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Base Erosion and Profit Shifting in South Africa: A critical analysis of the effectiveness of the transfer pricing rules with regard to the elimination of profit shifting.

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DECLARATION

I declare that this research is my own unaided work. It is submitted for the degree of Masters in Commerce in 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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ABSTRACT

Tax base erosion and profit shifting (BEPS) is a key tax issue both locally and internationally. Multinational corporations are constantly trying to find means of reducing the amount of taxation that is payable by identifying gaps in tax laws. The aim is to lower the taxation that the group would be liable for. This study will analyse the developments of tax base erosion and profit shifting. There will also be an examination and comparison of South African transfer pricing laws with other countries' tax laws (United State of America, United Kingdom, Australia and Nigeria), specifically with regards to discouraging profit shifting in order not to obtain a tax advantage. Section 31 of the Income Tax Act 58 of 1962, is one of the tools that is currently being utilised by South Africa in addressing the issue of profit shifting. An analysis of Section 31 will be undertaken and it will be necessary to consider whether there are any loopholes or vagueness in the tax laws that may result in taxpayers manipulating the interpretation of the law in order to obtain a tax advantage. Profit shifting is a global problem that has left many countries deliberating on what could be an ideal solution. This study will also propose recommendations that might be used by Commissioner for the South African Revenue Service.

Key Words: tax base erosion, profit shifting, impermissible tax avoidance, Organisation for Economic Co-operation and Development, aggressive tax planning, transfer pricing, tax gap, tax avoidance, scheme, abnormalities, advanced pricing agreement, commercial substance, base erosion and profit shifting,

LIST OF ACRONYMS

APA	Advanced pricing agreement
BEPS	Base erosion and profit shifting
CFC	Controlled Foreign Company
DTC	Davis Tax Committee
HMRC	Her Majesty's Revenue and Customs
IRS	Internal Revenue Service, USA
SARS	South African Revenue Sevice
TP	Transfer Pricing
MAP	Mutual agreement procedure
MNEs	Multinational enterprises
OECD	Organisation for Economic Co-operation and Development,
PE	Permanent Establishment
USA	United State of America
UK	United Kingdom

TABLE OF CONTENTS

CHAPTER 6 Discussion and conclusion

CHAPTER 1

INTRODUCTION

1.1 BACKGROUND

BEPS is a tax term used to describe international tax planning strategies that rely on mismatches and gaps that exist between the tax rules of different jurisdictions, to minimise multinational entities' tax that is payable by the group, by either making tax profits 'disappear' or shifting profits to low tax jurisdictions where there is little or no genuine activity. According to the Financial Times (n.d.):

> BEPS strategies are not illegal; rather they take advantage of different tax rules operating in different jurisdictions, which may not be suited to the current global and digital business environment.

Profit shifting can be regarded as a tax avoidance scheme and in terms of the OECD (n.d.), tax avoidance is an:

> ... arrangement of a taxpayer's affairs that is intended to reduce its ability and that although the arrangement could be strictly legal, it is usually in contradiction with the intent of the law it purports to follow.

It is important to note that tax avoidance is not tax evasion. Tax evasion is where a taxpayer unlawfully arranges his affairs in such a way that he escapes any tax liability which he ought to pay. Multinational entities that are involved in profit shifting activities usually take advantage of the poorly written tax laws. In an increasingly interconnected world, national tax laws have not kept pace with global corporations, fluid capital, and the digital economy, leaving gaps that can be exploited by companies who avoid taxation in their home countries by pushing activities (genuine or otherwise) abroad to low or no tax jurisdictions. This undermines the fairness and integrity of the tax systems.

According to the OECD's Action Plan report on base erosion and profit shifting, there are 15 specific actions that are needed in order to equip governments with instruments that would address the arrangements those results to double non-taxation. These 15 actions include:

- Address the tax challenges of the digital economy.
- Neutralise the effects of hybrid mismatch arrangements.
- Strengthen Controlled Foreign Corporation (CFC) rules.

