**University of the Witwatersrand**

# AN EXAMINATION OF BASE EROSION AND PROFIT SHIFTING EXPOSURE FOR SOUTH AFRICA

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A research report submitted to the Faculty of Commerce, Law and Management, University of the Witwatersrand, Johannesburg, in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation)

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## ABSTRACT

Base erosion and profit shifting (BEPS) is a key concern in international tax. In 2010 the Organization for Economic Co-operation and Development (OECD) was tasked with the study of BEPS. In 2013 the OECD released the study report "Addressing base erosion and profit shifting" emphasising BEPS and the risk for the world's economies and tax bases.

The OECD has been focused on BEPS due to several reasons, namely; increase in globalisation, an ever-changing digital economic environment, mismatches of different countries' tax legislation and the ease with which intellectual property can be transferred. They has released several documents detailing the risk of BEPS as well as an action plan outlining their aim for the transformation of local and international tax.

According to the OECD corporate income taxes, as a percentage of gross domestic product (GDP) is a possible indication of base erosion. In South Africa, the corporate income tax rate as a percentage of GDP has decreased from 7.2 % in 2008[1] to 5% in 2013[2]. Is this a possible indication of base erosion or profit shifting taking place?

Protecting South Africa's tax base is paramount for future growth of the country and the economy. It is therefore important to identify whether BEPS is a real risk and to determine whether South Africa has adequate legislation in place to protect its tax base.

Keywords: Base erosion and profit shifting, BEPS, Organisation for Economic Co-operation and Development, OECD, international tax, transfer pricing, thin capitalisation, treaty abuse, treaty shopping

[1] National Treasury (2008), *2008 Tax Statistics: A joint publication between National Treasury and the South African Revenue Service*

[2] National Treasury (2013), *2013 Tax Statistics: A joint publication between National Treasury and the South African Revenue Service*

# DECLARATION

I declare that this research report is my own unaided work. It is submitted in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation) at the University of Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination at any other university.

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Vanessa Bob

31$^{st}$ December 2014

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## List of Acronyms

| | | |
|---|---|---|
| BEPS | - | Base erosion and profit shifting |
| CSOs | - | Civil Society Organisations |
| DTAs | - | Double Tax Agreements |
| ECJ | - | European Court of Justice |
| FBE | - | Foreign Business Establishment |
| GVC | - | Global Value Chain |
| ICT | - | Information and communication technology |
| IFRS | - | International Financial Reporting Standards |
| IHC | - | Intermediate Holding Company |
| IP | - | Intellectual Property |
| ITA | - | Income Tax Act |
| IWT | - | Interest Withholding Tax |
| OECD | - | Economic Co-operation and Development |
| MNEs | - | Multi-national enterprises |
| NGOs | - | Non Government Organisations |
| PE | - | Permanent Establishment |
| PN | - | Practice Note |
| POEM | - | Place of Effective Management |
| ROE | - | Return on Equity |
| TAA | - | Tax Administration Act of 2011 |
| TLAB | - | Taxation Laws Amendment Bill |
| WACC | - | Weighted Average Cost of Capital |

# 1 Introduction

## 1.1 Background and motivation

There is a global perception that high profile multinationals are engaging in tax avoidance techniques. With growing attention from the media and the debate over BEPS having reached the highest levels of governments, the OECD has taken up the matter of BEPS.

The OECD launched the BEPS project that is intended to address the use of certain abusive tax planning strategies (legal and illegal) by multinational enterprises (MNEs). It is perceived that these are designed to exploit shortcoming in tax systems and result in double non-taxation of profits (stateless or nowhere income) or otherwise artificially shift profits to locations where little or no related economic activity occurs. Therefore the overall aim of the project is to develop a series of technical measures within a multilateral context that governments could later adopt and implement to combat various BEPS strategies.

The OECD, in effect, launched the BEPS project with the release of the study, 'Addressing Base Erosion and Profit Shifting', in February 2013, which was commissioned by the G20 countries. This was followed by the Declaration on Base Erosion and Profit Shifting, adopted by the OECD Ministerial Council on May 29, 2013. The Declaration officially called for the development of a comprehensive Action Plan to address all facets of BEPS and vested the Committee on Fiscal Affairs with leading the project. The Action Plan on Base Erosion and Profit Shifting was issued in July 2013, and later fully endorsed by the G20 countries in September 2013 and, thereby, officially launched the project. For the first time in OECD tax matters, this project is being developed with the full cooperation of the Non-OECD G20 countries, as well as with regional consultations in order to incorporate the perspectives of developing countries. Likewise, input is also being sought from other stakeholders, including business, trade unions, non Government Organisations (NGOs) and academia.

The Action Plan identifies 15 specific actions that are needed to accomplish the aims of the BEPS project. These actions are to be completed with deliverables submitted over three phases; September 2014, September 2015 and December 2015.

## 1.2 The Research Problem

### 1.2.1 Statement of the Problem:

This research will evaluate the risk of base erosion and profit shifting to the South African economy in light of the documents and Action Plans issued by the OECD.

### 1.2.2 The Sub-problems:

A number of sub-problems will assist in attempting to answer the main research problem.

- The first sub problem is to understand what the key causes of BEPS are. For example, a fundamental concern is that international tax standards, both in terms of domestic law and bilateral arrangements, have not kept pace with developments in the global economy. This will entail an analysis of whether it is a country specific risk or an issue that will be addressed at international tax level.

- The second sub-problem is to determine whether South Africa as a developing African country is at risk for BEPS.

- The third sub-problem is to evaluate whether South Africa is adequately protected against base erosion and profit shifting given the tax legislation that is currently in place.

## 1.3 Research Methodology

A qualitative approach was used in this research based on an examination of the literature on the subject. The primary information has been obtained from the extensive work done by the OECD on BEPS as well as documents issued by National Treasury, other sources of information includes legislation, international case law, articles, journals and electronic resources. Various Internet sites were consulted in order to obtain current information on the topic.

## 1.4 Scope and limitations

The purpose of the research report is to determine South Africa's exposure to BEPS based on the work performed by the OECD. There will be a high level discussion on the background of BEPS and how it affects South African Income Tax. The research report will specifically focus on CFC regimes, finance payments, transfer pricing (TP) and treaty abuse and how they are dealt with in income tax legislation in South Africa.

Any tax other than income tax is out of the scope of this research. Even though there might be international tax avoidance by high net worth individuals, structures using trusts or domestics

avoidance techniques are not addressed by the OECD's work on BEPS and will not be addressed by this research.

## 1.5 Organisation of report

### 1.5.1 Chapter 1: Introduction

The introductory chapter will introduce the background and significance of the research, the problem and sub-problems identified and the research methods used.

### 1.5.2 Chapter 2: Understanding BEPS

In this chapter background is given on BEPS which is based on the work that the OECD has done. An evaluation was done relating to what gives rise to BEPS and where the main risk areas are as well as highlighting the Action Plan proposed by the OECD.

The important thing to note is that there are numerous causes of BEPS, and these can be difficult to identify, as revenue authorities require information from multiple jurisdictions which may not be readily available. Even when information can be shared, the detail required to analyse a multinational's arrangements is seldom provided unless specifically requested, and not enough may be known to support such a request to a particular jurisdiction. The proliferation of different information disclosure standards and formats has made it difficult to compare data sets between countries even when the information has been exchanged.

### 1.5.3 Chapter 3: The risk to the South African economy

On the South African income tax front there have already been many legislative changes made to deal with BEPS specifically. The following sections of the report will be focused on understanding the current South African legislation that is in place. It will then evaluate this legislation in light of the work performed by the OECD.
The specific legislation that will be discussed relates to:

- Controlled Foreign Company (CFC) regimes
- Financial payments
- Transfer Pricing
- Treaty abuse

#### *1.5.3.1 Controlled Foreign Company (CFC) regimes*

In some cases, BEPS reflects gaps and inadequacies in the design of domestic laws. Countries' domestic rules for taxing multinationals on their worldwide profits, being CFC rules, may be inadequate. Although OECD Member States generally apply CFC regimes, the OECD has done little work on this area in the past.

There are CFC regimes in all G20 member states, with the exception of four developing countries, two of which have announced an intention to adopt a CFC regime. The taxation of foreign income, derived directly or via a foreign subsidiary, is a key aspect of the fiscal policy of national governments to encourage economic growth, competitiveness and foreign investment. The difference in fiscal policy is one of the main reasons why CFC rules vary significantly between jurisdictions. It is unlikely that the OECD will achieve a common position on CFC rules when sovereign nations have chosen such different ways to encourage economic activity. Some narrowing of practices on CFC rules could be expected.

For example, while it is common for unrelated party passive income relating to third party investments, etc. to be subject to inclusion in amounts attributable back to the home territory, certain countries like the United Kingdom, United States and Canada have an exemption for related party passive income.

From a South African perspective, section 9D of the Income Tax Act (ITA) has recently been overhauled to simplify the core calculations associated with the tainted income determination. The rules relating to passive income have been split into separate categories setting out different tax treatment for the various categories and the exemption regulations have been amended. In addition, the CFC rules have been adjusted to treat different cells (any entity incorporated, established or formed in terms of any law of any country other than South Africa) of an offshore company as a separate CFC for tax purposes.

This section will examine whether CFC rules need to be reinforced to prevent abnormal tax deductions of expenses paid by group companies in high to other group companies in low tax jurisdictions. This is necessary to assess whether the current CFC and anti-deferral rules counter BEPS in a comprehensive manner.

#### *1.5.3.2 Financial payments*

In action 4 of the BEPS Action Plan, the OECD seeks to target a broad range of what it describes as ‘excessive’ interest and other financial payments.

It makes commercial sense for companies to finance their operations with either equity or debt, as long as the arrangements are in line with TP principles on the level of debt and the rate of interest payable. It is a basic tenet of the arm’s length principle, which the Action Plan endorses, that the tax treatment within a country should essentially be the same whether payments are made to a foreign group entity or to a third party.

A natural extension of this, as well as a consequence of market dynamics, is that the non-taxation of the income received by a recipient — whether or not a foreign recipient — should not impact upon deductibility to the payer provided the relevant TP tests are met. The OECD, however, wishes to link rules on the tax deductibility of interest with a consideration of whether the recipient is taxed on that interest.

Overall, the tax authorities globally are probably closer to an agreed list of approved anti-base erosion measures that will apply consistently to multinational companies and others

for financial payments than has hitherto been the case even without the additional impetus given by the Action Plan.

This section will focus on what measures have been implemented by National Treasury to address these concerns. For example, excessive interest payments between related companies are another issue of concern as it could result in substantial base erosion. TP guidance has been developed regarding the pricing of related party financial transactions, including guarantees, derivatives, and captive and other insurance agreements.

#### *1.5.3.3 Transfer pricing*

Approximately 60% of world trade takes place through MNEs.[3] How profit is allocated between different parts of the multinational enterprise is called TP. Therefore the majority of the profits could be allocated to low tax jurisdictions and a mismatch arises between where the actual economic activity takes place and the profits are taxed. The major challenges for developing countries according to the OECD is the lack of necessary legislative measures, lack of comparable information and lack of skills to identify complex TP risks.

In some instances, certain TP practices (i.e. "mispricing") result in BEPS. These practices are particularly prevalent in relation to multinational profits generated by brands, intellectual property or digital services that are highly mobile and can be located anywhere in the world, but can also exist in relation to the pricing of extractive resource-related contracts, for example.

This paper will focus on the changes that National Treasury has made to the TP legislation that is currently in place, as well as further changes that they are looking at making. SARS is specifically looking at country by country reporting (i.e. a "big picture" view of a MNE's GVCs that is not always available to tax authorities). SARS is already using the OECD's draft handbook on TP risk assessment and TP of intangible assets and other high-risk transactions.

#### *1.5.3.4 Treaty abuse*

To date, bilateral tax treaties which follow either the UN or OECD models have been focused on removing double taxation between the two countries who signed the treaty and prevent tax evasion and avoidance. Treaty abuses, including the practice of residents of third countries effectively gaining access to treaty benefits intended only for residents in the signatory states (i.e. "treaty shopping") also contributes to BEPS.

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[3] Love, P (2013), *BEPS: why you're taxed more than a multinational,* OECD Insights [Online] Available from http://oecdinsights.org/2013/02/13/beps-why-youre-taxed-more-than-a-multinational/ [Accessed 4 September 2014]

According to the OECD, it is inefficiencies in tax treaties that have triggered double non-taxation in a number of situations. [4] Further work is required on revamping flawed tax relations between jurisdictions with respect to tax treaties (also referred to as treaty-shopping), responsible for inconsistencies and particular enablers of double non-taxation.

This section will focus on how South Africa plans to develop recommendations for domestic law to counter the granting of treaty benefits in what the OECD refers to as 'inappropriate circumstances'.

### 1.5.4 Chapter 4: Conclusion

This chapter will conclude on the findings of the research drawing on the recommendations and Action Plans recommended by the OECD and suggest further areas for research.

For example, once agreement is reached on a specific solution to a BEPS issue the focus will shift to giving effect to the required changes. While amendments to the OECD Transfer Pricing Guidelines or Commentary on the OECD Model Tax Convention can be made with relative speed, amendments to the network of over 3,000 bilateral tax treaties[5] would require these treaties to be individually renegotiated. Not only would this be an extremely lengthy process requiring significant resources, but may prove problematic if there are existing tensions between countries who may not wish to enter into negotiations without a full reconsideration of the terms of the treaty.

This section will investigate the creation of a new multilateral instrument which would allow countries to adopt specific measures without having to individually renegotiate treaties.

# 2 Understanding BEPS

## 2.1 What is BEPS?

BEPS, in summary, is where multinational companies are artificially shifting their profits cross border to low tax jurisdictions in order to pay less taxation or by exploiting mismatches in legislation of different jurisdictions which leads to double non taxation. The result is that taxation is not being paid in the country where the main economic activity of the company takes place. In most cases this is legal and done within the parameters of the tax laws.

## 2.2 Why is BEPS taking place?

Since the global financial crisis countries have had less disposable income. Governments have as a result been under pressure to reduce costs and raise revenue. One of the ways this can be achieved is through increased tax collections. Governments have to consider the impact of increased taxation on taxpayers as there are many factors that need to be taken into account

[4] OECD (2013d), *Addressing Base Erosion and Profit Shifting,* OECD Publishing
[5] OECD (2013d), *Addressing Base Erosion and Profit Shifting,* OECD Publishing

such as inflationary price increases, interest rates and other costs that impact the taxpayer. There also needs to be a balance between tax collections and economic growth. Higher taxes leads to less disposable income and less spending by consumers and that could affect the GDP and growth of the economy. Large MNEs such as Apple, Google and Starbucks have been criticized by the media for seemingly paying little tax. These MNEs have been labeled as being immoral, as they are not contributing their part to society.

According to the OECD, BEPS is on the increase and multilateral action from different jurisdictions is needed in order to address this. The following key reasons have been identified for the existence of BEPS.

### 2.2.1 Business is now truly global and business cycles have become more complex

Globalisation has increased significantly in the last few years. This is mainly due to MNEs having Global Value Chains (GVCs)that are spread over multiple countries. The spread of MNEs over multiple countries has been encouraged by the ease of movement of capital and labour. MNEs now have the option to move their operations from high cost countries to low cost countries. There has been gradual removal of trade barriers which eases the way in which goods can be imported and exported. The internet has opened up a world of electronic transactions which could originate from anywhere in the world and operations do not have to be based where the customers are.

In recent years there has been a shift from country-specific operations to global operations with matrix management organizations and integrated supply chains. These MNE's have GVCs that span across developed as well as developing economies. This makes it increasingly difficult to determine where value is added and taxing rights should be allocated and in many cases developing countries are the most adversely affected. Please refer to chapter 2.5 on challenges for developing countries.

The domestic and international tax rules and legislation of most countries have not always managed to keep pace with this ever changing global environment. The BEPS project therefore needs to become a collaborative task between different jurisdictions in order for it to succeed. The difficulty with BEPS is that in most cases MNE's are not acting illegally, they are compliant with legal requirements of the countries that they operate in.

In South Africa in the past strict foreign exchange rules protected the tax base and prevented BEPS from taking place. In the last few years these foreign exchange rules have been relaxed in order to stimulate international investment and for South Africa to be internationally competitive. This has increased South Africa's exposure to BEPS.

### 2.2.2 Increase in competition due to globalization

Increased globalization has also lead to increased competitiveness and companies are no longer just competing in-country; they are competing on a global scale with MNE's. Businesses have to deliver the best products at the best prices, in order to do that costs have

to be minimized. Tax is a significant cost for most companies and therefore minimizing the tax paid becomes a focus area of MNE's.

Just as companies need to stay competitive, governments are also competing for foreign investment and therefore they have to make their country attractive for foreign investment. Governments attract foreign investment by providing favourable tax incentives for certain industries. By providing these tax incentives and essentially lowering the tax payable the OECD has labeled this the 'race to the bottom' and it is seen as a harmful tax practice.[6]

### 2.2.3 Technological advancements

In the past Intellectual Property (IP) and technological advancements could be linked to a specific jurisdiction. With globalization and the internet borders have disappeared and IP can now be moved between jurisdictions with relative ease. Where technology used to be expensive and only available to a select few it has now become available to the majority of people and businesses around the world. Figure 1 details the growth in access to the internet.[7] While fixed communication access paths have stayed fairly constant over time the total communication paths have increased significantly and this is due to technological advancements in devices giving more users access to the internet.

