second Interim Report on Base Erosion and Profit Shifting(BEPS) in South Africa: Introduction p25 see: https://www.taxcom.org.za/docs/New_Folder3/2%20BEPS%20Final%20Report%20-%20Introductory%20Report.pdf

witnessing in the short-term of South Africa depositing its ratification to the MLI. This is because, as pointed out by the DTC, South Africa's comprehensive economic strategy and policy is very unique. The South African economic landscape is still in a developmental stage and as such, the country has a commitment with its citizenry to further economic growth. Therefore, the country's policies should be such that they attract investment from international counterparts who are already developed. In particular, the National Development Plan (NDP) provides that one of the prescriptions of this policy of attracting foreign investments is that it should advance the Constitutional objectives, particularly those of redressing the injustices of the past.[237] The DTC therefore recommends that, rules relied upon to mitigate profit shifting and to uphold the sovereignty of the country's tax regime should ensure consistency with South Africa's Constitution and the government's economic objectives.[238]

To sum up, South Africa was an active participant in the development of the MLI through its attendance of various forums when the MLI was crafted. South Africa's Finance Minister in 2015 was among those that endorsed the committee to oversee the codification of a Multilateral Instrument (MLI) on tax agreements to mitigate profit shifting and its undesired consequences.

Although there has been significant effort by South Africa to align itself to international developments on how to tackle BEPS, it is not an easy task to get a consolidated guide from SARS on how the rules of international law and the MLI will be uniformly applied within the South African borders given that administrative capacity can be a major challenge.

[237] Supra note 219 p.26 paragraph 2.3
[238] Supra note 219 p.26 paragraph 2.3

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