- Limit base erosion via interest deductions and other financial payments.
- Counter harmful tax practices more effectively, taking into account transparency and substance.
- Prevent treaty abuse.
- Prevent the artificial avoidance of permanent establishment status.
- Develop rules to prevent BEPS by moving intangibles among group members.
- Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members.
- Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties.
- Establish methodologies to collect and analyse data on BEPS and the actions to address it.
- Require taxpayers to disclose aggressive tax planning arrangements, this would be a case whenever a taxpayer actively push limits of what is allowed in terms of the law e.g. this may be stretching the definition of a term in legislation to access a loophole, or dressing up an arrangement so that it appears to be something else (Beattie, 2015).
- Make dispute resolution mechanisms more effective.
- Analyse the tax and public international law issues related to the development of a multilateral instrument.
- Re-examine transfer pricing documentation.

In terms of the OECD (n.d.), profit shifting reduces government revenue and it contributes to the increase in the tax gap, therefore it is critical for governments to prevent it at all costs. Some of the effects of profit shifting include a corrosive effect upon taxpayer compliance, the uneconomic allocation of resources, upward pressure on marginal tax rates, an unfair redistribution of the tax burden and a weakening of the ability of Parliament and National Treasury to set and implement economic policy.

Transfer pricing rules play a critical role in ensuring that tax avoidance is reduced or eradicated. According to the OECD (n.d.), ‘transfer pricing is the price charged by a company for goods, services or intangible property to a subsidiary or other related company'. It results in the setting of prices among related entities. In terms of the OECD (n.d.), 'Abusive transfer pricing occurs when income and expenses are improperly allocated for the purpose of reducing taxable income'. For example, if a subsidiary company sells goods to a parent company, the cost of those goods is the transfer price. Legal entities considered under the control of a single corporation include trusts and companies that are wholly or majority owned ultimately by the parent corporation. Certain jurisdictions consider entities to be under common control if they share family members on their boards of directors. Transfer price can be used as a profit allocation method to attribute a multinational corporation's net profit (or loss) before tax to other countries where it does business.

Appropriate clarification of transfer pricing laws by the South African government, will make the implementation of transfer pricing laws easier and that might reduce non-compliance. In April 2012, an amendment to Section 31 of the Income Tax Act was done in order to modernise South African transfer pricing rules and to bring it in line with the latest transfer pricing guidelines issued by the OECD.

1.2 THE PROBLEM STATEMENT

There are a lot of uncertainties with regards to the practical application of transfer pricing rules contained in Section 31 of the Income Tax Act.

> The complexity of transfer pricing regulations and the continuously changing transfer pricing environment make it challenging for multinational companies to manage their transfer pricing position and to be compliant with the latest requirements (Wolf & Verhoosel 2014).

Non-compliance with the transfer pricing rules is increasing the tax gap and has an impact on the economic stability of South Africa. There might still be a substantial amount of uncertainty as to how SARS interprets and implements the new transfer pricing rules. Of particular interest in this regard is how SARS intends applying the arm's-length principle in the context of the thin capitalisation rules. These uncertainties may create loopholes that weaken the fight against profit shifting.

> Section 31 is causing structural problems and uncertainty, as the literal wording unduly focuses on isolated transactions as opposed to arrangements driven by an overarching profit objective. In addition, SARS is of the opinion that the language gives rise to an excessive emphasis of the Comparable Uncontrolled Price (CUP) method as opposed to other more practical transfer pricing methodologies. Further, SARS is also of the opinion that the current legislative emphasis on "price" as opposed to "profits" does not align with the wording in the associated

enterprises articles in the tax treaties concluded by South Africa (South Africa Chartered Accountant, 2014).

Due to globalisation, foreign companies are investing in South African companies or creating South African subsidiaries and the inconsistencies of the transfer pricing rules between their countries and those of South Africa can be frustrating. These inconsistencies may lead to disinvestments, therefore it is fundamental for South Africa's transfer pricing laws to be in line with international standards.