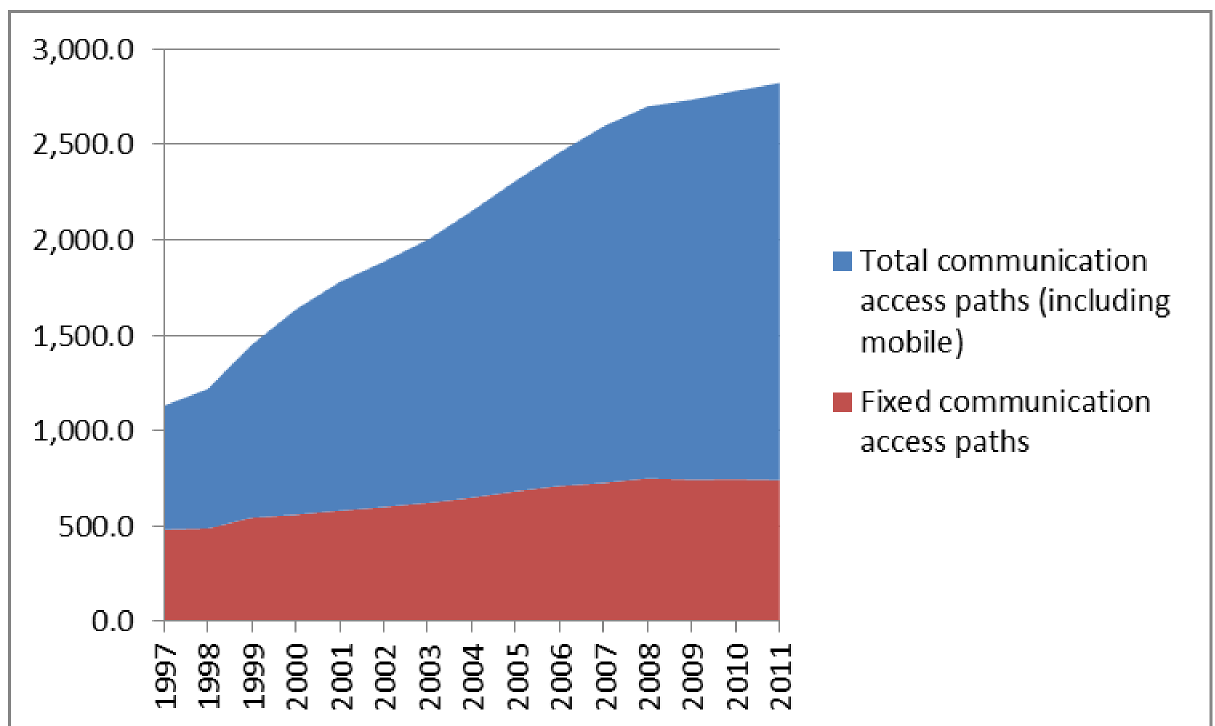


Figure 1 : Total Internet Access

The OECD describes the evolution of information and communication technology (ICT) as follows:

[6] OECD (2013d), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing

[7] OECD (2014f), *BEPS Action1: Address the tax challenges of the digital economy*, OECD Publishing

‘*The development of ICT has been characterised by rapid technological progress that has brought prices of ICT products down rapidly, ensuring that technology can be applied throughout the economy at low cost. In many cases, the drop in prices caused by advances in technology and the pressure for constant innovation have been bolstered by a constant cycle of commoditisation that has affected many of the key technologies that have led to the growth of the digital economy. As products become successful and reach a greater market, their features have a tendency to solidify, making it more difficult for original producers to change those features easily. When features become more stable, it becomes easier for products to be copied by competitors. This is stimulated further by the process of standardisation that is characteristic of the ICT sector, which makes components interoperable, making it more difficult for individual producers to distinguish their products from others. Unless the original producer can differentiate its product from the copies (for example, by bundling its product with services or other features that are not easily duplicated), or otherwise find a way to maintain a dominant position in the market, it will be forced to compete solely on price or move to other market segments*.’[8]

This has lead to vast competition in the ICT market and that has made the value chain so critical.

In addition to a highly competitive environment, the advancement of technology has caused a change in business models. Where retailers used to have physical stores they now have online stores which exposes them to global markets and reduces overhead costs. Examples of such retailers in South Africa are; ‘Kalahari.net’ and ‘Takealot.com’. With the introduction of these online retailers the consumer no longer has to physically go to a store. The consumers can now purchase goods from the comfort of their home and have the goods delivered to their door. These retailers will still have physical presence in the form of warehouses and dispatch/storage facilities which will create a taxable presence. Where products include downloadable data such as games, music, programs physical presence could be anywhere in the world. This digital platform gives businesses easy access to global markets and easy access to avoidance of tax in jurisdictions that they operate in and therefore BEPS.

The technological advances coupled with decrease in transportation cost, liberalization of trade policy and relaxation of foreign exchange controls has given multinational entities the opportunity to take advantage of GVCs by spreading certain functions to countries where it is advantageous.

A major change to the digital economy has been the introduction of E-Commerce. The OECD defines E-Commerce as follows:

‘*The sale or purchase of goods or services, conducted over computer networks by methods specifically designed for the purpose of receiving or placing of orders. The goods and services are ordered by those methods, but the payment and the ultimate delivery of the good service do not necessarily have to be conducted online. An e-commerce transaction can be between*

[8] OECD (2014f), *BEPS Action1: Address the tax challenges of the digital economy*, OECD Publishing

*enterprises, households, individuals, governments, and other public or private organisations.'*[9]

There are different forms of E-commerce as identified by the OECD. These include:

- 'business – to – business' models where a business sells products and services to another business,
- 'business-to-consumer' models where a business sells products and service to a consumer, and
- 'consumer to consumer' models where internet websites provide platforms for individuals to sell items rent property or provide services to other consumers.[10]

The digital advancements and E-Commerce as such are therefore creating opportunities for BEPS by not having a taxable presence in the country of source.

### 2.2.4 Non fixed valuable assets

This is an extension of technological advancements, with the developments in the digital economy many companies' most valuable assets are their IP that they have developed over time. There are effectively no borders in the digital economy and intellectual property could be saved on various servers all over the world. In MNEs this IP can therefore easily be moved from high tax jurisdictions to low tax jurisdictions and therefore creates the opportunity for BEPS to take place.

### 2.2.5 Performance pressure

Shareholders value is determined by way of earnings per share. A key element of earnings per share is tax. For example in South Africa, if you have an effective tax rate of 28% your earnings per share are decreased by 28%. Although tax doesn't affect all financial indicators it does affect ratios such as Return on Equity (ROE) or the Weighted Average Cost of Capital (WACC). There is therefore added pressure from a shareholders point of view to lower taxes and increase earnings per share.

Whether or not aggressive tax structures are put into place by MNE's will depend on their risk appetite and the period of time they are targeting. Aggressive tax structures may increase shareholders wealth significantly over the short term but could be detrimental over the medium to long term, due to countries clamping down on aggressive tax structures. Over the medium to long term this could be extremely costly and damage the reputation of the company should it be associated with tax avoidance/evasion strategies.[11]

### 2.2.6 Tax rules have not kept pace & loopholes and mismatches exist

[9] OECD(2011), *OECD Guide to Measuring the Information Society 2011,* OECD Publishing
[10] OECD (2014f), *BEPS Action1: Address the tax challenges of the digital economy*, OECD Publishing
[11] OECD (2013d), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing

As mentioned previously globalization and technological advancements local tax legislation and international tax agreements have not kept pace with developments. Due to imperfect and widely varying tax rules between different tax jurisdictions mismatches and loopholes occur which are then exploited by multinational enterprises. This has also created the opportunity for BEPS.

## 2.3 Significance and measurement of BEPS

The OECD has gathered information from various sources and identified possible indicators of BEPS. These indicators may indicate that BEPS has taken place but is not conclusive proof thereof.

The different indicators can be broken up into 3 main groups:

### 2.3.1 Corporate Income Tax revenues

The two main indicators in this group are corporate income tax as a percentage of GDP and total tax revenues. On average the OECD member countries raise corporate income tax revenue of 3% of GDP and 10% of total tax revenues.[12]

In general corporate income tax does not represent the majority of taxes collected which could indicate that losses as a result of BEPS may not be significant when looking at the total revenue collected. It could however be significant due to the value. According to the information gathered by the OECD there have been fluctuations in corporate tax revenues as a percentage of GDP over the last 50 years. Corporate revenues showed an increasing trend up to 2007, dropped slightly in 2007/2008 and increased again slightly up to 2011. Refer to Figure 2 below. The study performed is based on OECD member countries' statistics and does not necessarily represent developing countries.

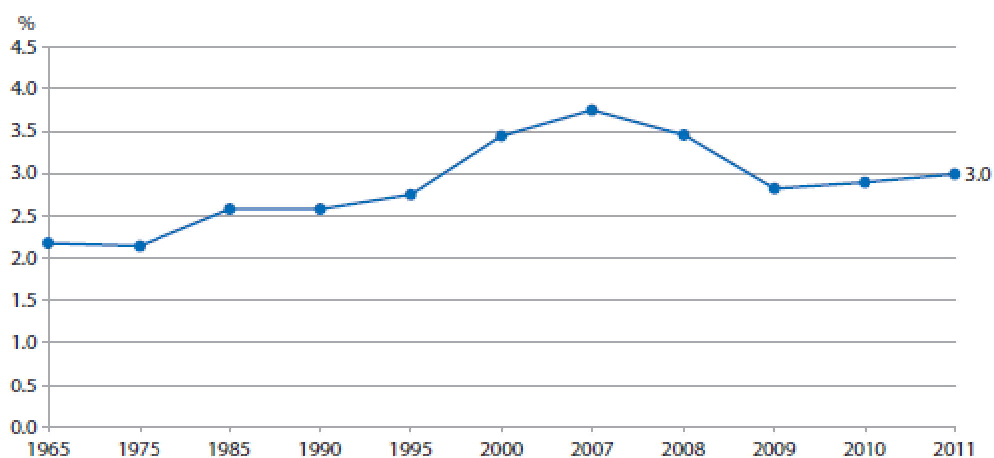


**Figure 2: Taxes on corporate income as a percentage of GDP (OECD unweighted average)**

[12] OECD (2013c). *Addressing Base Erosion and Profit Shifting,* OECD Publishing

In South Africa the corporate income tax rate as a percentage of GDP has decreased from 7.2 % in 2008[13] to 5% in 2013[14]. This could be indicative of BEPS taking place however it is not conclusive evidence thereof.

As many different factors impact on corporate tax revenue collections the formula above could be an indication of BEPS but it does not confirm the existence of BEPS.

### 2.3.2 Foreign Direct Investment

The data collected by the OECD and the International Monetary Fund (IMF) on foreign direct investment shows very interesting statistics. The highlights of these findings are as follows:

'*In 2010 Barbados, Bermuda and the British Virgin Islands received more foreign direct investment (5.11% of global foreign investment) than Germany (4.77%) or Japan (3.76%). During the same year, these three jurisdictions made more investments into the world (combined 4.54%) than Germany (4.28%). On a country-by-country position, in 2010 the British Virgin Islands were the second largest investor into China (14%) after Hong Kong (45%) and before the United States (4%)*' [15]

'*Mauritius is the top investor country into India (24%), while Cyprus (28%), the British Virgin Islands (12%), Bermuda (7%) and the Bahamas (6%) are among the top five investors into Russia.*'[16]

Companies may use these low tax jurisdictions in order to get a tax benefit however this may not be the only reason for investing through these countries. For example Mauritius has no exchange controls currently in place.

### 2.3.3 Effective tax rates

As MNEs operate in multiple countries they have the opportunity to lower their effective tax rate by having operations in low tax jurisdictions. The effective tax rate of MNEs may be significantly lower than a company that only operates in a high tax jurisdiction. A low effective tax rate could therefore indicate that BEPS is taking place.

As with the other financial indicators, the effective tax rate is made up of multiple components. These components may lower the effective tax rate but does not mean that there is a risk of BEPS. For example, additional tax allowances or incentives may lower the effective tax rate.

[13] National Treasury (2008), *2008 Tax Statistics: A joint publication between National Treasury and the South African Revenue Service*
[14] National Treasury (2013), *2013 Tax Statistics: A joint publication between National Treasury and the South African Revenue Service*
[15] OECD (2013c). *Addressing Base Erosion and Profit Shifting,* OECD Publishing
[16] OECD (2013c). *Addressing Base Erosion and Profit Shifting,* OECD Publishing

The information gathered by the OECD does indicate that there is an increased segregation between where actual economic activity is taking place and where profits are being reported and taxes paid.

Consistent measurement of effective tax rates could provide valuable information as to whether BEPS is taking place. Available studies on effective tax rates of MNEs are useful however all the studies are different and use different methodologies. The use of different methodologies to calculate effective tax rate and shortcomings in the data can result in different conclusions as to whether BEPS is taking place.

Measuring the risk of the existence of BEPS is a complex exercise. The indicators of BEPS mentioned above all have many variables that influence the data and cannot conclusively indicate that BEPS has taken place

## 2.4 How is BEPS taking place?

**(How is BEPS taking place and what measures are included in the OECD's Action Plan to curb the existence thereof?)**

The causes of BEPS can be difficult to identify as revenue authorities require information from multiple jurisdictions, which may not be readily available. Even when information can be shared, the detail required to analyse a multinational's arrangements is seldom provided unless specifically requested, and not enough may be known to support such a request to a particular jurisdiction. The proliferation of different information disclosure standards and formats had also at times made it difficult to compare data sets between countries even when the information has been exchanged.

There are certain high risk areas when it comes to BEPS. The following high risk areas have been identified. This chapter will link these high risk areas with the specific recommendations made by the OECD BEPS Action Plan.

### 2.4.1 Opportunities for BEPS in the digital economy

The risks associated with the digital economy are not one dimensional and therefore many of the actions identified by the OECD will indirectly address the digital economy. Thus Action 1 together with the other actions will aim to curb the existence of BEPS in the digital economy. The OECD has appointed a dedicated task force to assess the digital economy on an ongoing basis.

The main purpose of Action 1 is as follows:

'*Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. Issues to be examined include, but are not limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus*

*under current international rules, the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services, the characterisation of income derived from new business models, the application of related source rules, and how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector*'[17]

The main risks associated with the digital economy as identified by the OECD are as follows:

1) '*Elimination or reducing tax in the market country:*
   a) *MNE's avoiding a taxable presence*
   b) *Minimising the income allocable to functions, assets and risks in market jurisdictions*
   c) *Maximising deductions in market jurisdictions*
2) *Avoiding withholding tax*
3) *Eliminating or reducing tax in the intermediate country*
4) *Elimination or reducing tax in the country of residence of the ultimate parent.*'[18]

The above points will be briefly discussed in order to determine how the digital economy poses a risk to BEPS and which Action points will address these risks:

#### 2.4.1.1 Eliminating or reducing tax in market country

***MNEs avoiding taxable presence***

In most cases treaties follow a resident approach to taxation, by allocating taxing rights to non-resident jurisdictions on the basis that there is a (Permanent Establishment) PE in that country. This international framework and principles have been in place for decades and have mostly been effective. With the development of the digital economy and the internet, companies are trading in various jurisdictions through independent agents without having a taxable presence (PE). This therefore directly impacts the PE principle in tax treaties.

There are some concerns raised in light of the work performed by the OECD and the possible impact thereof on the PE principles of tax treaties;

'*It is possible that recommendations could deem PEs in the places where customers access a website. Deeming the digital presence to constitute a permanent establishment (PE) would represent a significant departure from existing treaty rules that generally find a PE only if the non-resident corporation has either a fixed place of business or an agent that has authority to and habitually concludes contracts on its behalf*.'[19]

[17] OECD (2013d), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing
[18] OECD (2014g). *Addressing the Tax Challenges of the Digital Economy,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing
[19] Carr, J., Hoerner, J., Sorokina, V., Wu, S. Y. (2014). *BEPS Action Plan: A Case Study of the potential implications for a U.S.-Based Multinational*. Tax Notes International, Volume 73, Number 11,p1035

There is an argument to question; if there is no physical presence, is there any value creation in that country?

Another valid argument is if this is even a BEPS issue? This seems to be a domestic tax issue which should likely be addressed in domestic legislation. The OECD addresses this by stating that MNE's may artificially fragment their operations among multiple group companies to avoid PE status, thereby artificially avoiding tax in that country.

Avoiding PE status is made easier by the digital economy but it is not restricted to the digital economy. Please see the later section on "Avoiding permanent establishment (PE) status" for more detail on this.

***Minimizing the income allocable to functions, assets and risks in market jurisdictions***

In the case where an MNE has a PE in a jurisdiction it can avoid paying tax by structuring the operations in such a way that very little profit is made by the PE. This can be done by contractually allocating risks which is not in line with actual functions performed. This risk therefore links in with TP rules on the one side and MNE's being able to structure their business functions and activities in a tax efficient manner on the other.

***Maximizing deductions in market jurisdictions***

When a MNE has a taxable presence in a country another common way to lower the taxable income is to increase the deductions. This can be done with inter group charges such as interest, services fees or royalties. In the digital economy this can be done by moving intellectual property to a low tax jurisdiction and then charging royalties or license fees to a high tax jurisdiction. This can also be done using hybrid instruments where a company claims a deduction in one jurisdiction but the income is not taxed in the other. This risk therefore links in with TP and hybrid mismatch arrangements.

#### 2.4.1.2 Avoiding withholding tax

By paying royalties, interest and service fees to countries that have treaties with the market country, withholding taxes can be reduced to nil. This could lead to treaty shopping which will be discussed in detail later in this research.

#### 2.4.1.3 Reducing tax in the intermediate company

According to the OECD this can be achieved by low tax/preferential regimes, the use of Hybrid mismatch arrangements or through excessive deductions as previously discussed.

#### 2.4.1.4 Reducing tax in the holding company

The same techniques to avoid tax in the market country and the intermediate company are applicable to the avoidance of tax in the holding company.

In jurisdictions that don't have CFC legislation income can be deferred by keeping income in a subsidiary in a low tax jurisdiction. There are still many countries that do not have CFC legislation which would make them vulnerable to such a structure.

The OECD aims to address the above mentioned risks in the digital economy by addressing the digital economy in Action 1 as well as in the other BEPS action points. The actions that will affect the digital economy are:

- Action 3 - the strengthening of CFC Rules will aim to protect the tax base of the ultimate holding company,
- Action 6 - preventing treaty abuse,
- Action 7 - prevent the artificial avoidance of PE status,
- Action 2 - addresses hybrid mismatch arrangements
- Actions 4 and 9 limit base erosion via interest deductions and other financial payments
- Action 5 - aims to counter harmful tax practices more effectively, and
- Actions 8-10 which addressed TP will be used to address BEPS in the digital economy.

From the above it is clear that the digital economy spans the majority of the actions as raised by the BEPS Action Plan. It will be imperative to understand how the OECD aims to address specific digital economic risks in their work going forward.

### 2.4.2 International mismatches in entity and instrument characterisation

In order for a jurisdiction to tax a person there must be a connection between the person and the country or between the activities performed by that person and that country. These connections result in either a 'residence jurisdiction' or a 'source jurisdiction'. With the 'residence jurisdiction' there is a direct link between the country and the person whereas with the 'source jurisdiction' there is a direct link between the activities of the person which give rise to income and the country. 'Residence' allows jurisdictions to tax entities and individuals on their world-wide income and 'source' allows jurisdictions to tax individuals and entities on all income sourced within that jurisdiction.

Neither of these jurisdiction's rules are uniform and therefore there are overlaps where 'double taxation' occurs but there are also areas where neither jurisdiction tax transactions which is called 'double non-taxation'.

The double tax treaties are designed to resolve situations where double taxation arises. Double tax treaties govern certain income streams where there is a conflict between two jurisdictions. It determines which jurisdiction has taxing rights over the following income streams; business profits, immovable property, dividends, interest, royalties and technical fees.

Where there is a mismatch this is often referred to as hybrid mismatch arrangements. According to the OECD[20], the following elements are present in hybrid mismatch arrangements:

- Hybrid entities: Low tax for finance companies can be achieved in high tax jurisdictions by using hybrid entities. These are entities that are transparent in one jurisdiction but a legal person in another. The effect is that a deduction can be claimed in one country, but the income is not taxed in the other country due to the entity being treated as transparent.
- Dual resident entities: This relates to entities that are resident in two different jurisdictions for tax purposes. This leads to double taxation in most cases however this could be resolved by application of the double tax agreement (DTA) should there be one in place.
- Hybrid instruments: The difference between debt and equity gives rise to a difference in tax treatment. While interest in debt is a deductible expense dividends paid to shareholders is not. Therefore companies are opting for debt financing as opposed to equity financing. This could lead to hybrid mismatches where an interest deduction may be obtained in one jurisdiction but the income is not taxable in the other.
- Hybrid transfers: A transaction that is treated as a change of ownership of an asset in one country but not in another.[21]

From the above types of mismatch arrangements it is possible to achieve a double deduction where a deduction is claimed for the same contractual costs in different countries. Another effect is that there is a deduction in one country and no taxation in the other. Foreign tax credits could also be created that would otherwise not be available.

When looking at the hybrid mismatch arrangements one can see that these occur where there is different tax treatment in different countries which can easily be exploited by MNEs. In order to stop these mismatch arrangements, countries need to work collaboratively and align treatments of certain transactions, instruments and entities.

Action 2 deals with neutralising the effects of hybrid mismatch arrangements which include developing model treaty provisions to standardise the treatment of hybrid instruments and hybrid entities.

### 2.4.3 Effectiveness of anti avoidance measures

These are measures which limit the benefits of certain transactions under certain circumstances to attempt to stop abusive tax behavior. According to the OECD there are two types of strategies. 'Deterrence strategies' which include issuing public rulings, applying

[20] OECD (2012). *Hybrid mismatch arrangements*, OECD Publishing
[21] OECD (2012). *Hybrid mismatch arrangements*, OECD Publishing

penalties and imposing additional reporting obligations and 'detection strategies' to ensure availability of information in order to identify aggressive and abusive tax strategies.[22]

The anti avoidance rules currently in place are general anti-avoidance rules which place limitations on the use of the tax benefits where transactions lack business purpose. CFC rules aim at taxing certain tainted income derived by controlled foreign subsidiaries even if those monies are not repatriated. Thin capitalization (TP rules) rules aim to curb excessive debt and interest deductions; this is usually dictated by an acceptable debt-to-equity ratio. Anti-hybrid rules which aims to eliminate difference in treatment of certain transactions in different countries. Anti-base erosion rules which increase withholding taxes on certain transactions and deny the deductibility of certain costs.

Anti avoidance measures differ significantly between different countries and are linked to the level of sophistication of the tax system, legal traditions and the courts' interpretation of tax law. An example of anti avoidance measures being abused is for example MNE's structuring their group in order to avoid the CFC regime.

In legislation there is always an element of anti avoidance therefore anti avoidance will be covered by more than one of the BEPS Action Plan items.

#### 2.4.4 Related party debt-financing, captive insurance and other inter-group financial transactions

A typical way of BEPS taking place by way of debt financing is by setting up a finance operation in a low tax jurisdiction which lends money to a high tax jurisdiction. The interest received is then taxed at a lower rate while the interest is deducted where the operations are located. This can be closely linked to hybrid mismatch arrangements.

Action 4 of the OECD BEPS Action Plan deals with limiting base erosion via interest deductions and other financial payments, this action can be combined with the Action Plan on TP, action 9.

#### 2.4.5 Harmful tax regimes and tax havens

The OECD defines tax havens as follows:

'*Many fiscally sovereign territories and countries use tax and non-tax incentives to attract activities in the financial and other services sectors. These territories and countries offer the foreign investor an environment with a no or only nominal taxation which is usually coupled with a reduction in regulatory or administrative constraints. The activity is usually not subject to information exchange because, for example, of strict bank secrecy provisions. These jurisdictions are generally known as tax havens.*'[23]

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[22]OECD (2013c), *Addressing Base Erosion and Profit Shifting,* OECD Publishing

[23] OECD (1998), *Harmful tax completion; an emerging global issue,* OECD publishing

According to the OECD tax havens are used for 3 main purposes. Tax havens are used to hold passive income, to book profits and they give protection to persons from the scrutiny of other tax authorities. All these cause harm to other tax authorities.

The OECD defines harmful tax regimes as follows:

'*These regimes generally provide a favourable location for holding passive investments or for booking paper profits. In many cases, the regime may have been designed specifically to act as a conduit for routing capital flows across borders. These regimes may be found in the general tax code or in administrative practices, or they may have been established by special tax and non-tax legislation outside the framework of the general tax system*.'[24]

The main factors present in tax havens and harmful tax regimes are, no/nominal tax rates for companies and individuals, laws to protect the exchange of information with other governments, lack of transparency, absence of substance of activity and ring fencing of regimes.[25]

The OECD has identified four key factors in order to determine whether a preferential tax regime is potentially harmful, as follows:

1) no or low effective tax rate;
2) ring-fencing of the regime;
3) lack of transparency; and
4) lack of effective exchange of information.

For example a low-taxed branch of a foreign company is where a low tax country can be used to lower the tax payable in a company. Services, loans or licences can be provided through a foreign branch. A head office-company can be set up in a high-tax country that has an exemption (under local legislation or tax treaties) for foreign branches. The foreign branch can then be set up in a country with low tax or which doesn't regard a branch to have a taxable presence.

Both tax havens and harmful tax regimes are used by MNE's to shift profits from high tax countries to low tax countries. Action 5 of the BEPS Action Plan focuses on countering harmful tax practices more effectively taking into account transparency and substance.

### 2.4.6 Treaty related abuse

In many cases MNEs structure their operations and GVCs in order to get the maximum benefit from the treaties between different countries, this is also known as 'treaty shopping'.

Action 6 of the BEPS Action Plan aims to prevent this from happening by developing model treaty provisions rules to prevent the granting of treaty benefits in inappropriate circumstances.

[24] OECD (1998), *Harmful tax completion; an emerging global issue,* OECD publishing
[25] OECD (1998), *Harmful tax completion; an emerging global issue,* OECD publishing

### 2.4.7 Avoiding PE status

In the DTAs, in general, the country of residence would have taxing rights unless that company has a PE in the other country. Article 5 of the OECD model tax convention gives guidelines as to when a PE is created. These guidelines are sometimes technical and are circumvented by companies by breaking up contracts or splitting work amongst different entities in the same group of companies, thereby artificially avoiding being PE status.

Action 7 of the BEPS Action Plan focuses on changing the definition of a PE to prevent the artificial avoidance of PE status in relation to BEPS.

### 2.4.8 Transfer Pricing

TP is basically the allocation of profits to different jurisdictions based on arm's length principles. The arm's length principle implies that related parties should transact with each other at prices that they can trade with external independent parties in a competitive environment. This concept is sound however the practical application is cumbersome especially in an environment where information is not available.

TP also means that value of goods should be in the countries where the value adding functions are situated. It is therefore easy for MNE's to shift the functions to countries where there is low tax. Although some tangible functions may be difficult to move, intangible functions may be easier to move.

The OECD's Action Plan for TP (Actions 8, 9, 10 & 13) is to assure that TP outcomes are in line with value creation. Action 8 of the Action Plan specifically deals with intangibles; the goal with this action is to prevent BEPS by developing rules on moving intangibles between companies in the same group. Action 9 of the Action Plan is to prevent BEPS by developing rules on moving capital between group members. This is done to ensure that inappropriate returns are not accrued to groups due to contractual risks, thus aligning returns with value created. This will also link in with the work on financial payments and interest deductions. Action 10 relates to other high risk transactions which would not occur between external unrelated parties. Action 13 relates to the development of rules surrounding TP documentation thereby increasing transparency and gives countries the information to evaluate the transactions in the group.

### 2.4.9 Other focus areas of the Action Plan

The rest of the Action Plans are focused on:

- Action 11 - collecting and analyzing data about BEPS and developing actions to address it;
- Action 12 - requires taxpayers to disclose their aggressive tax planning arrangements;
- Action 14 - make dispute resolutions more effective; and

- Action 15 - developing a multilateral instrument to enable jurisdictions that wish to do so to implement BEPS measures and amend existing bilateral treaties.

The BEPS Action Plan together with the expected timeframes and status of these timeframes can be found in Annexure A.

## 2.5 What are the challenges facing developing countries including South Africa?

The OECD did some additional work on the challenges facing developing countries, this directly influences South Africa.

In addition to the normal BEPS challenges mentioned above, developing countries face additional challenges. Developing countries are reliant on the income and investment by MNE's for job creation and other reasons; they are therefore under pressure to provide a favourable tax environment for these enterprises by way of tax incentives.

According to the OECD, developing countries have a lack of skilled resources and capacity leading to lack in legislative measures which makes them vulnerable to MNE's with greater resources.[26] The lack of capacity limits these countries in doing value adding audits and enquiries. In many cases developing countries do not have the resources to identify and attack complex BEPS transactions. This lack of resources and legislation makes them an easy target for BEPS which undermines the credibility of the tax system.

As these countries are mostly still on manual tax systems as opposed to e-filing there is a lack of available information on transactions and arrangements.

In developing countries, there is often a lack of political awareness and commitment which makes it increasingly difficult to get political approval for making changes to legislation.

Treaty abuse is another risk which developing countries. According to the OECD, of the more than 3000 bilateral agreements that are in effect, roughly 1000 involve developing countries. Many developing countries levy withholding taxes which are then reduced by the bilateral agreements that are in place, MNE's then structure their operations to benefit from these treaties (also known as 'treaty shopping'). [27]

The OECD has identified the following key issues as being of most relevance:

- '*Base erosion caused by excessive payments to foreign affiliated companies in respect of interest, service charges, management and technical fees and royalties.*

[26] OECD (2014b). *Part 1 of a report to G20 development working group on the impact of BEPS in low income countries*, OECD Publishing

[27] OECD (2014b). *Part 1 of a report to G20 development working group on the impact of BEPS in low income countries*, OECD Publishing

- *Profit shifting through supply chain restructuring that contractually reallocates risks, and associated profit, to affiliated companies and low tax jurisdictions.*
- *Significant difficulties in obtaining the information needed to assess and address BEPS issues, and to apply their transfer pricing rules.*
- *The use of techniques to obtain treaty benefits in situations where such benefits were not intended.*
- *Tax loss caused by the techniques used to avoid tax paid when assets situated in developing countries are sold.'*[28]

In general developing countries face more problems than their developed counterparts.

# 3 The risk to the South African economy

The Davis Tax committee is a working group that was established in South Africa on 17 July 2013. This committee has been tasked with assessing South Africa's tax policy frameworks and its role in supporting the objectives of inclusive growth, employment, development and fiscal sustainability. It recently appointed a sub-committee to address BEPS in South Africa. The work of the sub-committee has been welcomed by various civil society organisations (CSOs) in South Africa. The aim of the sub-committee is to develop a 'national tax toolkit' in order to simplify complicated tax terms and distribute that to communities. [29]

The CSOs identified the following key issues in South Africa's tax regime:

- Social contract between citizen and government

  '*Jean-Jacques Rousseau's social contract theory is based on the ideology that a social contract exists between the government and its' citizens. The purpose of the collection of taxes as revenue is for the equitable redistribution of the country's wealth*. '[30]

  Seemingly this has not been the case in South Africa as the poor are living in unacceptable conditions.  Contracts require that both parties upheld their end of the bargain. High levels of corruption and poor service delivery undermine the 'social contract'. South African citizens are therefore not seen to be equal partners in this agreement leading to behaviour of tax avoidance.

- Tax avoidance (BEPS) as a human rights issue

  BEPS erodes the tax base of a country, low income results in less money to provide basic human rights such as education, health and housing. BEPS is therefore seen as a human rights issue.

- Widespread incompetence and/or corruption in terms of tax collecting

[28] OECD (2014b). *Part 1 of a report to G20 development working group on th impact of BEPS in low income countries*, OECD Publishing
[29] BEPS sub-committee (2014), *Base erosion and Profit-shifting as an impediment to economic development*
[30] BEPS sub-committee (2014), *Base erosion and Profit-shifting as an impediment to economic development*

This point refers to the lack of competency in collecting the maximum amount of taxes with the legislation that is currently at their disposal.

- Stringent regulation of multi-national corporations

  This focuses on not giving benefits to MNEs that avoid paying tax by using tax havens and other methods. This behaviour of MNEs should be penalised.

- South Africa is the voice of Africa

  South Africa should represent Africa's view on international tax issues, therefore South Africa should engage with other African countries.

- Tax competition

  Base Erosion only benefits large MNEs which affects small to medium business enterprises. Up to now African economies have aimed to attract large MNEs to stimulate growth in their economies. South Africa has also been involved in this anti-competitive behaviour by providing tax incentives for 'Industrial development zones'(IDZs), automobile industry and mining.

- Review of bilateral tax agreements

  It is acknowledged that the bi-lateral agreements need to be reviewed and changed where needed such as the granting of relief on withholding taxes.

- Alternative to the arm's-length standard

  '*An alternative to the arms lengths rule should be introduced that is administratively feasible and takes into account the lacking capacity of our revenue authority to prevent the manipulation of this somewhat fluid and flexible concept*.'[31]

  There are calls for a working group to be set up to investigate various alternatives.

- Domestic resource mobilization

  State resources should be better managed, i.e.: fraud, corruption and missing revenue should be investigated and recollected.

- Review of CFC Rules and TP Guidelines

  The South African legislation will consider the recommendations made by the OECD as discussed later on.

- African voice in review of international tax regime

  This point raises the concern that there has been a lack of consultation with developing countries in the OECD's publications. [32]

[31] BEPS sub-committee (2014), *Base erosion and Profit-shifting as an impediment to economic development*

Based on the above, South Africa faces other challenges in addition to the BEPS issues, and a holistic approach will be required in order to address these.

On the income tax front there have already been many legislative changes made to deal with BEPS specifically. The following sections of the report will be focused on understanding the current South African legislation that is in place. It will then evaluate this legislation in light of the work performed by the OECD.

The specific legislation that will be discussed relates to:

- Controlled Foreign Company (CFC) regimes
- Financial payments
- Transfer Pricing
- Treaty abuse

## 3.1 Controlled Foreign Company (CFC) regimes

### 3.1.1 Introduction

There are CFC regimes in all G20 member states, with the exception of four developing countries, two of which have announced an intention to adopt a CFC regime. CFC legislation is an anti-deferral regime, which is aimed at MNE's that route income through a non resident affiliate. The taxation of foreign income, derived directly or derived via a foreign subsidiary, is a key aspect of the fiscal policy of national governments to encourage economic growth, competitiveness and foreign investment. This is one of the main reasons why CFC rules vary significantly between jurisdictions.

As part of the OECD Action Plan on BEPS (Action 3) the OECD highlights the need to strengthen CFC legislation. It is very unlikely that a common position on CFC rules will be achieved when sovereign nations have chosen such different ways to encourage economic activity however some narrowing of practices is expected.

### 3.1.2 CFC legislation in South Africa

South Africa implemented CFC legislation in 2002 in the form of section 9D. CFC legislation was implemented in South Africa as an anti-deferral legislation. Should a South African company hold controlling shares in a foreign company and that foreign company earns income South Africa will only have taxing rights when those funds are repatriated to South Africa in the form of dividends. This method was used by South African companies to avoid paying tax which National Treasury aimed to prevent. [33]

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[32] BEPS sub-committee (2014), *Base erosion and Profit-shifting as an impediment to economic development*

[33] National Treasury (2002). *National Treasury's detailed explanation to section 9D of the income tax act*

This anti-deferral regime aims to impute the passive income earned into the taxable income of the parent company. This imputation would however affect the foreign subsidiary's international competitiveness which is not the aim of the legislation. For example, where the foreign company may be paying 10% tax in the foreign country combined with the section 9D imputation, the company ultimately would pay 28% tax. Other companies in the same foreign jurisdiction would pay only the 10%, this would affect the amounts the company could re-invest and therefore affect its competitiveness.

The legislation was aimed at passive income and transactions with a high tax avoidance risk as opposed to active operating income.

The above mentioned was the original intention with the implementation of section 9D. This section has been amended extensively since its implementation, however the intention and spirit of the legislation has not changed.

As section 9D currently stands amounts of income (or capital gain) received by a foreign subsidiary which is a CFC will be imputed unless certain exemptions are met. A company will be a CFC if it is directly or indirectly held more than 50% (voting rights or participation rights) by South African residents. A foreign company for the definition of a CFC includes a 'protected Cell Company' and a foreign company. A 'protected cell company' is defined as a foreign incorporated, formed or established entity whose principal trading activities is that of an insurer where the laws of the foreign country allows for the segregation or linking of assets and liabilities into independent cells or accounts or the separate participation rights in respect of each cell or account irrespective of whether that cell is regarded as a legal person.

'Participation rights' are defined as the right to participate in all or some of the benefit of the rights (excluding voting rights) attached to a share or similar interest in a company. Where no participation rights can be determined, voting rights would qualify as participation rights.

Section 9D is a complicated piece of legislation but if one could simplify this legislation it would be described as follows; if a South African resident company holds more than 10% participation rights in a CFC, all the income of the foreign subsidiary would be included in the resident companies income in the ratio of the participation rights. The CFC's net income would be calculated by using the average exchange rate to translate the functional currency to South African Rand. The CFC's taxable income is determined as if it were a South African taxpayer.

'Where all or a portion of income derived by a CFC is attributed to a resident of South Africa, a rebate for the foreign taxes paid on the proportionate amount attributed is granted against the South African tax payable.'[34] When a dividend is declared to the South African

[34] Deloitte (2014), *Guide to Controlled Foreign Company Regimes,* Deloitte Touche Tohmatsu Limited [Online]
http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-guide-to-cfc-regimes-120314.pdf [Accessed 8 September 2014]

tax payer at a later stage it will be exempt if the profits of the CFC have been included in the South African shareholders income.

Imputation of income will therefore take place unless the foreign subsidiary is located in a high tax country (i.e. you have not invested through that country for a tax benefit) or if the foreign subsidiary has a foreign business establishment (FBE) in the foreign country with active operations.

The high tax country exemption is not a simple concept as this is not linked to the tax rate of the country. In order to qualify for this exemption one has to prepare a South African tax computation for the foreign entity based on South African income tax legislation. If the tax payable based on South African income tax legislation is more than 75% of the tax payable in the foreign country the exemption will apply to all income received, even passive income. The calculation could be highly problematic for various reasons. For example, the information is needed not necessarily freely available or certain asset allowances would have to be calculated based on South African tax legislation which could mean keeping separate tax asset registers. This means keeping and maintaining records just for CFC tax calculation purposes which is not always practically possible.

However, one important aspect of the section 9D rules is that they are not purely based on 'anti-deferral' principles (i.e. deferral warrants complete taxation), as the CFC rules also recognise the need for international competitiveness by allowing an 'exemption' where the income stems from active operations. Therefore, section 9D is aimed at taxing income which stems from passive investments or income from transactions that meet objective criteria with a high tax avoidance risk. For active operations, the FBE exemption allows the 'net income' of a CFC to escape the ambit of section 9D unless that income is diversionary or passive.

The FBE exemption aims to exempt income imputation if the controlled foreign company has legitimate foreign business activities, thus operates at arm's length. A 'foreign business establishment' is defined in section 9D as a foreign fixed place of business which will be used for not less than a year through office, shops, factories, warehouses or other structures. The fixed place of business must have enough staff with on-site managerial staff and operational employees. The fixed place of business must be equipped and have the correct facilities to conduct the primary operations of the entity. This fixed place of business may be shared with another entity if that entity is taxed in the same country, and the entity is also a CFC or part of the same group of companies.

The main purpose of the entity cannot be to get a tax reduction or postponement of South African tax.