Profit shifting has continued to grow and it's causing harm in South Africa's economy. It's either that South Africa's transfer pricing laws are ineffective or they are too complicated for taxpayers. A detailed analysis of South Africa's transfer pricing laws will assist in diagnosing the root cause of the growth in profit shifting and tax base erosion. It will also be worthwhile to look at other tax authorities and the OECD to verify that South Africa's transfer pricing laws are aligned with international standards. We may also have to revisit our double tax agreements, to ensure that they do not encourage the increase of profit shifting.

The focus of this report is to determine whether the South Africa's transfer pricing rules are able to address the challenges posed by BEPS.

1.3 THE SUB-PROBLEMS

1.3.1 This research will analyse the impact of the allocation of taxable profits to locations different from those where the actual business activity takes place and how current tax laws can be adjusted to eliminate the unreasonable tax avoidance by taxpayers. The writer will look at the remedies available to SARS where such a contrived transaction has been entered into. A critical analysis of the new Section 31 of the Income Tax Act will be done in order to ascertain whether:

- It's clear and easy to understand;
- Its effectiveness in addressing profit shifting. This would be done by ascertaining whether South African transfer pricing laws are in line with international best practice. A comparison will be done between South

Africa's transfer pricing tax laws and those of some developed countries like USA and UK

- It's able to achieve its objective.

As the world is affected by BEPS, it's important to understand South Africa's exposure to BEPS and ascertain if South Africa's tax laws are stringent enough to safeguard the economy from BEPS.

1.3.2 A comparison will be done between the old and the new Section 31 of the Income Tax Act. An analysis will be done to ascertain whether it was necessary to amend the old section and if the new changes will improve compliance and reduce profit shifting.

It is yet to be seen how the new Section 31 of the Income Tax Act would be able to address challenges posed by BEPS, therefore this necessitate the importance of doing a literature review of the Section 31.

1.3.3 A comparison will be done between transfer pricing rules in South Africa and other major economies. English speaking countries that are leading tax jurisdictions with high Gross Domestic Product (GDP), being the United States of America (USA) and the United Kingdom (UK) have been selected for the purposes of the comparison. Also, Australia was also selected for comparison, as some of our legislation is borrowed from that country. The writer will look at potential loopholes in the legislation of these different countries. An analysis of the advantages and disadvantages of having an Advanced Pricing Agreement (APA) will also be done. The writer will also look at significant judgments, both locally and internationally. A critical analysis of precedents these judgments have set and how they have influenced the approach that can be adopted regarding the substance over form issue.

South Africa can't afford to be left behind while other tax authorities have advanced tax laws which address challenges posed by BEPS. A comparison of our tax laws is therefore significant in ensuring that our tax laws are in line with those of major economies.

1.3.4 Profit shifting cannot be combated without harmony among other countries and that is what the OECD has been striving to achieve. The writer will next look at the role of the OECD regarding Base Erosion and Profit Shifting (BEPS). There will be an assessment of the action plans proposed by the OECD in evaluating the practicality of the OECD's action plan. South Africa's transfer pricing laws will also be compared to the OECD's action plan.

Globalisation made the world to be small as most entities find themselves interacting with stakeholders from all over the world. In ensuring that South Africa is a good citizen of the global market we would have to ensure that our tax laws are in line with the OECD.

1.4 PURPOSE STATEMENT

Profit shifting has continued to grow and it's causing harm in South Africa's economy. It's either South Africa's transfer pricing laws are ineffective or they are too complicated for taxpayers. The goal of this study is to analyse the effectiveness of South Africa's transfer pricing laws in order to diagnose the root cause of growth in profit shifting and tax base erosion.

This study will enable lawmakers on how to tighten transfer pricing laws in order to minimise profit shifting. The study will assist in understanding variances between South African's tax laws and those of other tax authorities.

1.5 RESEARCH METHODOLOGY

1.5.1 The research method adopted is of a qualitative, interpretive nature, based on a detailed interpretation and analysis of amongst other things, case law.

An extensive literature review and analysis will be undertaken that includes the following sources –

- Books;
- Cases;
- Electronic databases;
- Electronic resources - internet;
- Journals;

- Magazine articles;
- Publications;
- Statutes.