There are specific requirements which will not be discussed in detail for exploration operations; construction operations; agricultural operations; vessels, vehicle and other rolling stock or aircraft used for transportation; international shipping and ships engaged in International traffic.

The exemption also applies to the passive income which arises from the principle trading activities of banking, financial services, insurance or rental business, provided the trading activities of the CFC do not constitute that of a Treasury operation or captive insurer.

'*Other exemptions include the following:*

- *The net income of the CFC is already taxable income in South Africa.*
- *Interest, royalties and rental income payable to a CFC by another CFC; reduction or discharge of a debt owed by a CFC to another CFC for no consideration or less consideration than the face value of the debt; and exchange differences arising on exchange items entered into between such parties, where the entities are part of the same group of companies (a deduction for this type of inter-CFC expenditure, however, is disallowed under CFC rules); and*
- *Capital gains, to the extent the asset disposed of(subject to exclusions) is attributable to a foreign business establishment of another CFC that forms part of the same group of companies as the CFC.*'[35]

If a company ceases to a CFC and there is no exemption provided, it triggers a deemed disposal of its assets at market value, thus triggering a CGT liability.

There have been a number of international cases that deal with CFC legislation and the right of countries to tax the profits of subsidiaries in other countries. One of the significant cases is the Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commisioners of Inland Revenue. The case concerned the compatibility of controlled foreign companies' rules with the Freedom of Establishment provided by the EU treaty, which allows companies resident in one Member State to participate unhindered, on a stable and continuing basis, in the economic life of another Member State by the pursuit of genuine economic activities through an actual establishment in that State.

The European Court of Justice (ECJ) decided that CFC's rules pursue a legitimate aim and are compatible with European law - so long as they are not applied to the profits of genuine economic activities undertaken in an actual establishment in another Member State.

In such circumstances CFC's rules must ensure that the parent company is:

"*…given an opportunity to produce evidence that a controlled foreign company is actually established [in another Member State] and that its activities are genuine". If it can, controlled foreign companies rules must not be applied to the profits of any genuine economic activities in such a business establishment in another Member State*".[36]

In the judgement of Cadbury Schweppes Overseas Ltd v Commissioner of Inland Revenue the ECJ precluded:

[35] Deloitte (2014a), *Guide to Controlled Foreign Company Regimes,* Deloitte Touche Tohmatsu Limited [Online]
http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-guide-to-cfc-regimes-120314.pdf [Accessed 8 September 2014]

[36] *Cadbury Schweppes plc & Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue (2006) AD, C-196/04*

*'the inclusion in the tax base of a resident company established in a Member State of profits made by a controlled foreign company in another Member State, where those profits are subject in that State to a lower level of taxation than that applicable in the first State, unless such inclusion relates only to wholly artificial arrangements intended to escape the national tax normally payable. Accordingly, such a tax measure must not be applied where it is proven, on the basis of objective factors which are ascertainable by third parties, that despite the existence of tax motives that controlled company is actually established in the host Member State and carries on genuine economic activities there'*.[37]

In the UK, the Government decided to amend the controlled foreign companies legislation in Chapter IV of Part XVII ICTA to reflect the judgment explicitly in the rules, and to provide a clear and certain procedure for companies to produce evidence to prove the extent of a controlled foreign company's genuine economic activities undertaken in a business establishment in another Member State and establish what amount (if any) of a controlled foreign company's profits should be excluded from the controlled foreign companies charge.

### 3.1.3 Conclusion

From the CFC legislation that is in place as an anti-deferral provision, South Africa seems to be adequately protected from BEPS in this respect as essentially all passive income with the exception of certain limited industries will be imputed for South African income tax purposes. The FBE exemption brings the South African legislation in line with the Cadbury Schweppes international judgement that only entities that do not have genuine operations in the CFC's country should be imputed in the South African residents' income. Even though the legislation may be adequate it is a complicated set of rules which is not easy to apply, and could lead to the misinterpretation and misapplication of the legislation. The South African Revenue Service has limited resources and possibly do not have the skills to audit the application of the provisions, this could leave the system vulnerable to abuse.

CFC rules differ considerably between different jurisdictions. The OECD has not as yet released any recommendations or publications with regards to CFC legislation. It would be important to look at any recommendations made as currently CFC legislation differs considerably between different jurisdictions. What is a concern however is that the OECD seems to favour the OECD member states as opposed to the G20 emerging economies with the focus being on resident taxation instead of taxation at source.

## 3.2 Financial payments

### 3.2.1 Introduction and background

[37] *Cadbury Schweppes plc & Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue (2006) AD, C-196/04*

Companies finance their operations either through equity or debt. This makes commercial sense as long as it complies with TP regulations on the level of debt and interest rate payable. Whilst the cost of equity is not deductible in the form of dividends, the cost of debt is deductible in the form of interest. Financial payments are a relatively simple way for MNEs to pay less tax.

It is a basic tenet of the arm's length principle, which the Action Plan endorses, that the tax treatment within a country should essentially be the same whether payments are made to a foreign group entity or to a third party.

A natural extension of this, as well as a consequence of market dynamics, is that the non-taxation of the income received by a recipient (whether or not a foreign recipient) should not impact upon deductibility to the payer provided the relevant TP tests are met. The OECD, however, wishes to link rules on the tax deductibility of interest with a consideration of whether the recipient is taxed on that interest.

According to National Treasury excessive interest deductions is one of the most significant types of base erosion in South Africa. This form of BEPS is achieved by having interest deductions in a high tax jurisdiction while the income is shifted to a low tax jurisdiction. According to the National Treasury there are four recurring concerns when it comes to this.[38] They are as follows:

- Hybrid Debt
- Connected Person Debt
- Transfer pricing
- Acquisition Debt

These concerns will be briefly discussed.

### 3.2.2 Hybrid Debt

Hybrid debt is a concern as it may be treated as debt in one country but as equity in another thereby having a tax deduction in one country but no corresponding income in the other. SARS has introduced section 8F and section 8FA of the ITA to address this issue.

Section 8F aims to re-characterise financial instruments which are labelled as debt but have equity like features to equity. It then re-characterises the interest paid to be dividends in specie which is not deductible for tax.

Hybrid debt instrument is defined as any instrument that:

- has an option to convert or exchange that instrument for shares within 3 years,
- the obligation to pay an amount is conditional upon the solvency (assets exceed the liabilities) of the company, or

[38] National Treasury (2013a). *Request for public comment for incorporation into forthcoming 2013 tax laws amendment bill: Proposed against excessive interest tax deductions*

- the money is owed to a connected party and is not repayable within 30 years from the issue of the instrument. [39]

Section 8FA aims to re-characterise the yield of certain financial instruments where the yield is labelled to be interest paid but have dividend like features to be a dividend in specie. Hybrid interest has been defined in the ITA as interest which is not determined with reference to an interest rate or time value of money or is determined by reference to the increase in profits of the company. This yield will be re-characterised as dividends in specie and not be deductible for tax.

### 3.2.3 Connected person debt

*Limitation on deductions of interest payable to related parties that are not subject to tax*

The connected person debt relates to debts owed to untaxed entities within the same group of companies. This could arise where the entity receiving the income within the group is not taxable. Examples of this could be when a company that is exempt from paying income tax or a foreign company which is not resident in South Africa for income tax purposes received interest income. In order to address this problem, SARS is in the process of implementing s23M of the ITA. Section 23M provides for a limitation on the amount of interest which can be deducted on loans sourced from a person that is in a 'controlling relationship' with the debtor where the interest is not subject to tax in the hands of the person to which it accrues.

Simply put, if a company pays interest to another entity within the same International Financial Reporting Standards (IFRS) group of entities and the interest is untaxed, the interest will be subject to a limitation. This interest limitation will also apply if an IFRS group entity guarantees or provides security for the debt of another group entity. In either circumstance the interest will be limited to 40 percent of the debtor's taxable income (excluding interest received, accrued, paid or incurred) plus interest received or accrued reduced by interest paid or incurred in respect of debt falling outside the limitations (debt from non connected third parties) . To the extent that interest is limited it can be carried forward to following years of assessment for up to five years.

The Taxation Laws Amendment Bill (TLAB), tabled in parliament on 22 October 2014, contained welcome changes to the provisions of section 23M of the ITA, due to come into operation on 1 January 2015.

The first important change in the TLAB amends the definition of 'controlling relationship'. The section will now require the person to directly or indirectly hold at least 50% of the equity shares in a company or control at least 50% of the voting rights in the company in order to be in a controlling relationship. This is a significant increase in threshold from the existing provisions which treated all connected persons as being in a controlling relationship with the company.

Secondly, the TLAB scraps a problematic provision in section 23M which would have resulted in interest payable to unrelated third parties, which are not subject to tax, being caught by

[39] Income Tax Act 58 of 1962

the limitation provisions simply by virtue of the loan being guaranteed by a person that is in a controlling relationship. Interest on loans provided by foreign funders or by exempt institutions in the local capital market and which were secured by other entities within the debtor company's group would have been subject to the provisions of section 23M. In terms of the revised section 23M, only loans owing to a creditor that is in a controlling relationship with the debtor or is owing to a third party creditor that has obtained the funding from a debt advanced from a person that is in such a controlling relationship are affected by the limitation. As indicated above, the provisions of section 23M further require that the interest is not subject to tax in the hands of the creditor.[40]

Finally, the TLAB read with the accompanying media release addresses the interaction of section 23M with existing transfer pricing and thin capitalisation provisions set out in section 31 of the ITA as well as with the interest limitation provisions applicable to acquisition and reorganisation transactions contained in section 23N of the ITA. Taxpayers will be required to firstly apply the provisions of section 31 of the ITA to any cross border loans. Where the loan has been used to fund an acquisition and reorganisation transaction, the provision of section 23N must be applied to that portion of the interest which is allowable as a deduction under section 31. Finally, the provisions of section 23M must be applied to determine whether any portion of the interest, not already disallowed under section 23N must be further limited in terms of section 23M.

Whilst the above changes are welcome both in terms of limiting the scope of section 23M as well as in clarifying the interaction with other sections of the ITA, some problems with the section persist. Most notably, the term 'subject to tax' remains undefined. Whether the imposition of Interest Withholding Tax (IWT), the introduction of which has been delayed until 1 March 2015 in terms of the TLAB, will result in interest becoming subject to tax may be debated as will be the impact of Double Taxation Agreements (DTAs) which reduce tax rates on interest to zero.

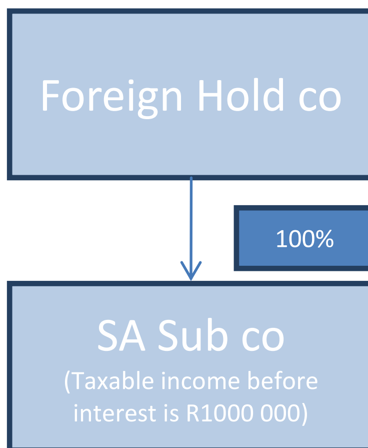
In order to fully understand the interest limitation and the impact thereof one has to understand the mechanics behind the calculation, which is demonstrated below with the help of examples.

The section 23M limitations can be illustrated as follows:

Example 1 (Adapted from an example used in 'Proposed limitation against excessive interest tax deductions')[41]

[40] National Treasury (2014). *Explanatory Memorandum on the Taxation Laws Amendment Bill*, 2014. 22 October 2014

[41] National Treasury (2013b). *Request for public comment for incorporation into forthcoming 2013 tax laws amendment bill: Proposed against excessive interest tax deductions*




Additional information:

- Foreign Holdco lends R6 million at 8% interest to a South African Sub co.
- SA taxable income before interest is R1 million

Result:

- The interest limitation applies as Foreign Holdco and SA sub co is part of the same IFRS group of entities and Foreign Hold co is not subject to income tax in South Africa on the interest received.
- Thus the interest will be limited to R400 000 (R1000 000 x 40%) and the balance of R80 000 will be carried to the next year of assessment

Example 2[42]

Additional information:

- Assume the same information as Example 1
- SA Sub co has not repaid the loan as yet and has a taxable income before interest of R1 500 000.

Results:

- The interest limitation applies as Foreign Holdco and SA sub co is part of the same IFRS group of entities and Foreign Hold co is not subject to income tax in South Africa on the interest received.
- The interest will be limited to R600 000 however the interest incurred for the year was only R480 000, the balance of the limitation can be used to claim a deduction for the interest limitation brought forward from the prior year. Thus a R560 000 deduction may be claimed in year 2 calculated as follows: (R480 000 + R80 000) limited to R600 000. If for example the taxable income before interest was only R1 100 000 the interest deduction would be calculated as R480 000 and R120 000

[42] National Treasury (2013b). *Request for public comment for incorporation into forthcoming 2013 tax laws amendment bill: Proposed against excessive interest tax deductions*

(R480 000 + R80 000 – R440 000 = R120 000) would be carried forward for a maximum of 5 years.

In the case where there is an intermediary such as a bank which loans an amount to an IFRS group entity and the foreign parent provides a guarantee or security for the loan the same interest limitation applies as per the above example.

### 3.2.4 Transfer Pricing and financial payments

South Africa has legislation governing the pricing of inter-company transfer of goods and services. The goods relate to tangible property and the services to intangible property, financial assistance and other services across international boundaries. Specific transfer pricing legislation was introduced in South Africa in July 1995 under section 31 of the Act.

The overriding principle of the transfer pricing legislation is if cross border intra-group transactions between connected persons are not conducted at arm's length, then SARS may adjust pricing to reflect what it regards as an arm's length price for the supply or acquisition of goods or services involved. The onus is on the taxpayer to prove that the price was an arm's length price.

This is a significant risk area for base erosion. Firstly connected persons could charge excessive interest cross border within a group of companies thereby shifting profits to low tax jurisdictions. In MNE's the issue of debt instruments is often tax driven as opposed to economically driven.

The thin capitalisation rules in the TP legislation in section 31 of the ITA aim to regulate the issue of debt between related parties. SARS has issued a draft interpretation note on 'the determination of the taxable income of certain persons from international transactions: Thin Capitalisation'.

Where these rules used to have an acceptable ratio of debt to equity in the past it has now moved to a more subjective set of rules which is based on arm's length principles.

#### 3.2.4.1.1 The South African thin capitalisation provisions applicable as at 31 December 2011

The previous South African thin capitalisation provisions were contained in section 31(3) of the Act as at 31 December 2011, read together with Practice Note (PN) No. 2, dated 14 May 1996 issued by SARS in relation to thin capitalisation, could only be applied where a non-resident connected person (referred to as an "investor") granted financial assistance in the form of an interest-bearing loan, advance or debt to a resident, as well as where that investor provided any security or guarantee to the resident concerned. The provisions applied whether such financial assistance was granted directly or indirectly and indirect financial assistance was deemed to include back-to-back arrangements through independent parties or co-investors.

A "connected person" in relation to a company is defined in section 1 of the Act as a person who individually or jointly with any connected person in relation to himself holds, directly or indirectly, at least 50% of the company's equity share capital or voting rights.

Insofar as the thin capitalisation provisions applied and the Commissioner was of the opinion that the financial assistance was excessive in relation to the fixed capital of the resident, then any interest, finance charge or other consideration payable in respect of the financial assistance which relates to the amount which is excessive will be disallowed as a deduction in the hands of the resident when calculating its taxable income.

The PN contained the guidelines for the application and interpretation of the thin capitalisation provisions in South Africa. In terms of the PN, the Commissioner of SARS would generally not regard a company as being thinly capitalised provided its interest-bearing foreign debt to fixed capital ratio did not exceed a ratio of 3:1. Where the South African resident company did not comply with the 3:1 safe harbour ratio prescribed in terms of the PN, the Commissioner would disallow a deduction claimed in terms of section 11(a) read with section 23(g) of the Act on the portion of interest relating to the excessive portion of financial assistance. The excessive portion of financial assistance was the amount which exceeded an amount equal to 3 times the fixed capital of the South African resident company and the interest expense payable in relation to the financial assistance was apportioned between the amount which was considered to be acceptable (falling within the 3:1 safe harbour ratio) and the amount which was considered to be excessive.

Furthermore, up until 31 March 2012 section 64C of the Act deemed certain amounts to constitute dividends, in which event they became subject to STC. In terms of section 64C(2)(e) of the Act any amount that represented additional taxable income or a reduced loss of a company by virtue of any transaction with a shareholder, the consideration of which was adjusted in terms of section 31 as at 31 December 2011, was deemed to be a dividend declared by that company. Consequently, section 64C(2)(e) of the Act deemed the disallowable portion of interest to be a dividend which was subject to STC (which is payable to SARS) at a rate of 10%.

###### 3.2.4.1.2 The South African thin capitalisation provisions applicable from 1 April 2012

South Africa has revised its transfer pricing rules and the thin capitalisation provisions are now contained in the transfer pricing rules. Under the revised transfer pricing rules (effective from 1 April 2012) the arm's length principle (which is based on OECD methodologies) will now be applied in order to determine whether a resident company can be said to be thinly capitalised.

As the 3:1 debt to equity ratio (or the safe harbour ratio) has been replaced by an arm's length test, an analysis has to be performed to determine whether the debt received from a foreign connected person is at arm's length. This could require an economic analysis in order to determine whether the lending arrangement represent an arm's length arrangement. The arm's length test will apply to both the level of debt as well as the interest rate being charged. Accordingly, interest charged on connected party cross-border loans will not be tax deductible to the extent that the underlying debt-related finance would not have

economically existed had the financing been arranged on an arm's-length basis between independent parties.

Due to the fact that the amended transfer pricing rules consider the cross-border transactions, operations, schemes, agreements or understandings that have been effected between, or undertaken for the (tax) benefit of connected persons, there will no longer be a focus on separate, isolated transactions but a focus on overall arrangements. In short, the emphasis on the 'price' of services rendered by connected persons i.e. interest in respect of financial assistance is no longer relevant. The emphasis will rather be on the terms and conditions of the financial assistance as a whole.

If terms or conditions made or imposed in transactions, operations, schemes, arrangements or understandings differ from the terms and conditions that would have otherwise existed between independent persons acting at arm's length, and the difference confers a South African tax benefit on one of the parties, the taxable income of the parties that have benefited must be calculated as if the terms and conditions had been at arm's length.

Whether a company is 'thinly capitalised' will be determined based on whether the terms and conditions of that company's lending arrangement with its non-resident connected person(s) are comparable to lending arrangements of independent third parties. In order to do this an economic analysis would have to be performed.

ITAThe arm's length transaction has not been defined in the ITA. According to the OECD the internationally accepted principle underlying TP determinations is the arm's length principle, which requires that for tax purposes, related parties must allocate income as it would be allocated between independent entities in the same or similar circumstances.

The OECD describes the objective of the arm's length principle as follows:

'*The objective of the arm's length principle is for the price and other conditions of transactions between associated enterprises to be consistent with those that would occur between unrelated enterprises for comparable transactions under comparable circumstances. In transactions between two independent enterprises, compensation usually will reflect the functions that each enterprise performs, taking into account assets used and risks assumed. Therefore, in determining whether controlled and uncontrolled transactions or entities are comparable, a comparability analysis is needed to ensure that the economically relevant characteristics of the situations being compared are sufficiently comparable. One of the key factors in that comparability analysis is a functional analysis to identify and compare the economically significant activities and responsibilities undertaken, assets used and risks assumed by the parties to the transactions.*'[43]

The arm's length principle is easier to apply to certain transactions. With financial payments an acceptable level of debt and an appropriate interest rate needs to be determined.