1.6 BRIEF OVERVIEW OF CHAPTERS

1.6.1 Chapter 1: Introduction

This chapter will introduce the background and significance of the research, the problems and sub-problems identified and the research methodology used. The research will also consist of an analysis of literature that is available on the subject matter and a qualitative review.

1.6.2 Chapter 2: Analysis of transfer pricing legislation

With effect from 01 October 2011, South African Transfer Pricing legislation was significantly changed by the implementation of an amendment to Section 31 to the Income Tax Act 58 of 1962. A comparison will be done between the old and new Section 31.

1.6.3 Chapter 3: Risk and challenges posed by base erosion and profit shifting

The purpose of this chapter is to look into the economic impact of base erosion and profit shifting. It can be argued that to a certain extent the cause of Greece's financial misfortunes can be attributed to tax evasion (Karnitschnig & Stamouli 2015). Profit shifting has a potential of increasing the tax gap for a lot of countries. Some countries are very cautious about tightening tax laws in order not to discourage investment. This chapter will analyse the notion that countries with strict tax laws are likely to lose direct foreign investment compared to the so called tax havens.

1.6.4 Chapter 4: The Lack of Commercial Substance approach

This chapter examines the way in which some taxpayers avoid tax by entering into a transaction with no commercial value. There are a number of simulated transactions and schemes that have been created by taxpayers which involves the claiming of excessive interest and incurring unnecessary debt or entering into unnecessary transaction with connected parties. The Commissioner for the

SARS is currently imposing heavy penalties on taxpayers found to be evading taxation as per Section 222 and 223 of the Tax Administration Act however the effectiveness of such measures are still questionable. The chapter will analyse whether it might be necessary to have an advance pricing agreement (APA) in order to increase compliance. Sections 80A to 80L of Income Tax would also be examined to ascertain the impact it might have on transfer pricing compliance.

1.6.5 Chapter 5: Necessary actions to be taken to address base erosion and profit shifting

This study will examine possible actions that can be taken to simplify the transfer pricing rules and to increase compliance. The OECD has already made significant progress in trying to come up with the means of discouraging tax avoidance. This study will critically analyse the work that has already been done by the OECD and ascertain if it is sufficient. The transfer pricing laws of other countries (the United State of America, the United Kingdom, and Australia) will also be examined and assessed if it will be ideal in South Africa. The study will also look into the court cases such as *DSG and others v HMRC, Lankhorst-Hohorst Gmbh v Finanzamt Steinfrut and CSARS v NWK Ltd*. A critical analysis will be done on the precedence that has been set by the outcome of these court cases.

1.6.6 Chapter 6: Conclusion

This chapter will summarise the findings of the research, suggest recommendations and propose areas requiring further research.

CHAPTER 2

ANALYSIS OF SECTION 31

2.1 Introduction

Transfer pricing legislation was implemented to address tax avoidance resulting from intercompany transactions across borders. The lawmakers decided to make amendments to Section 31 of the Income Tax Act in 2012. The amended wording in the new Section 31 of the Income Tax Act, which is effective from 01 April 2012, changed the structure of the section but not the fundamental principles. The author would analyse the new Section 31 and also compare it will the previous legislation in order to assess if it's able to halt base erosion and profit shifting.

2.2 The concept of transfer pricing

2.2.1 Introduction

Globalisation created an environment whereby entities have representation throughout the world. This resulted in entities acquiring subsidiaries and establishing subsidiaries in other countries in order to grow revenue. Some multinational companies are targeting countries with low tax rates by shifting their profits to these so called tax havens in order to reduce their tax liability. The prices of items sold between connected companies might not be at arm's length as this is usually done in order to reduce the tax liability. This can be illustrated in the example below:

> Take a beverage company located, say, in Mexico, which has a subsidiary in France. Let's assume that the French subsidiary pays royalties to the Mexican headquarters for the rights to sell its drinks.Taxes are owed in France based on the French subsidiary's results. The higher the royalties paid by the French subsidiary, the lower the taxable profits in France. The French tax authorities will be satisfied if they see that the royalties paid by the French company to its headquarters in Mexico are not higher than those that would be paid to an independent enterprise for a similar transaction. But if the royalties are too high, there is a possibility that profits are being shifted out of France to reduce tax liabilities there. The "arm's length principle" is used to address such issues. Under the arm's length principle, one compares the remuneration from cross border controlled transactions within multinationals with the remuneration from transactions made between independent enterprises in similar circumstances (Silberztein n.d)

Transfer pricing legislation was designed to ensure that intercompany transactions across borders are at arm's lengths and there is no profit shifting between different jurisdictions.

It is critical for Section 31 to properly address profit shifting otherwise there will be a major loss to the fiscus. According to Schussler (2012) South Africa's companies pay the second highest effective tax rate among the biggest 60 economies in the world. This means that South Africa is among the countries with a high tax rate, therefore it is likely that companies operating in South Africa would consider shifting profit to jurisdictions with lower tax rates.

2.3 Old transfer pricing rules

2.3.1 Introduction

The new Section 31 came into operation on 1 April 2012. This meant the principles that were proposed by the old legislation would have to be disregarded. A brief summary of the old legislation will enable us to ascertain whether the new legislation is progressive and there won't be recurring errors from the previous legislation, if any.

The old Section 31 focused on ensuring that a transfer price charged by connected parties is at an arm's length. The previous section granted the Commissioner of SARS the discretion to adjust the price paid should he or she not be satisfied that it reflected an arm's length price. The old section deemed such an adjusted amount to be a dividend which was historically subject to secondary tax on companies (Hart 2014)

2.3.1 The necessity for changing Section 31

The old Section 31 of the Income Tax Act had to be modernised in order to ensure that South African transfer pricing laws are in line with the latest transfer pricing guidelines issued by the OECD. In terms of the old Section 31, the concept of arm's length was linked to price and not necessary the transaction, operation or scheme entered into on terms and conditions which would have applied had the parties involved been independent persons dealing with each other at arm's length

(Steenkamp n.d.) This meant should a difference occur or a tax benefit result to one of the parties, the taxpayer is required to calculate their taxable income based on the arm's length terms and conditions of the affected transaction.

The wording of the old legislation was causing structural problems and uncertainty, as the literal wording unduly focused on isolated transactions as opposed to arrangements driven by an overarching profit objective. In addition, the language gave rise to an excessive emphasis of the comparable uncontrolled price (CUP) method as opposed to other more practical transfer pricing methodologies. By not looking into the whole arrangement, SARS could overlook simulated transactions which have unprecedented terms and conditions.

The old Section 31 provided that the Commissioner could adjust the consideration in respect of the transaction to reflect an arm's length price for the goods or services. This meant that taxpayers were not obliged to make the adjustments on their tax returns for transactions even if such transactions were not conducted on an arm's length basis. Taxpayers could therefore file tax returns with excessive deductions, and then sit and wait and hope for the best - which would be that the Commissioner did not pick up these excessive deductions. The Commissioner doesn't have capacity to review all the return submitted by multinational entities, therefore a number of entities might not comply with transfer pricing legislation and still not be picked up for a tax audit.

Therefore it is clear that the old legislation had a number of challenges and it was necessary to make amendments in order to address the shortcomings of the old Section 31. Some taxpayers took advantage of the old Section 31 by conducting aggressive tax planning, which involved shifting extensive amount of profit into tax havens. The legislation did not concern its self with ensuring that the terms and conditions of the whole arrangements conducted by South African taxpayers with their foreign related entities are normal and are not conducted with the motive of obtaining a tax benefit. Moreover, SARS was heavily burdened with checking that all the transactions were at arm's length and had to process all the necessary adjustments into the taxpayers return.

2.4 The new transfer pricing rules

In order to eliminate uncertainties brought by the old legislation, the new rules have been worded similarly to the wording of Article 9 of the OECD Model Tax Convention on Income and on Capital (OECD 2015), with the focus on the economic substance of the arrangements between related parties, rather than the pricing of specific transactions.

The new Section 31 will be applicable whereby:

- Any transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into between connected persons with a cross border nexus;
- 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 parties been independent persons dealing at arm's length; and
- The transaction, operation, scheme, agreement or understanding results or will result in a tax benefit being derived by any party to it.