National Treasury has issued some guidelines on determining the arm's length amount for debt. It is recommended that one consider the transaction from both the lender and the

[43] OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing

borrower's perspective. It therefore needs to be determined whether in an arm's length transaction with a third party the amount the lender would have borrowed could have been borrowed at arm's length. Thus, what kind of financing would a willing third party give the lender if they were not connected? From the borrowers perspective one needs to determine whether that borrower would have lent the same amount of funds at the same rate to an unrelated third party.

According to the draft interpretation note:

'*The arm's length amount of debt is the lesser of the amount that could have been borrowed and the amount that would have been borrowed in a transaction between parties dealing at arm's length*'[44]

The principle is explained as follows. If a company has excess funds and a healthy balance sheet an independent lender will be willing to lend the company funds however economically there is no need for funds as the company has enough reserves. The arm's length amount of debt in such a situation would be nil. The arm's length principle needs to be applied on a case by case basis.

National Treasury requires each company to do a functional analysis and comparability analysis of their arm's length debt assessment.

For a functional analysis the taxpayer should take into account certain factors that are relevant. The funding structure that is being put in place which would include dates of transactions and where the funds come from as well as the reason for obtaining and the application of the funds. A background of the business, its industry, strategy, external market conditions and plans for its trading operations needs to be taken into account. The overall financial strategy including how capital will be utilised, the details of cash flows and how repayment of debt will be funded is an important factor. The companies in the group which are involved in funding transactions and any changes to the funding structure are significant. The companies' current and future expected financial position taking into account projections and cash flows should be determined. There are also some financial ratios which are appropriate such as debt: EBITDA ratio, interest cover ratio and debt: Equity ratio. Other factors that are significant are the creditworthiness of the company which includes ratings if available from independent parties, the quality of security, whether the debt is subordinated, the repayment terms and the cost of funding.

National Treasury suggests that comparable data is important when determining the arm's length principle. This should take into account the qualitative and quantitative factors that third party lenders would take into account to make lending decisions. SARS will consider the appropriateness of the comparable data obtained. SARS is also investigating the possibility of the third party provided South African database in order to assist taxpayers.

[44] SARS (2013). *Draft Interpretation Note: Determination of the taxable income of certain persons from International transactions: thin Capitalisation*

The databases would work on the basis of a scorecard which would look at industry norms and credit ratings. [45]

Determining the arm's length principle for finance arrangements is truly difficult as some third party lenders may have an appetite for risk and are willing to lend more funds at lower interest rates whereas other third party lenders have no appetite for risk and would therefore limit the funds and charge higher interest rates. There are also various factors that need to be taken into account and a lack of information could make it very difficult to determine what arm's length is. It is also a subjective process which could make it open to scrutiny and difference in opinion which could lead to exposure for tax payers.

National Treasury has also provided some guidance on determining whether an interest rate is at arm's length. A taxpayer may a have an arm's length amount of debt but not an arm's length rate of interest. SARS is investigating credit risk and scorecard models to determine what a reasonable interest would be between two unrelated parties. [46]

Should SARS determine that either the amount of debt is not arm's length or the interest rate is not at arm's length, a TP adjustment will have to be made. Primary TP adjustments include the disallowance of interest deductions and any other cost related to that debt. Secondary adjustments will currently be treated as a deemed loan on which interest will be calculated and included in taxable income. This deemed loan will remain payable until the amount is regarded as being repaid by the taxpayer. It will be regarded as repaid if the taxpayer is refunded the excessive interest or the other party pays the interest on the deemed loan.

The deemed loan concept works as per the following example. A South African company borrows R1, 5 million from its foreign parent at a rate of 10% per annum. In the 2014 year of assessment the money was borrowed for 3 months. It is determined that the arm's length amount is actually R1m at and interest rate of 8%. The following tax consequences arise:

The interest that is disallowed is R17 500 ([R500 000 x 10% x 3 / 12] + [R1 000 000 x 2% x 3/12]). The R17 500 will constitute a deemed loan by the South African company to the foreign parent for the purpose of section 31 of the ITA. The deemed loan will be considered repaid if the excessive R17 500 is refunded by the parent company. If the loan is not regarded as being repaid by the end of the year of assessment interest will be charged on the deemed loan at 8%. The interest will have accrued over the 3 months therefore R350 inclusion in taxable income. For every year thereafter interest will continue being calculated and capitalised to the loan and included in taxable income until the loan is considered repaid. As from 1 January 2015 the deemed loan principle will fall away and the secondary adjustment will be that a dividend in specie is declared (Kindly refer to Chapter on TP).

[45] SARS (2013). *Draft Interpretation Note: Determination of the taxable income of certain persons from International transactions: thin Capitalisation*

[46] SARS (2013). *Draft Interpretation Note: Determination of the taxable income of certain persons from International transactions: thin Capitalisation*

Interest limitations due to TP adjustments are permanent and will not be allowed as a deduction at a later stage.

SARS will consider a company thinly capitalised if certain factors are present. If the taxpayer has more debt than it can realistically sustain by itself, the duration of the lending is longer than would be the case in an arm's length situation or the repayment terms is not what would be entered into between unrelated third parties. According to SARS a 'Debt: EBITDA' ratio of more than 3:1 will be of greater risk and could trigger audits for tax payers although being under the ratio does not mean that there is no risk.[47]

With the implementation of section 23M the risk of TP on related party debt is reduced significantly. National Treasury is also looking at a safe harbour that will be added for TP rules. According to National Treasury in order to fall within the safe harbour, interest in connected person cross border debt must comply with the following criteria:

- '*Firstly, interest on the connected person debt may not exceed 30 per cent of taxable income (with no adjustment for other interest received, accrued, interest paid or incurred); and*
- *Secondly, the interest rate depends on the currency denomination of the loan. The interest on the debt may not exceed the foreign equivalent of the South African prime rate if denominated in foreign currency. The interest rate on the debt may not exceed the South African prime rate if denominated in Rand.*' [48]

### 3.2.5 Acquisition Debt

Acquisition debt is where a company acquires debt in order to obtain shares in a business or in order to acquire assets to expand its current operations. Under the previous section 23K legislation debt incurred for the purpose of acquisitions is subject to discretionary limitations by SARS. This was replaced by the introduction of section 23N of the ITA 'Limitations of interest deductions in respect of reorganisation and acquisition transactions' which relates to indirect section 45 acquisitions or direct section 24O acquisitions. This is an objective set of rules instead of the discretionary system.

Section 45 acquisitions are acquisition where assets are sold between companies within a group of companies and group relief applies. A section 24O acquisition relates to the acquisition of an operating company and as a result the acquiring company becomes a controlling group company in relation to that operating company.

The interest limitation will apply to all debt used to fund indirect and direct share acquisitions. These limitations are in line with the rules of section 23M as mentioned in section 4.2.2 above.

[47] SARS (2013). *Draft Interpretation Note: Determination of the taxable income of certain persons from International transactions: thin Capitalisation*

[48] National Treasury (2013a). *Request for public comment for incorporation into forthcoming 2013 tax laws amendment bill: Proposed against excessive interest tax deductions*

The limitation of interest deduction on acquisition debt on section 45 acquisitions is calculated as 40 per cent of the debtor's taxable income before interest (received, accrued, paid or incurred) plus interest received or accrued, less interest paid or incurred which falls outside of the debt limitations. The excess can be carried forward for 5 years of assessment.

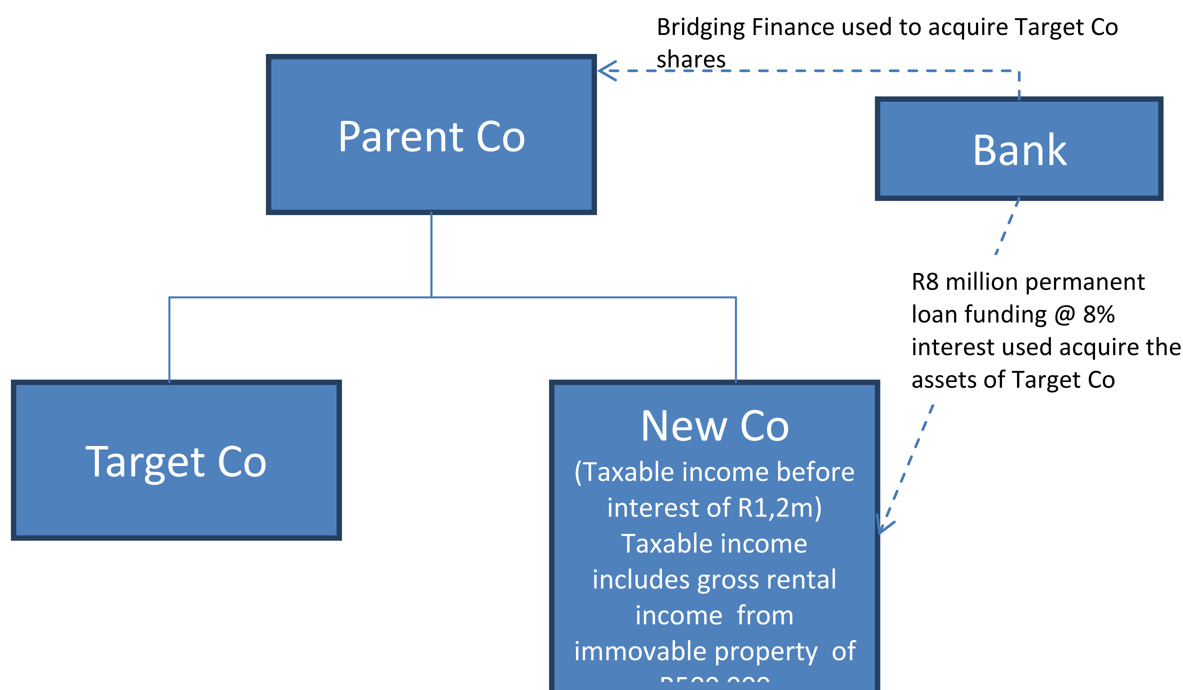
The limitation of interest deduction on acquisition debt on a section 24O acquisition is calculated as 40 per cent of the target company's taxable income before interest (received, accrued, paid or incurred). The 40 per cent taxable income limitation will be further adjusted in accordance with the percentage stake being acquired if the acquisition company is not acquiring all the shares of the target company. For example if 70% of the target company is acquired the limitation will be 70% of the 40 per cent of the target company's taxable income.

50% uplift will apply to rental income if the debt is incurred to acquire immovable property as commercial lenders are more willing to lend money to acquire immovable property.

In order to fully understand the interest limitation and the impact thereof one has to understand the mechanics behind the calculation. The calculation of the interest limitations of section 23N and 23O have been demonstrated below with the help of examples.

The section 23N limitation can be illustrated as follows:

Example 3: section 45 acquisition of assets generating rental income (Adapted from an example used in 'Proposed limitation against excessive interest tax deductions')[49]




[49] National Treasury (2013a). *Request for public comment for incorporation into forthcoming 2013 tax laws amendment bill: Proposed against excessive interest tax deductions*

Information:

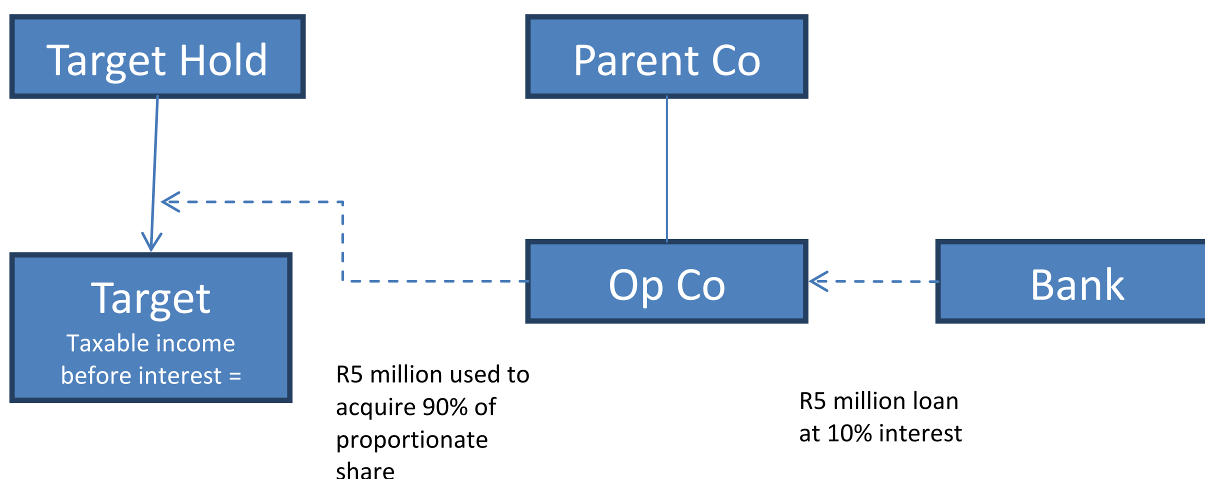
Parent Co acquires the shares in Target Co

New Co, a fellow subsidiary of Target Co which is part of the same group of companies acquires the assets of Target Co through a section 45 transaction. The transaction is financed through a loan from the Bank.

Result of interest limitation:

- The interest is R640 000 in New Co.
- The interest limitation in New Co is R580 000 (R1 200 000+0.5[R500 000] x 40%).
- New Co's interest deduction will be limited to R580 000 and the balance of R60 000 will be carried forward for up to 5 years.

Example 4: section 24O acquisition of partial interest in an operating company (Adapted from an example used in 'Proposed limitation against excessive interest tax deductions')[50]




Information:

Op Co obtains R5 million financing from the bank to acquire 90% of the shares in Target Co.

Result of interest limitation:

Interest subject to interest limitation is R500 000

Interest limitation: R180 000.

Interest deduction is limited to R180 000 and the balance of R320 000 will be carried forward to the next year of assessment for up to five years

[50] National Treasury (2013a). *Request for public comment for incorporation into forthcoming 2013 tax laws amendment bill: Proposed against excessive interest tax deductions*

The intention with the acquisition debt interest limitation is to discourage over lending to finance capital investment and to curb BEPS at the same time.

### 3.2.6 Interest withholding tax

The South African source rules are contained in section 9 of the Act and apply to amounts received by or accrued to a non-resident (i.e. the Intermediate holding company (IHC)). In terms of section 9(2)(b) of the Act, interest will be regarded as being derived from a South African source where the interest is attributable to an amount incurred by a person that is a resident, unless the interest is attributable to a PE (of the resident situated outside of the Republic) or where the funds, upon which the interest is charged, are utilised or applied in South Africa.

In South Africa, there is currently no WHT on interest paid to non-residents. Interest income received by or accrued to a non-resident from a South African source is currently exempt from normal tax provided certain requirements are met.

Section 10(1)(h) of the ITA provides an exemption in respect of interest which is received or accrued by a non-resident provided that the non-resident does not carry on business in South Africa through a PE (please note that the interest does not need to be effectively connected to such PE). Where the domestic exemption does not apply and there is no relief in terms of a DTA that South Africa has concluded with another country, the non-resident recipient of interest is required to register for income tax in South Africa to account for the tax on the interest.

Effective from 1 January 2015, the section 10(1)(h) exemption provides that the interest received by the non-resident will only be exempt from normal tax unless the debt from which the interest arises is effectively connected to the PE of that non-resident in South Africa. Effective from 1 January 2015, WHT on interest will apply at the rate of 15%.

The non-resident will be exempt from WHT where the debt claim in respect of which that interest is paid is effectively connected with a South African PE of the non-resident if the non-resident is registered in South Africa as a taxpayer in terms of the Tax Administration Act of 2011 (TAA). Where the non-resident accrues/receives such South African sourced interest and where it is found that such interest income is attributable to its PE in South Africa, such interest will be taxed in South Africa at a rate of 28% (on a net basis) subject to the application of a DTA that South Africa has concluded with another country.

In order for the non-resident to benefit from any reduction in the rate of WHT on interest certain requirements must be met. The non-resident must make, either on the date of payment or the date of determination by the company paying the interest, a declaration and written undertaking in such form as may be prescribed by the Commissioner that the interest is not subject to tax in South Africa as a result of the application of a DTA and that the non-resident will forthwith inform the company making payment should the circumstances change.

### 3.2.7 OECD recommendations

#### *3.2.7.1 Action 2: Neutralising the effect of hybrid mismatch arrangements*

In the OECD's report on neutralising the effect of hybrid mismatch arrangements the following transactions/arrangements are targeted:

##### 3.2.7.1.1 Arrangements that achieve a deduction but no inclusion in income

This is an arrangement where a deduction for example interest is achieved in one country but there is no inclusion in the income of the other country, the following transactions have been identified by the OECD to have this result:

**Hybrid financial Instrument and hybrid payments**

Hybrid financial instruments are instruments issued by a company in one country to a company in another country where the instrument is treated as debt in the first country but not taxed or given tax relief in the second country. The most likely reason is due to it being debt in the one country but equity in the other.

The recommendation made by the OECD is that the deductibility should be determined by reference to the taxability in the other country.

Hybrid payments are generally situations where there is a difference in tax treatment due to one country applying the legal form and the other country applying the substance of the arrangement which could result in a deductible amount being disregarded in the other jurisdiction.

**Disregarded payments made by a hybrid entity payer**

This situation exists where a 'Company A' resident in country A has a subsidiary 'Company B' in country B. 'Company A' loans money to 'Company B' but Company B is treated as transparent under the laws on country A. Therefore the income is not taxed in Country A as Company A and Company B is considered to be one entity. Company B however consolidated into its operating subsidiary Company C which allows it to surrender its tax benefit of the interest deduction through a consolidation regime. Therefore the interest is deductiblein Country B but not taxable in Country A.

**Reverse Hybrids**

The deduction /no income outcome can also arise out of payments made to a hybrid payee. In essence it is the reverse of the situation where there is a hybrid entity payer. It is described as a reverse hybrid is it is seen as transparent by its country of incorporation and not by its foreign investor.

##### 3.2.7.1.2 Arrangements that produce double deduction outcomes

**Deductible hybrid payments and deductions made by dual residents**

The most common hybrid referred to in this arrangement involves a hybrid subsidiary that is treated transparent under the laws of the investors' tax jurisdiction and not transparent under the laws of the jurisdiction where it is established or operates, the other form of double deductions is where a company is dual resident and surrenders the tax benefit through a consolidation regime.

###### 3.2.7.1.3 Arrangements that produce indirect deduction /No inclusion outcomes

**Imported mismatch arrangements**

This type of arrangement exists where a hybrid financial instrument relationship exists and then a vanilla arrangement is entered into to shift the effect of the hybrid mismatch to another jurisdiction.