The new Section 31 successfully shifts the focus from separate transactions to the entity-based approach desired by SARS. Section 31(2) of the Income Tax Act provides that the new rules are to apply to an "affected transaction" if (i) any term or condition of that transaction is different from what would have been agreed to between independent persons dealing at arm's length, and (ii) it results in any tax benefit being derived by a person who is party to the transaction, operation, scheme, agreement or understanding. Analysing the new wording leads one to believe that the arm's length principle is more far-reaching than before; being applicable to any party to a transaction, operation, scheme, agreement or understanding. Large corporates will now be required to ensure that the overall transaction does not result in an undue tax benefit that is contrary to the arm's length principle (Hart 2014). Aggressive taxpayer can get into transactions which are not commercially viable in other to obtain a tax benefit, the new legislation will assist in ensuring that such transactions are challenged and profit shifting is halted.

The new rules stipulate that the taxable income of a party to the affected transaction who derives a tax benefit must be calculated as if the affected transaction had been entered into on the terms and conditions that are expected between parties dealing with each other on an arm's length basis. This requirement effectively removes the Commissioner's discretion to make an adjustment and shifts the responsibility to make a voluntary transfer pricing adjustment onto each party to the transaction. Determining whether the terms and conditions of a transaction are different to what would have been agreed to between independent persons dealing at arm's length might not always be an easy excise to conduct. Certain businesses don't have a standard model and therefore it might be difficult to come up with a benchmark. For example, a bank might fund Project A at 11% interest rate, with a 5 year payment term, while Project B might be funded at 8% interest rate, with a 5 year payment term. Should a connected foreign entity decides to run Project C, it will be difficult to ascertain an appropriate interest rate that will convince SARS that the transaction is at arm's length. (Hart 2014)

Transfer pricing adjustments (whether voluntary or through a SARS audit) are no longer considered to be a deemed dividend, but rather the adjusted amount is seen to be a loan on which interest is due (on an arm's length basis). The interest to be charged on this deemed loan may be discharged if the loan is repaid in the same financial year. This further indicates that the interest charge will be indefinite, pending the settlement of the debt created through the adjustment (Hart 2014).

CHAPTER 3

Risks and challenges posed by base erosion and profit shifting

3.1 Introduction

BEPS poses a serious risk to a number of countries, especially the developing countries like South Africa. Government expenditure should mainly be funded by tax revenue instead of borrowed funds, for a country to have a healthy financial status, this impact of BEPS might make it hard for a lot of countries to attain this. The purpose of this chapter is to look into the economic impact of base erosion and profit shifting and the challenges that it poses to society at large.

3.2 The economic impact of BEPS

It can be argued that BEPS is one of the causes of many countries' recent financial hardships. In the Davis Tax Committee Interim Report (2014), it is stated that

> Tax Justice Network report "The Missing Billions" which estimates that GBP12 billion of corporate income tax is lost each year due to tax avoidance by the 700 largest companies in the United Kingdom. For developing countries Oxfam, a non-profit organisation, attributes a revenue loss of USD50 billion to tax avoidance by multinationals (Davis Tax Committee Interim Report, 2014).

This is a serious challenge for many states, as the government can't deliver on its mandate without having financial resources. According to the Tax Justice Network report, few issues can be more important to a modern democracy than the integrity of its tax system. It is deeply troubling, therefore, to discover that the tax system is being increasingly undermined by the practice of tax avoidance.

The gap between the rich and poor people will increase even further if BEPS is not properly addressed.

> Tax justice and the struggle against tax havens has to be a central part of any inequality-focused agenda. With some $21-32 trillion in financial assets sitting offshore, largely untaxed, the offshore system of tax havens clearly has mind-bending effects on inequality within and between countries. All that offshore wealth is held by the world's 10 million wealthiest people: and a large share of that by the wealthiest 100,000. Because of tax havens, inequality is certainly significantly worse than what economists measure (read more about that here). Worse still, tax competition is 'compressing' tax systems around the world, with the effect of reducing tax rates on the wealthy and increasing tax rates on the poor. Many other unjust features of tax systems make the problem still worse: corporate tax avoidance, for instance, routinely facilitated by offshore tax shenanigans (Tax Justice Network n.d)

Some Global multinational enterprises (MNEs) are obsessed with accumulating wealth and they have no regard for economic upliftment in countries where they operate. MNEs need to realise that paying their fair share of tax is to their benefit. A country with an effective economic system will enable citizens to have buying power which would enable them to buy MNEs' products.