In all the hybrid mismatch arrangements as mentioned above the OECD's recommendation is that the deductibility of the interest should be determined by reference to the taxability of the income in the other country (also called the 'linking rules'). The primary defensive rule is to disallow the interest deduction; the secondary defensive rule is to tax the income.[51] In contrast the South African Income tax legislation aims to characterise the substance of the transaction as opposed to aligning the tax treatment as recommended by the OECD. The risk in the South African legislation is that an item may be taxed as income in the hands of one taxpayer but due to the terms of the instrument it would be re-characterised and the deduction will be disallowed in the hands of the payer. The South African legislation also doesn't limit the application of the legislation to cross border transactions between connected parties, the South African legislation can re-characterise any hybrid debt instrument whether cross border or not. The current South African legislation could therefore have detrimental effects for companies if the legislation is not considered carefully.

Another recommendation by the OECD where for example a country exempts income such as dividends to avoid economical double taxation should only be applied if that dividend is paid out of after-tax profits. The improvements to CFC legislation, information reporting requirements and other specific changes are also recommended by the OECD.[52]

The following areas have been highlighted as requiring further work or areas of concern:

'*Certain substantive issues require further work (eg how to deal with intra-group hybrid regulatory capital, certain on-market stock-lending and repos (ie high volume transactions; the application of the imported mismatch rule to treasury centres, and how to deal with CFCs). In addition the implementation of the rules has to been dealt with cautiously. It is suggested that transitional rules may be required to ease the process and the provision of*

[51] OECD (2014d). *Neutralising the Effects of Hybrid Mismatch Arrangements*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing.
[52] OECD (2014d). *Neutralising the Effects of Hybrid Mismatch Arrangements*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing.

*guidance on the implementation and core operation of the rules is still under consideration.'*[53]

*'…the proposal will impact many widely used hybrid financing arrangements such as the 'Tower' structure. The recommendations do not contain any grand-fathering provisions and business utilisation and businesses utilising these types of arrangements should review their strategies.'*[54]

### 3.2.8 Conclusion

National Treasury should give some consideration to the recommendations made by the OECD for domestic legislation purposes with regards to hybrid arrangements. The current legislation that is in place may have adverse tax consequences for taxpayers which could make South Africa unattractive to foreign investment or may make South African residents commercially uncompetitive.

At the time of writing this research report, no recommendation had been issued on Action point 4: Limit Base erosion via interest deductions and other financial payments. National Treasury has however already taken precaution in the form of section 23M and section 23N as discussed. When the OECD releases its recommendations SARS can re-evaluate the legislation.

Based on the legislation that is in place and what SARS is planning to implement, South Africa seems to be adequately protected from a BEPS perspective. One will however have to assess the impact of the interest deduction limitations as well as the IWT on the economic investment into South Africa. The legislation may deter foreign investment and could be detrimental to the growth of the economy.

## 3.3 Transfer pricing

### 3.3.1 Introduction

*'The term transfer pricing describes the process by which entities set the prices at which they transfer goods or services between each other. The transfer prices adopted by a multinational have a direct bearing on the proportional profit it derives in each country in which it operates. If a non-market value (inadequate or excessive consideration) is paid for the transfer of goods or services between the members of a multinational, the income calculated for each of those members will be inconsistent with their relative economic*

[53] Brunton, L (2014). *The OECD/G20 base erosion and profit shifting project leaders shed light on the future of the international tax landscape.* Tax Alert 10 October 2014. DLA Cliffe Dekker Hofmeyer [Online] http://www.cliffedekkerhofmeyr.com/en/news/publications/2014/tax/tax-alert-10-october-the-oecdg20-base-erosion-and-profit-shifting-.html [Accessed 21 December 2014]

[54] Deloitte (2014b), *BEPS Action 2: Hybrid mismatch arrangements,* Deloitte Touche Tohmatsu Limited [Online] http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-uk-beps-action-2.pdf [Accessed 23 December 2014]

*contributions. This distortion will impact on the tax revenues of the relevant tax jurisdictions in which they operate.'*[55]

### 3.3.2 Background of transfer pricing in South Africa

Pre 1995 SARS had limited TP legislation in place. SARS could attack a transaction on the basis that the expenditure was grossly excessive in terms of the general deduction formula or in terms of the anti avoidance section 103(1) of the ITA and make a TP adjustment. The deemed donation section 58 could also be applied if property was disposed of at less than market value (which implies an arm's length principle) it would be seen as a deemed donation and taxed accordingly. To a large extent the exchange control rules also protected South Africa against TP. [56]

In light of the relaxation of exchange controls and the adverse effects thereof as well as the recommendations of the Katz Commission, TP rules were introduced in the ITA with effect from 19 July 1995 when section 31 was implemented: 'previously section 31'. This was replaced by the 'current section 31' with effect from 1 October 2011.

#### *3.3.2.1 The previous section 31*

The previous section 31 consisted of a combination of TP and thin capitalisation anti avoidance provisions. The provision to address TP was contained in section 31(1) and section 31 (2). The provisions to address thin capitalisation was contained in section 31(3).

The previous section 31 allowed the Commissioner to adjust the consideration of goods and services between connected parties if it was considered not at arm's length. This amount may have been included in taxable income of either of the parties. SARS issued PN 7 in 1999 in order to assist tax payers to determine the arm's length price.

In addition to the above SARS also had article 9 of the DTAs in order to deal with TP. Article 9 reads as follows:

'*Where*

*a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or*

*b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have*

[55] SARS (1999), *Practice note no. 7: Section 31 of the Income Tax Act, 1962:Determination of the taxable income of certain persons from international transactions: Transfer pricing*

[56] Olivier, L. & Honiball, M. (2011), *International Tax: A South African Perspective*, 5 ed*,* Cape Town: Siber Ink.

*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.*

*2. Where a Contracting State includes in the profits of an enterprise of that State —and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.*'[57]

Article 9 is still important today but this would only apply if a DTA is in place.

'*In terms of section 108 of the Income Tax Act read with s232 of the Constitution of the Republic of South Africa, 1996, a tax treaty becomes part of South African tax law. A tax treaty may override domestic tax law to the extent it conflicts with such law*'[58]

Therefore Article 9 provides that transactions be at arm's length. Where the company has a foreign branch which is a PE in the other country, the arm's length principle should be applied to the profits allocated to the PE. In general withholding tax relief also only applies to transactions that are at arm's length.

#### *3.3.2.2 Arm's length principle*

In PN 7 SARS gave some guidelines on determining an arm's length transaction. According to SARS an arm's length transaction is:

'*This simply means that the transaction should have the substantive financial characteristics of a transaction between independent parties, where each party will strive to get the utmost possible benefit from the transaction.*'[59]

SARS further states that comparability is fundamental to the determination of an arm's length price. Therefore third party comparable information should be used when determining whether a price is at arm's length. The comparability of information is influenced by the characteristics of the products and services as well as the functions undertaken, the economic circumstances and business strategies.

#### ***3.3.2.3 1995 OECD Transfer Pricing Guidelines***

The OECD Guidelines provide guidance on the application of the "arm's length principle" for the valuation, for tax purposes, of cross-border transactions between associated enterprises. In a global economy where MNEs play a prominent role, governments need to ensure that the taxable profits of MNEs are not artificially shifted out of their jurisdiction and that the tax base reported by MNEs in their country reflects the economic activity

[57] OECD (2010b), *Model Convention on Income and on Capital*, OECD Publishing

[58] Olivier, L. & Honiball, M. (2011), *International Tax: A South African Perspective*, 5 ed*,* Cape Town: Siber Ink.

[59] SARS (1999), *Practice note no. 7: Section 31 of the Income Tax Act, 1962:Determination of the taxable income of certain persons from international transactions: Transfer pricing*

undertaken therein. For taxpayers, it is essential to limit the risks of economic double taxation that may result from a dispute between two countries on the determination of the arm's length remuneration for their cross-border transactions with associated enterprises.

The OECD Guidelines were originally approved by the OECD Council in 1995. They were completed with additional guidance on cross-border services, intangibles, costs contribution arrangements and advance pricing arrangements in 1996-1999. In the 2009 edition, some amendments were made to Chapter IV, primarily to reflect the latest developments on dispute resolution.

On July 22, 2010, the OECD released a new edition of transfer pricing guidelines that (i) updated prior guidance in Chapters I – III, and (ii) provided new guidance on the transfer pricing issues presented in the context of business restructuring. These new Guidelines represent the results of several years of intensive work on the part of the OECD exploring issues related to comparability, the use of transactional profits methods, and business restructuring.

Since the OECD Guidelines incorporate the joint know-how of the member countries and balances the different interests of jurisdictions our analysis is based on the 2010 OECD Guidelines to ensure that the documentation complies with international standards.

#### *3.3.2.4 Status of the OECD Guidelines*

Although South Africa is not a member country of the OECD, the OECD Guidelines 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 countries. The OECD Guidelines are also followed by many countries which are not OECD members and are therefore becoming a globally accepted standard. In order to determine whether the purchase price of the relevant product is at arm's length, it is necessary to examine OECD Guidelines.

In this regard paragraph 3.2.1 of PN 7 states that because of the international importance of the OECD Guidelines, the PN 7 is based on, inter alia, those guidelines. Furthermore paragraph 3.2.3 of PN 7 requires that the OECD Guidelines should be followed in the absence of specific guidance in terms of PN 7, the provisions of section 31 or the tax treaties entered into by South Africa.

In PN 7, SARS provides acceptable methods to be used to determine an arm's length price. The methods that should be chosen would be the method that gives the highest degree of comparability.

The OECD lists the following TP methods:

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

According to PN 7 the Commissioner endorsed the CUP, RP, CP, TNMM and the profit split methods and applied whichever is appropriate in the specific circumstance. There is no provided hierarchy but the Commissioner provides that some methods may give more reliable information than others depending on available data.

With the previous TP provisions and PN 2 issued by SARS, a safe haven was provided for thin capitalisation. A debt to equity ratio of 3:1 was provided as a guideline. Therefore SARS would not attack companies for thin capitalisation if their debt equity ratio was less than 3:1. If it was above 3:1 then SARS would disallow interest deductions that relates to the excess debt. [60]

#### 3.3.2.5 The current section 31

According to the explanatory memorandum issued on the changes to the legislation a reason for the change was that the wording in the previous section 31 was not in line with tax treaty wording. Another reason for the change was that the wording of the previous section 31 was interpreted very literally, which gave rise to a very transactional approach to TP as opposed to a high level economic substance approach. With regards to thin capitalisation rules, there was a loophole when a foreign resident with a South African PE was giving financial assistance to another foreign resident. This type of transaction fell out of the rules of section 31. The thin capitalisation rules was parallel to the TP rules which was not in line with the OECD and UN Model tax conventions, therefore thin capitalisation is seen as an extension of the TP provisions. [61]

The aim of the new section 31 provisions was to modernise the previous section 31 by bringing it in line with the guidance provided by the OECD as well as to merge the thin capitalisation provisions with the TP provisions.

The current TP rules relate to any affected transaction. An 'affected transaction' is defined in the ITA as:

'*any transaction, operation, scheme, agreement or understanding where-*

*(a) that transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected between or for the benefit of either or both-*

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

*(bb) any other person that is not a resident;*

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

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

[60] SARS (1999), *Practice note no. 7: Section 31 of the Income Tax Act, 1962:Determination of the taxable income of certain persons from international transactions: Transfer pricing*

[61] National Treasury (2010). *Explanatory Memorandum on the Taxation Laws Amendment Bill*, 2010

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

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

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

*(bb) any other person that is a controlled foreign company in relation to any resident,*

*And those persons are connected persons in relation to one another; and*

*(b) any term or condition of that transaction, operation, scheme, agreement or understanding is different from any term or condition that would have existed had those persons been independent persons dealing at arms' length;'*[62]

From the above definition one can see that the legislation is very wide in its application and it is aimed at encompassing any cross border transactions with any connected parties.

#### 3.3.2.6 Subsequent changes to legislation and planned changes to legislation

Since the new section 31 was legislated there have been several changes to the legislation as well as some future changes which are not yet effective. The changes are mostly around the primary and secondary adjustments made by SARS where TP was not applied.

Initially the TP adjustment made would constitute a deemed dividend on which STC (Secondary Tax on Companies) would be payable. In the 2011 Explanatory Memorandum SARS wanted to change the deemed dividend to a deemed loan as according to them

'*The primary adjustment under current rules does not place the financial position of the parties to the transaction onto an arm's length basis because this primary adjustment only accounts for taxable income, not actual income.'*[63]

Due to the fact that the deemed dividend regime could not continue with the implementation of dividends tax and the current deemed dividend only accounted for taxable income SARS implemented the deemed loan adjustment. The adjustment will constitute a deemed loan from the South African taxpayer to the non-resident and require the taxpayer to calculate deemed interest at an arm's length rate. This interest would have to be calculated and paid to SARS until the deemed loan is 'repaid'.

In 2012 SARS provided relief on interest free loans for TP when it came to CFC's in high tax countries as these loans were not tax driven and could be seen as share capital. A TP adjustment often led to income being taxed in South Africa but the CFC not being able to

[62] Section 31(1) of the Income Tax Act 58 of 1962
[63] National Treasury (2011). Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011,25 October 2011

get the deduction, it reduced the international competitiveness of South African MNEs. This led to the change in legislation and the addition of section 31 (6) to the ITA.[64]

In 2013 SARS provided for relief of TP rules for equity loans. As these loans are usually low yielding, long-term and have indefinite maturity dates, it is not seen to be used for tax evasion. Once again applying TP to these equity loans makes the South African shareholder internationally uncompetitive. SARS therefore exempts outbound loans that are in substance equity. [65]

In 2014 (only effective in 2015) SARS recognised that the deemed loan primary adjustment has certain flaws. According to the 'OECD TP guidelines for MNEs and tax administrations' the secondary adjustments are usually 'constructive dividends', 'constructive equity' or 'constructive loans'. SARS however recognises the a deemed loan places an administrative burden on companies and in many cases this 'loan' cannot be repaid as there is no contractual legal grounds for the repayment of the loan. The accounting treatment of the loan and calculation of interest is also cumbersome. The secondary adjustment proposed by SARS is that the resident company be deemed to have declared a dividend in specie. The dividend in specie will be deemed to have been declared and paid on the last day of a period of six months following the year end in which the adjustment was made.

### 3.3.3 Items in BEPS Action Plan aimed at transfer pricing

TP is an important part of the BEPS Action Plan, this is evident by the attention it received in the Action Plan. Four of the fifteen action points relate to TP, which have been touched on in previous chapters.

The OECD has released their reports on:

- Action 8: Guidance on TP aspects of Intangibles,
- Action 13: TP documentation and country-by-country reporting, and draft discussions on
- Action 10: Proposed modifications to chapter VII of the TP Guidelines relating to low value-adding intra-group services.

The OECD has not as yet released any recommendations with regards to Action 9 but these are planned to be released in the 2015 year. A brief discussion of the OECD recommendations on Action 8, 10 and 13 follows.

**Action 8: Guidance on Transfer Pricing Aspects of Intangibles**

[64] National Treasury (2012). Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012, 10 December 2012

[65] National Treasury (2013). Explanatory Memorandum on the Taxation Laws Amendment Bill, 2013. 24 October 2013

The revised TP guidelines on intangibles report was issued as part of the 2014 deliverables by the OECD. The report focuses on the revision of Chapter's I, II and VI of the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. This aims to clarify the definition of, identify transactions with and determine arm's length conditions for transactions with intangible assets. The work on intangibles has not been completed as yet, therefore the report will be discussed in brief.

Chapter I and II of the guidelines explain how functional value creation is still the most important aspect which should be identified. This is done by analysing the entire value chain of an MNE to show how intangibles interact with other functions, risks and assets.

Chapter VI of the guidelines focuses on determining arm's length conditions for transactions with intangible assets. This relates to the principles in Article 9 of the OECD guidelines as previously discussed. In accordance with the guideline to the extent that an item or activity has economic value it should be determined whether or not it falls into the definition of an intangible.

In determining the arm's length conditions for an intangible asset the following items should be considered in the functional and comparability analysis:

- *'The identification of specific intangibles,*
- *The legal ownership of the intangibles,*
- *The contribution of MNE group members to their development, enhancement, maintenance, protection and exploitation; and*
- *The nature of controlled transactions involving intangibles including the manner in which such transactions contribute to the creation of value.'*[66]

The following items might affect the arm's length price:

- 'Location savings' – these are savings due to geographical market in which the business is operated.
- 'Local market features' – these are local market advantages or disadvantages which are not necessarily related to location savings for example purchase power, product preference whether the market is expanding or contracting etc.
- 'Assembled workforce' – some MNE's have an assembled experienced workforce which affects the efficiency with which services are delivered or goods are produced which affects the arm's length price.
- 'MNE group synergies' – group synergies may give MNE's advantages over and above what would be available between independent parties.

According to the OECD difficulties arise in defining intangible assets. An intangible has been defined as:

*'…something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be*

[66] OECD (2014j). *Guidance on Transfer Pricing Aspects of Intangibles,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing

*compensated had it occurred in a transaction between independent parties in comparable circumstances'*[67]

Intangibles may not be disclosed for accounting purposes so they are not always easily identified. The OECD identifies the following categories of intangibles:

- *'Patents,*
- *Know-how and trade secrets,*
- *Trademarks, trade names and brands,*
- *Rights under contracts and government licences,*
- *Licences and similar limited rights and intangibles,*
- *Goodwill and ongoing concern value,*
- *Group synergies; and*
- *Market specific characteristics'*[68]

The section on 'ownership of intangibles' has not as yet been finalised therefore identifying and determining prices for intangibles will not be discussed in detail.

Some of the independent commentary on the OECD report is as follows:

*'It is important to understand the value and use of intangibles across a multinational enterprise and in many cases the use of a 'one-sided' analysis (looking only at one party to the transaction, such as a distributor) will not give an arm's length result, particularly when the intangible is unique and valuable. There will be more use of the transactional profit split methodology for pricing intangibles transactions, in the absence of reliable comparables (CUPs) but the guidance is clear that the most appropriate pricing method should be used. The guidance respects legal arrangements if they are consistent with the actions of third parties and value-creating activities. Situations where contractual arrangements are inconsistent with third party behaviour will require further analysis and adjustment to pricing.*

*Some of the difficulties inherent in determining the arm's length price of intangibles will remain. Demonstrating the capacity for an entity to exert control over another will be an important part of allocating profits, as will determining options realistically available to both parties and the returns that should be anticipated from intangibles. '* [69]

*'…the output with respect to Action 8 contains both final and interim guidance. The element that is final, to be implemented in 2015, contains clear guidance to be used in transfer pricing analyses. It stresses the importance of a thorough comparability analysis. Consequently, a transfer pricing policy based on the generic features of a group of entities without due regard*

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[67] OECD (2014j). *Guidance on Transfer Pricing Aspects of Intangibles,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing

[68] OECD (2014h). *BEPS Action10: Proposed Modifications to Chapter VII of the Transfer Pricing guidelines relating to low value-adding intra-group services*, OECD Publishing

[69] Deloitte (2014c), *BEPS Action 8: Transfer Pricing Aspects of Intangibles,* Deloitte Touche Tohmatsu Limited [Online] http://www2.deloitte.com/content/dam/Deloitte/ie/Documents/Tax/2014-deloitte-ireland-beps-action-8-transfer-pricing-aspects-of-intangibles.pdf [Accessed 23 December 2014]

*to the specific circumstances of the transactions may be challenged. Even though the guidance will only be implemented in 2015 in connection with other related BEPS work, in practice, tax authorities' behavior may be expected to be affected by the guidance before such implementation.'*[70]

The OECD's work on intangibles will be important when countries are looking at defining and assigning value to intangibles. It will also be important when applying the arm's length principle to transactions with intangible assets. SARS will have to consider these in their guidelines to taxpayers going forward.

**Action 10: Proposed Modifications to Chapter VII of the Transfer Pricing Guidelines relating to low value-adding intra-group services**

Management fees or intra group service fees is another way in which MNE's can move profits from high tax jurisdictions to low tax jurisdictions. The OECD has released a report which indicates from a management fee perspective which fees should and shouldn't be charged. It also investigates what will constitute and arm's length price for these services.

The OECD makes a distinction between low value adding services which can be charged between related parties and 'shareholder activities', which according to the proposal should not be charged as it adds no value to the company. The OECD defines low value adding services as follows:

'*Low value-adding intra-group services are services performed by one member or more than one member of an MNE group on behalf of one or more other group members which*

- *are of a supportive nature;*
- *are not part of the core business of the MNE group;*
- *do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles; and*
- *do not involve the assumption or control of substantial or significant risk and do not give rise to the creation of significant risk.* '[71]

Examples of low value-adding services are:

- accounting and auditing:
- processing and management of accounts:
- human-resources activities, for example staffing and recruitment, training and employee development and remuneration services:
- information technology services where they do not form part of the principal activity of the group
- legal services: and

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[70] EY(2014), *OECD issues updated guidance under BEPS Action 8 on transfer pricing aspects of intangibles,* Global Tax Alert 21 September 2014, Ernest & Young [Online] http://www.ey.com/GL/en/Services/Tax/International-Tax/Alert--OECD-issues-updated-guidance-under-BEPS-Action-8-on-transfer-pricing-aspects-of-intangibles [Accessed 23 December 2014]

[71] OECD (2014h). *BEPS Action10: Proposed Modifications to Chapter VII of the Transfer Pricing guidelines relating to low value-adding intra-group services*, OECD Publishing

- activities with regard to tax obligations for instance information gathering and preparation of tax returns.

The ‘simplified method’ of arm’s length charges is recommended by the OECD for low value-adding services as mentioned above. The simplified method has been broken down by the OECD into 3 steps.

- The first step is to pool all low value-adding costs associated with all group companies within an MNE.
- The second step is to remove costs from this pool that relates to a specific company within the group.
- The third step is to determine an ‘allocation key’ which will be used to allocate the pool of costs among the different companies in the group. This allocation key should represent the benefit that each company derives from the pool of costs. Each type of service can have a different key, for example human resource functions’ allocation key may be the number of staff per company etc.

A profit mark-up should then be used for all low value-adding intra-group services. The mark up should not be less than 2% and not be more than 5% of the relevant cost.

When it comes to determining the costs associated with the profit mark-up method, the OECD recommends that the following ‘shareholders activities’ not be on-charged. The costs associated with ‘shareholder activity’ do not add value to the subsidiary business.

The following shareholder activities are not regarded as services:

- Costs related to the juridical structure of the parent company itself, such as shareholders meetings, the issuing of shares, listing costs and the costs of a supervisory board;
- Costs relating to reporting requirements of the parent company, including the consolidation of reports;
- Costs of raising funds for the acquisition of participations and costs relating to the parent company’s investor relations such as communication strategy with shareholders;
- Costs relating to compliance of the parent company with tax laws; and
- Costs which are ancillary to the corporate governance of the multinational entity as a whole.

According to commentary from KPMG, this simplified method could lead to significant compliance cost saving by MNEs when determining intergroup pricing for low value adding services. [72]

[72] KPMG (2014). *OECD - Transfer pricing and BEPS Action 10 discussion draft,* KPMG LLP [Online] Available from http://www.kpmg.com/global/en/issuesandinsights/articlespublications/taxnewsflash/pages/2014-2/oecd-transfer-pricing-and-beps-action-10-discussion-draft.aspx [Accessed 20 December 2014]

By implementing the above theory in the local legislation or guidelines to the application of TP countries can stop BEPS from taking place through excessive management fees which is a significant risk.

**Action 13: Country by country reporting as suggested by the OECD in their Action Plan**

Action 13 of the BEPS Action Plan recognises that enhanced transparency for tax administration will assist countries in evaluating TP risks in order to address BEPS appropriately

The OECD suggests standards for TP documentation and a template for the different levels of documentation and recognises the following three objectives for TP documentation:

- '*to ensure that taxpayers give appropriate consideration to transfer pricing requirements in establishing prices and other conditions for transactions between associated enterprises and in reporting the income derived from such transactions in their tax returns;*
- *to provide tax administrations with the information necessary to conduct an informed transfer pricing risk assessment ; and*
- *to provide tax administrations with the information that they require in order to conduct an appropriately thorough audit of the transfer pricing practices of entities subject to tax in their jurisdiction.*'[73]

The OECD further suggests a three tiered approach to TP documentation in order to achieve the objectives. They also suggest a standardised approach to TP documentation. The three tiers of TP documentation are:

- The master file. This file will contain general information about the MNE, the group structure, the nature of its global business and the global allocation of economic activity and profits. This is a high level report of the MNE's business including its intercompany financial activities and tax positions.
- The local file. This file provides detail information about specific transactions. The local file information will contain the TP analysis of certain transactions. The analysis will include a comparability analysis and the selection of the TP method.
- A country-by country report. That report requires disclosure of activities in different tax jurisdictions as well as global allocation of income, taxes paid and activity in the different jurisdictions. This reporting will assist in high level TP risk assessment procedures.

The OECD has provided templates that can be used when designing the TP documentation requirements. TP documentation requirements need to be built into domestic legislation taking into consideration various factors. The time frame for documentation and frequency of updates, materiality of transactions, confidentiality of information, penalties for non-compliance and the language of reporting are just some of the issues that need to be taken under consideration.

[73] OECD (2014i). *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing

KPMG has recently undertaken a survey with their offices in different countries with regards to BEPS. The questions asked were:

"*Do you expect that the BEPS project and related developments will lead to changes in:*

*(a) the behaviour of tax authorities; and*

*(b) requirements (i.e. especially in relation to new requirements for TP documentation including country by country reporting – cf. Action 13 of OECD Action Pan on BEPS) in your country? And what is your expectation in relation to timing of changes?*"

This gives a global perspective of the attitude towards the BEPS project. In general all countries have welcomed the work of the OECD and authorities are working towards making changes as suggested by the OECD. Please see Annexure A for detailed responses received from the different KPMG offices.

Deloitte makes the following comment on the Action 13 released by the OECD:

'*The OECD proposes very significant changes to the compliance and reporting of global information for risk assessment and transfer pricing purposes. Whilst some key issues on the filing and sharing of information remain to be decided, the requirements are taking shape and businesses will need to prepare for them.*

*As a practical matter, it is likely that only the parent company will be able to obtain the information necessary to prepare the country-by-country information and the master file. For businesses that do not prepare their transfer pricing documentation on a global basis, the new approach will require a substantial change. Even if businesses do prepare their documentation on a global basis, the new guidance is likely to require the compilation and explanation of substantially more information than currently.*

*Businesses are also likely to find that it is necessary to prepare or coordinate their documentation centrally to ensure that the country-by-country template, master file and local files provide consistent information about global and local operations and transfer pricing policies. There will be a need to implement new procedures to locate, collect, store, validate and assemble the information. The increase in transparency and the greater need for global consistency may require some businesses to increase the resources devoted to transfer pricing compliance, and the collection of data for the country-by-country template*.'[74]

### 3.3.4 Conclusion

[74] Deloitte (2014d), *BEPS Action 13: Transfer Pricing Documentation and Country – by – Country Reporting,* Deloitte Touche Tohmatsu Limited [Online] https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-uk-beps-action-13.pdf [Accessed 23 December 2014]

With the implementation of the new TP legislation in the ITA, National Treasury has aligned itself with international rules and legislation. There have however been very little guidelines provided to taxpayers with regards to implementing the TP rules and applying the arm's length principle. The only guideline given to date has been the thin capitalisation draft interpretation note to help taxpayers in applying the arm's length principle to financial transactions and interest between related parties.

Up to date there have also not been standardised requirements for TP documentation. SARS does request TP documentation from companies from time to time but this is not required to be kept by law. It would be recommended that SARS uses the work performed by the OECD to provide guidelines to taxpayers in order to apply the arm's length principle and prepare TP documentation.

Once the OECD finalises their work on TP, the requirements or guidelines can be used in providing guidance to taxpayers.

## 3.4 Treaty abuse

### 3.4.1 Introduction

Currently there are over 3000 negotiated bilateral tax treaties in the world. Approximately 75% of these are identical to the wording used in the OECD Model tax convention. The DTAs are the most important part of international tax and govern income from cross border transactions. [75]The original intention of DTAs was to prevent double taxation between different jurisdictions but the unintended consequence was double non taxation.

According to the OECD treaty abuse is one of the main concerns and risk areas for BEPS. Treaty abuse in some cases can lead to double non taxation. MNEs therefore implement their operations in countries that have favourable treaties with other countries in order to exploit these benefits.

Action 6 of the BEPS Action Plan specifically recognises the need for anti-abuse legislation that prevents the granting of treaty benefits in inappropriate circumstances. Work will also need to be done to ensure that double non taxation is addressed and that significant issues be taken into account before entering into DTAs with other countries.[76]

In the work performed by the OECD, two types of treaty benefits in 'inappropriate circumstances' were identified. There are cases where a company tries to circumvent limitations provided by the treaty or the provisions of domestic legislation using treaty benefits.

[75] Avi-Yonah, Reuven S., Double Tax Treaties: An Introduction (December 3, 2007). Available at SSRN: http://ssrn.com/abstract=1048441 or http://dx.doi.org/10.2139/ssrn.1048441

[76] OECD (2014a), *BEPS Action 6:Preventing the granting of treaty benefits in inappropriate circumstance,* OECD Publishing

An example of when a company tries to circumvent the limitations of the treaty includes 'treaty shopping'. This exists mainly where a resident of a third State is aiming to access the benefits of a treaty between two Contracting States. The 'beneficial owner' concept was introduced by the OECD for this very reason. The 'beneficial owner' concept cancels out where dividends are paid to one party but that party is obliged to pay the dividend on. It would be difficult to curb treaty shopping by way of domestic legislation; this would rather have to be done by implementing anti-abuse rules within the treaties. The OECD recommends that the 'Entitlement to benefits' article be included in the tax treaty. The entitlement to benefits article has already been added in treaties concluded by the United States, Japan and India and aims to curb treaty shopping; there are also existing provisions in the OECD Model tax convention to curb other forms of treaty abuse. [77]

For treaty shopping the OECD makes the following three pronged approach recommendation:

- '*First, it is recommended to include in the title and preamble of tax treaties a clear statement that the Contracting States, when entering into a treaty, wish to prevent tax avoidance and, in particular, intend to avoid creating opportunities for treaty shopping,*
- *Second, it is recommended to include in tax treaties a specific anti-abuse rule based on the limitation-on-benefits provisions included in treaties concluded by the United States and a few other countries. Such a specific rule will address a large number of treaty shopping situations based on the legal nature, ownership in, and general activities of, residents of a Contracting State,*
- *Third, in order to address other forms of treaty abuse, including treaty shopping situations that would not be covered by the specific anti-abuse rule described in the preceding paragraph (such as certain conduit financing arrangements), it is recommended to add to tax treaties a more general anti-abuse rule. The benefits of a tax treaty should not be available where one of the main purposes of arrangements or transactions is to secure a benefit under a tax treaty and obtaining that benefit in these circumstances would be contrary to the object and purpose of the relevant provisions of the tax treaty.*'[78]

In cases where a person circumvents domestic legislation by using treaty provisions, anti-abuse rules are required in domestic legislation. There are tax avoidance issues that are created by domestic legislation and facilitated by treaties. Avoidance issues of this nature include:

- thin capitalisation and other finance arrangements,

[77] OECD (2014a), *BEPS Action 6:Preventing the granting of treaty benefits in inappropriate circumstance,* OECD Publishing

[78] OECD (2014a). *Preventing the Granting of Treaty Benefits in Inappropriate circumstances,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing

- dual residence strategies,
- non compliance with TP requirements,
- exploitation of mismatches between different countries legislation, and
- transactions that abuse the relief given by DTAs.

The interaction between local legislation and treaties is therefore important. Many of the aforementioned tax avoidance methods are covered under other points in the OECD's Action Plan on BEPS.

### 3.4.2 Treaty Abuse in South Africa

SARS has already started reviewing and revising existing treaties. Mauritius has always posed a threat to the South African tax base as it is closely situated to South Africa with a low tax rate. On the 17th of May 2013, South Africa and Mauritius concluded a new DTA. The new DTA is not yet in effect as it is still going through the final stages of approval.

In the past, for those taxes covered by the treaty, dual resident companies would be treated as being tax resident solely where the place of effective management (POEM) was located. However, the new treaty contains a different tie breaker clause. In future the authorities of the two Contracting states will settle the question of dual residence by way of mutual agreement. If no agreement is reached the company falls outside the scope of the DTA, except for the provisions of Article 25·

By doing this, the certainty of a legislated provision is being substituted for the uncertainty of a negotiation between revenue authorities and in which the taxpayer will play no direct part. The dispute can also not be determined by an independent court, which is currently the case. Under the new treaty, if the two revenue authorities cannot reach consensus, the treaty simply ceases to apply to the company concerned. Given the practical application this is hardly acceptable. At the very least, the treaty should have bound the revenue authorities to submit themselves to a binding arbitration process (something which is provided for in the Organisation for Economic Co-operation and Development (OECD) rules).

Companies which are incorporated in Mauritius and have structured their affairs in such a way that they have their effective management in Mauritius (or at least not in South Africa) would not be impacted by the new treaty. By not having their POEM in South Africa, they would not be dual resident and the question for dispute/mutual agreement simply does not arise.

For these companies (incorporated in Mauritius), the challenge is to ensure that there is no effective management in South Africa, and often this is challenging, which is why so many Mauritian structures are at risk. They were however always at risk, as the tie-breaker under the existing treaty breaks in favour of the country where the POEM is located.

For companies incorporated in South Africa, but with Mauritian tax resident status (which will require management and control from Mauritius), the mutual agreement procedures creates real uncertainty, as they would be dual residents.

On the one hand, where the Mauritian company is correctly set up, incorporated in Mauritius and run as an independent company with substance and effectively managed in Mauritius, there is no risk. On the other hand, in any other cases, there is no doubt that the new treaty deprives a taxpayer of legal rights to obtain a more certain outcome.

The new treaty is unattractive for at least three other reasons as well. Under the current treaty, interest and royalties payable to a Mauritian company are free from SA withholding tax. In addition, under the existing treaty, it is fairly easy to escape South African capital gains tax on capital gains generated by a Mauritian treaty resident from an interest in fixed property situated in South Africa and held through a company (and, of course, Mauritius does not levy capital gains tax).

Under the new treaty:

- Interest payable to a Mauritian company will, generally, be subject to a 10% South African withholding tax;
- Royalties paid to a Mauritian company will, generally, be subject to a 5% South African withholding tax; and
- Capital gains generated by a Mauritian tax resident could be subject to South African capital gains tax if the gain results from a disposal of shares deriving more than half of their value from fixed property in South Africa.

### 3.4.3 Conclusion

SARS is currently taking active steps to renegotiate tax treaties in order to curb 'treaty abuse'. It may be beneficial to add an 'entitlement to benefits' section in the South African DTAs as recommended by the OECD in order to stop MNE's from abusively using the DTAs (this Article already appears in the United States and Japan DTA).Perhaps, instead of having to re-negotiate all treaties, a multilateral instrument to cover the BEPS issues which will then additionally from part of the DTAs should be developed.

# 4 Conclusion

## 4.1 Summary of findings in respect of the research problem

South Africa is exposed to BEPS and various different ways. South Africa has taken active steps in protecting the economy from BEPS. The OECD has already done extensive work on BEPS and issued papers in line with the time frame provided by their Action Plan on BEPS. The work of the OECD seems to have been welcomed by the OECD and the G20 and it appears to be a collaborative process.

There are some concerns with the work performed by the OECD, they have not provided a timeline for implementation of their recommendations by the various jurisdictions. This could lead to staggered implementation which could make a jurisdiction that early adopts uncompetitive in the international market. South Africa has already implemented legislation

to address the risk of BEPS. Has this not already put South Africa in an uncompetitive position?

Even though BEPS is a domestic tax issue the OECD fails to address domestic tax avoidance which is just as much a risk to tax authorities. It is unknown how countries will react to the recommendations made by the OECD.

***Controlled Foreign Company (CFC) regimes***

From the CFC legislation that is in place as an anti-deferral provision, South Africa seems to be adequately protected from BEPS in this respect as essentially all passive income with the exception of certain limited industries will be imputed for South African income tax purposes. It is also in line with the Cadbury Schweppes Overseas judgement that only entities that do not have genuine operations in the CFC's country should be imputed in the South African residents' income. Even though the legislation may be adequate it is a complicated set of rules which is not easy to apply, and could lead to the misinterpretation and misapplication of the legislation.

The South African Revenue Service has limited resources and possibly do not have the skills to audit the application of the provisions, this could leave the system vulnerable to abuse.

CFC rules differ considerably between different jurisdictions. The OECD has not as yet released any recommendations or publications with regards to CFC legislation. It would be important to look at any recommendations made as currently CFC legislation differs considerably between different jurisdictions. What is a concern however is that the OECD seems to favour the OECD member states as opposed to the G20 emerging economies with the focus being on resident taxation instead of taxation at source.

***Financial payments***

National Treasury should give some consideration to the recommendations made by the OECD for domestic legislation purposes with regards to hybrid arrangements. The current legislation that is in place may have adverse tax consequences for taxpayers which could make South Africa unattractive to foreign investment or may make South African residents commercially uncompetitive.

At the time of writing this research report, no recommendation had been issued on Action point 4: Limit Base erosion via interest deductions and other financial payments. National Treasury has however already taken precaution in the form of section 23M and section 23N as discussed. When the OECD releases its recommendations SARS can re-evaluate the legislation.

Based on the legislation that is in place and that SARS is planning to implement South Africa seems to be adequately protected from a BEPS perspective. One will however have to assess the impact of the interest deduction limitations as well as the IWT on the economic investment into South Africa. The legislation may deter foreign investment and could be detrimental to the growth of the economy.

***Transfer Pricing***

With the implementation of the new TP legislation in the ITA National Treasury aligned itself with international rules and legislation. There have however been very little guidelines provided to taxpayers with regards to implementing the TP rules. The only guideline given to date has been the thin capitalisation draft interpretation note to help taxpayers in applying the arm's length principle to financial transactions and interest between related parties.

Up to date there have also not been standardised requirements for TP documentation. SARS does request TP documentation from companies from time to time but this is not required to be kept by law. It would be recommended that SARS uses the work performed by the OECD to provide guidelines to taxpayers in order to apply the arm's length principle and prepare TP documentation.

Once the OECD finalises their work on TP, the requirements or guidelines can be used in providing guidance to taxpayers.

***Treaty Abuse***

SARS is currently taking active steps to renegotiate tax treaties in order to curb 'treaty abuse'. It may be beneficial to add an 'entitlement to benefits' section in the South African DTAs as recommended by the OECD in order to stop MNE's from abusively using the DTAs (this article already appears in the United States and Japan DTA).Perhaps, instead of having to re-negotiate all treaties, a multilateral instrument to cover the BEPS issues which will then additionally from part of the DTAs should be developed.

## 4.2 Potential areas of future research

Further research can be done as the OECD gets further in their Action Plan on the implementation of their recommendations and the effect on global economies. For example, will staggered implementation lead to an international advantage? It would also be interesting to observe how low tax jurisdictions react to the recommendation of the OECD as in many cases they are the lead cause for BEPS.

While amendments to the OECD TP Guidelines or Commentary on the OECD Model Tax Convention can be made with relative speed, amendments to the network of over 3,000 bilateral tax treaties would require these treaties to be individually renegotiated. Not only would this be an extremely lengthy process requiring significant resources, but may prove problematic if there are existing tensions between countries who may not wish to enter into a negotiation without a full reconsideration of the terms of the treaty.

Further research could be done to investigate the creation of a new multilateral instrument which would allow countries to adopt specific measures without having to individually renegotiate treaties. In the OECDs work so far it has determined that such an instrument is necessary and feasible.

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**Annexure A - The BEPS Action Plan**

| **Action** | **Description** | **Expected output** |
|---|---|---|
| **Action 1:**<br><br>Address the challenges of the digital economy | Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. | Report identifying issues and possible actions to address the issues by September 2014.<br><br>Paper on tax challenges in the digital economy published on 16 September 2014 |
| **Action 2:**<br><br>Neutralize the effects of Hybrid mismatch arrangements | Develop model treaty provisions and recommendations for the design of domestic rules to neutralize the effect (e.g., double non-taxation, double deduction, long-term deferral) of hybrid instruments and hybrid entities | Revise OECD Model Tax Convention and make recommendations regarding the design of domestic rules by September 2014<br><br>Paper on hybrid mismatch arrangements published on 16 September 2014 |
| **Action 3:**<br><br>Strengthen CFC rules | Develop recommendations regarding the design of CFC rules | Recommendations regarding design of domestic rules by September 2015 |
| **Action 4:**<br><br>Limit Base erosion via interest deductions and other financial payments | Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial | Recommendations regarding design of domestic rules by September 2015; changes to transfer pricing guidelines by December 2015 |

| | | |
|---|---|---|
| | payments that are economically equivalent to interest payments. | |
| **Action 5:**<br><br>Counter Harmful tax practices more effectively, taking into account transparency and substance | Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring "substantial activity" for any preferential regime | • Finalize review of member country regimes by September 2014<br><br>• Establish strategy to expand participation to non-OECD members by September 2015<br><br>• Revise existing criteria for identifying preferential regimes by December 2015<br><br>Paper on harmful tax practice published on 16 September 2014 |
| **Action 6:**<br><br>Prevent Treaty abuse | Develop model treaty provisions recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances | Changes to the OECD Model Tax Convention and recommendations regarding domestic rules by September 2014<br><br>Paper on prevention of the abuse of treaties published on 16 September 2014 |
| **Action 7:**<br><br>Prevent the artificial | Develop changes to the definition of permanent establishment (PE) to prevent the artificial avoidance of PE | Changes to the OECD Model Tax Convention due by |

| | | |
|---|---|---|
| avoidance of PE status | status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions | September 2015 |
| **Action 8:**<br><br>Assure that transfer pricing is in line with value creation/intangibles | Develop rules to prevent BEPS by moving intangibles among group members including: adopting a broader and clear definition of intangibles, ensuring that profits associated with the transfer of intangibles are associated with value creation, developing special rules for hard-to-value intangibles, and updating guidance on cost contribution arrangements | Changes to the OECD transfer pricing guidelines and the model tax convention by September 2014 - September 2015<br><br>Paper on transfer pricing issues in the key area of intangibles published on 16 September 2014 |
| **Action 9:**<br><br>Assure that transfer pricing outcomes are in line with value creation/risks and capital | Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members including adopting rules to prevent inappropriate returns from accruing to entities solely on the basis of provision of capital or contractual assumption of risks | Changes to transfer pricing guidelines and possibly the OECD Model Tax Convention by September 2015 |
| **Action 10:**<br><br>Assure that transfer pricing outcomes are in line with value creation/other high risk transactions | Develop rules to prevent BEPS by engaging in transactions that would not, or would occur only very rarely between third parties including adopting re-characterization rules, clarifying the application of transfer pricing methods in GVCs, and protecting against base eroding payments such as management fees and head office expenses | Changes to transfer pricing guidelines and possibly the OECD Model Tax Convention by September 2015 |
| **Action 11:**<br><br>Establish | Develop recommendations on the indicators of the scale and economic | Recommendations on data to be collected and analytic |

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| methodologies to collect and analyze data on BEPS and the actions to address it | impact of BEPS and ensure tools are available to assess effectiveness and impact of measures to address BEPS | methodologies by September 2015 |
| **Action 12:**<br><br>Require taxpayers to disclose their aggressive tax planning arrangements | Develop recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures, taking into consideration the | Recommendations regarding the design of domestic rules by September 2015 |
| **Action 13:**<br><br>Re-examine transfer pricing documentation | Develop rules regarding transfer pricing documentation to enhance transparency, including a requirement that multinational entities provide all "relevant governments" with information on global allocation of income, economic activity, and taxes paid among countries in accordance with a common template | Changes to transfer pricing guidelines and recommendations for the design of domestic rules by September 2014<br><br>Paper on transfer pricing documentation and a template for country by country reporting published on 16 September 2014 |
| **Action 14:**<br><br>Make dispute resolutions more effective | Develop solutions to address obstacles that prevent countries from solving treaty-related disputes under Mutual Agreement Procedures (MAP), including the absence of arbitration provisions and denial of access to MAP in certain cases | Changes to the OECD Model Tax Convention by September 2015 |
| **Action 15:**<br><br>Develop a multilateral instrument | Analyze tax and public international law issues related to the development of a multilateral instrument to enable jurisdictions that wish to do so to implement BEPS measures and amend existing bilateral treaties | • Report on relevant public international law and tax issues by September 2014<br><br>• Develop a multilateral |

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| | | instrument by December 2015<br><br>Paper on feasibility of developing a multilateral instrument published on 16 September 2014 |

**Annexure B**

**Country survey on BEPS**

*Question asked: "Do you expect that the BEPS project and related developments will lead to changes in (a) the behaviour of tax authorities and (b) requirements (i.e. especially in relation to new requirements for transfer pricing documentation including country by country reporting – cf. Action 13 of OECD Action Pan on BEPS) in your country? And what is your expectation in relation to timing of changes?"*

| OECD | Contact | Full Response | Are BEPS initiatives likely to increase requirements in the country? |
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| **Australia** | Anthony Seve<br>Email: aseve@kpmg.com.au | (a) The Australian Tax Authorities (ATO) has already initiated BEPS based audits that focus on transactions with non treaty countries and in particular restructure, IP and financing transactions. As part of these reviews the ATO request disclosure of overseas supply chain information in line with the Country by Country initiative. So in some respect, BEPS is already part of the ATO field compliance activity. As Australia is leading G20 discussions we expect significant BEPS focus to continue in Australia.<br>(b) We have recently had significant TP legislation changes that incorporate the need to confirm that agreements have arms length terms and conditions and provide the ATO the power to reconstruct transactions they do not believe are arms length. Given this and the above field compliance activity we expect early adoption of country by country report. | **LIKELY** |
| **Denmark** | Henrik Lund<br>Email: henrik.lund@kpmg.com | Danish tax authorities have actively participated and provided input to the discussion around BEPS and we expect them to be in the forefront of future developments. We also expect that Danish Tax Authorities will introduce new requirements for TP documentation in line with BEPS initiatives in the future. In respect of timing we would expect the Danish tax authorities to implement the changes very close to the finalisation of the work by OECD | **LIKELY** |

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| **Japan** | Jun A Tanaka<br>Email:<br>jun.a.tanaka@jp.kpmg.com<br><br>Ayako Suzuki<br>Email:<br>ayako.sukuzi@jp.kpmg.com | Yes, it is envisaged that the Japanese transfer pricing regulations will be revised in line with the OECD guidelines/BEPS project if there are any material changes or new developments such as CBC reporting.<br>Usually any amendments of the Japanese transfer pricing regulations are promulgated within one year or so, after the OECD guidelines are revised. | **LIKELY** |
| **New Zealand** | Kim Jarrett<br>Email: kmjarrett@kpmg.co.nz | *Do you expect that the BEPS project and related developments will lead to changes in the behaviour of tax authorities?*<br>Yes. As New Zealand is involved in Working Party No. 6 of the OECD Committee on Fiscal Affairs we expect that the New Zealand tax authorities will fully endorse and support the guidelines produced. Specifically, we expect there to be an increased focus on the pricing of intangibles.<br>*Do you expect that the BEPS project and related developments will lead to changes in requirements (i.e. especially in relation to new requirements for transfer pricing documentation including country by country reporting – cf. Action 13 of OECD Action Pan on BEPS) in your country?* There may potentially be an increased level of documentation required in line with the final agreement on country by country reporting.<br>*And what is your expectation in relation to timing of the changes?*<br>We have received no specific indications as yet. However, for larger taxpayers (i.e. with turnover greater than NZD $80 million) the tax authorities have indicated that increased disclosure requirements will be necessary as part of the annual tax return process. Such requirements are anticipated to have transfer pricing implications. In addition, we expect that the balance of any BEPS-related changes will occur in the next two years once the BEPS agenda has been finalised. | **LIKELY** |
| **Korea** | Gil Won Kang<br>Email:<br>gilwonkang@kr.kpmg.com | As an OECD member, Korea has followed almost all OECD initiatives. In reference to the BEPS, Korean tax authorities will try to change the law to reflect OECD recommendation after OECD revised the TP guidelines. | **LIKELY** |

| G20 | Contact | Full Response | Are BEPS initiatives likely to increase requirements in the country? |
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| **China** | Cheng Chi<br>Email: cheng.chi@kpmg.com<br><br>Ho-Yin Leung<br>Email: hoyin.leung@kpmg.com | The Chinese tax authorities have actively followed the development of the BEPS regime and could even contemplate regulatory changes in order to adopt key elements of BEPS. Based on our market intelligence, the State Administration of Taxation (SAT), China's highest tax authority, is expected to publish a revised version of the prevailing transfer pricing guidelines in China contained in Circular Guoshuifa [2009] No. 2 (Circular 2), which will likely provide additional requirements regarding various aspects of a Chinese taxpayer's transfer pricing, including documentation. However, taxpayers should note that China already has extensive documentation requirements that align with the proposed approach put forth by the OECD. Although the timing has not been confirmed by the tax authorities, the revised Circular 2 is expected to be issued by the end of 2014. | **LIKELY** |
| **India** | Rohan K Phatarphekar<br>Email: rohankp@kpmg.com<br><br>Atul Jain<br>Email:<br>atuljain1@bsraffiliates.com | Indian tax authorities have been actively participating in the BEPS discussions. As a key member of the G20, India's role in BEPS project is considered critical. A special delegation of Business and Industry Advisory Committee (BIAC) to OECD specifically met Indian tax authorities earlier this year to discuss BEPS project. In several public-forum discussions with the Indian tax authorities, we understand that they are actively providing inputs on various BEPS action items, from specific view point of India.<br>The Country-by-Country reporting requires greater disclosure of global value chain, key personnel in various jurisdictions, key financial metrics of group entities. The overall objective is greater transparency and better risk assessment. In India, a lot of such details are increasingly being asked by tax authorities / transfer pricing officers during their routine transfer pricing audits already. We expect India to increasingly adopt the c-b-c norms both through legislative amendments and in practice (during their information requests for TP audits). | **LIKELY** |

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| **Indonesia** | Iwan Hoo<br>Email: iwan.hoo@kpmg.co.id | Indonesia is one of the non-OECD countries contributing to the BEPS initiative. At the level of the Directorate General of Taxation consequently there is a great awareness of the TP issues related to BEPS. However, in the field the tax auditors are still getting to grips with TP in general and are struggling to even apply basic principles to TP issues. However, as their experience and knowledge improves going forward, BEPS may indeed be in the forefront of their attention | **LIKELY** |
| **South Africa** | Natasha Vaidanis<br>Email:<br>Natasha.vaidanis@kpmg.co.za<br><br>Jonathan Sweidan<br>Email:<br>Jonathan.Sweidan@kpmg.co.za | As a G20 member state, South Africa is in the forefront of international co-operation on base erosion and profit shifting ("BEPS"), which in July 2013 led to the formation of the BEPS Action Plan under the auspices of the Organisation for Economic Co-operation & Development ("OECD"). South Africa's observer status in the work of the Committee of Fiscal Affairs ("CFA") and its close ties with the management and staff of the Centre for Tax Policy and Administration ("CTPA") has significantly assisted the South African Revenue Service in building capacity and enhancing its knowledge and skills in respect of tax administration. As an observer to the OECD's CFA and by working in close collaboration with the OECD on various projects including Tax and Development, Transfer Pricing, Compliance and the exchange of tax information issues, SARS has been able to review and benchmark its own systems and strategies and to advise other countries, through inbound and outgoing study visits, as well as a member of the African Tax Administration Forum. Furthermore SARS is a member of the BEPS committee bureau and is moving towards automated data exchange between member countries and country peer reviews. Going forward, SARS will be focussing on fragmentation of the supply chain globally, treaty abuse and the treatment of intangibles in order to increase its access to information, South Africa has already signed the ATAF Agreement on Mutual Assistance in Tax Matters which allows for the sharing of skills and expertise in all tax matters, most notably including transfer pricing and exchange of information. South Africa is also busy ratifying the Foreign Account Tax Compliance Act (FATCA). South Africa is also targeting the digital economy through its recently implemented 'VAT on electronic services'. One can therefore expect a firm fight from SARS against BEPS by collaborating with the OECD and the rest of Africa against this phenomenon. | **LIKELY** |

| Other | Contact | Full Response | Are BEPS initiatives likely to increase requirements in the country? |
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| **Malaysia** | Bob Kee<br>Email: bkee@kpmg.com.my<br><br>Chang Mei Seen<br>Email:<br>meiseenchang@kpmg.com.my<br><br>Ern Suey Wun<br>Email: eswun@kpmg.com.my | The Malaysian tax authorities are actively involved in the BEPS initiatives, with the head of the Multinational Tax Department sitting in the Peer Review Group which discusses peer review reports that are finally adopted by Global Forum members as well as working party discussions on intangibles. They are planning to invite major accounting firms to provide our feedback with regard to this matter. We are also expecting the Malaysian tax authorities to introduce new requirements for TP documentations in line with BEPS in the future. As for the timing, the Malaysian tax authorities would be following closely on the BEPS Action Plans by OECD and we would expect changes if they can be implemented in Malaysia post September 2014. Although Malaysia is not an OECD country, the Malaysian Tax Authority participated in OECD as well as UN initiatives/developments in respect of transfer pricing matters. | **LIKELY** |
| **Singapore** | Geoffrey Soh<br>Email:<br>geoffreysoh@kpmg.com.sg | Although Singapore is not an OECD member, Singapore tax authorities have actively engaged with and provided input to the OECD. They have seconded officials to the OECD Working Party 6, to assist in fleshing out the BEPS Action Plan items.<br>A consultation paper concerning tweaks to existing transfer pricing guidance and expanded requirements (in response to BEPS concepts) will be released next month. Subject to public input, this paper is expected to be finalized into new requirement in Dec 2014 or early next year. | **LIKELY** |
| **Thailand** | Kullakattimas Benjamas<br>Email: Benjamas@kpmg.co.th | Although Thailand which is not a member of OECD has not seriously taken the OECD Action Plan on BEPS but the discussion around BEPS project leads Thai tax authorities to take the further steps in respect of transfer pricing issue. It is anticipated that the Thai tax authorities will introduce the Transfer pricing law to replace the current transfer pricing guidelines. We expect that the new regulation will include the disclosure requirement and/ or mandatory transfer pricing documentation. There is no disclosure for the timeline at this stage but it is expected some new rules next year. | **LIKELY** |

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| **Hong Kong** | Kari Pahlman<br>Email: kari.pahlman@kpmg.com<br><br>Jeffrey Chan<br>Email: Jeffrey.chan@kpmg.com | a) The Hong Kong IRD has been monitoring and acknowledging the global developments regarding the ongoing BEPS initiative but has not been actively involved in driving the global tax policy development process. In one respect the IRD has already shifted its behaviour and responded to BEPS on an enforcement level by launching a large number of tax and transfer pricing focused audits. One key take away from the audits so far is the IRD is dissatisfied with the level of transfer pricing documentation prepared and maintained by Hong Kong taxpayers. As a result, future taxpayer scrutiny is likely to intensify as the IRD becomes increasingly sophisticated and also wary of international perception / pressure that Hong Kong, as a low tax jurisdiction, would be aiding multinationals in producing BEPS incompliant outcomes.<br>b) The IRD has not specifically set out its position and timeline for local adoption of the BEPS actions to Hong Kong taxpayers. Historically, Hong Kong's transfer pricing framework has been closely aligned and reliant on the OECD guidelines and principles. In this context, we anticipate there is a strong possibility of Hong Kong following the OECD's lead and adopting BEPS initiatives, potentially on a gradual basis. | **LIKELY** |
| **Vietnam** | Hoang Thuy Duong<br>Email: dthoang@kpmg.com.vn | The Vietnamese tax authority does not have a clear indication of adopting BEPS. Vietnam is not yet an OECD member and the laws do not require adoption of OECD guidelines although the Vietnamese tax authority appear willing to apply international best practice in particular cases. In our recent discussions, actually they said they were not interested in BEPS. That said, as the local transfer pricing regulations are scheduled to be revised, there is a possibility that the tax authority watches out for the development of BEPS in their proposed revisions of the regulations including those on transfer pricing documentation. | **UNLIKELY** |
| **Bangladesh** | Adeeb H. Khan<br>E: adeebkhan@kpmg.com | Bangladesh adopted Transfer Pricing (TP) regulations for the first time in 2013. These are effective from 1 July 2014. However, there is still some uncertainty on how it will be implemented.<br>Tax officials are becoming more sensitive about local profits shown by multinationals operating in Bangladesh. However that concern turning into anything more than implementation of above newly introduced TP rules is unlikely at this stage. | **UNLIKELY** |

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| **Dubai** | Nilesh Ashar<br>E: nashar@kpmg.com<br><br>Jyothi Kasi<br>Email: Jkasi@Kpmg.com | The Gulf region does not have very detailed tax regulations. The UAE in fact does not enforce corporate income tax except on foreign banks and oil companies. Even though authorities in the region are looking to enter into more tax treaties to encourage cross border investments, we do not expect the UAE to introduce corporate income tax or transfer pricing regulations – atleast there is no discussion in the public domain on this as yet by the authorities. | **UNLIKELY** |