3.3 Tax havens impact on the spread of BEPS

Tax haven can be defined as a 'country with little or no taxation that offers foreign individuals or corporations residency so that they can avoid tax at home'. Naturally, most MNEs would prefer to be in countries where they would pay little or no taxation. Does this mean countries should compete to have the lowest tax possible in order to attract foreign investors or would minimum tax revenue received by these countries collapse their economy?

The Republic of Ireland can be regarded as a tax haven as they have a 12.5% corporate tax rate, which is lower than international standard's. Ireland is one of the worst tax havens in the world, it has helped big business to dodge billions of euro. Bermuda and the Cayman are also used by some big businesses to avoid tax (Irish Times 2016). Ireland came out of the economic crisis as one of the best performing economies, with GDP growth rates of 8.5% in 2014 and an extraordinary 26.3% in 2015 (Tax Justice Network 2017). Moreover, it is important to note that Ireland is an economy dominated by foreign companies. The foreign controlled affiliates provide almost 50% of employment in the country and 80% of exports (90% of manufacturing exports), it is clear that foreign investment is plays a significant role in Ireland's economy. This, combined with Ireland's status as a tax haven, makes Irish GDP figures particularly vulnerable to profit shifting, therefore most companies will consider shifting their profits in Ireland, in order to take advantage of low tax rates. Through transfer pricing, which involves the Irish subsidiary overcharging other parts of the company based elsewhere for goods and services, profits can be moved from the rest of the world to Ireland. It can be argued that this kind of internal profits shifting does very little for the domestic workforce. In some certain cases you would notice that headquarter companies based in Ireland may be employing very few people or not employing anyone at all. What is even more disappointing is that profits declared in Ireland are likely to quickly be taken out of the country again (Tax Justice Network 2017).

It can be noticed that tax havens don't really benefit from having little or no taxation. Moving MNEs headquarters to a tax haven doesn't necessary mean the citizens would benefit from job creation. The main beneficiaries of BEPS are the MNEs. They pocket maximum profits without paying their fair share of tax. Employment in Ireland could not reach crisis levels in Ireland, despite the fact that the country has been experiencing net emigration, which should decrease the work force. It was also noticed that the wage share, that is the amount of national income that is paid out as wages, has declined severely. This means investors did not born the economic costs provoked by the financial crisis (Tax Justice Network 2017)

The Republic of Ireland's GDP growth, as a tax heaven, is questionable and is it even possible for countries to follow the Irish development model, which relies on freeloading of profits earned elsewhere.

> This result puts the Irish role as a blueprint for other countries into question. Ireland's strategy of attracting foreign owned companies by low corporate taxation rates can be seen as a beggar-they neighbour strategy, increasing downward competition for taxation in the EU. The strategy is not even clearly positive for Irish citizens, at least not for those relying on wage income. Therefore, it is surprising that the government seems to be willing to continue to compete for foreign owned companies by low corporate taxation rates, as a series of publications of the Department of Finance (2014) seems to indicate as well as the discussion of having to accept tax payments of Apple (Tax Justice Network 2017)

Tax heavens enable the spread of BEPS and they don't get meaningful benefit from it. We don't have an international watchdog that can stop countries from becoming tax havens. Perhaps all countries should decide to be tax heavens, then no country would be a tax haven, however this won't benefit anyone, except for the MNEs.

The top 10 countries with the highest gross domestic product (Statistics times, 2017) have an average tax rate of 27% (OECD, 2017). This is a clear indication that a healthy tax rate has a significant impact on the countries' GDP growth. It is no surprise that none of the countries who are considered to be tax havens feature in the top 10 countries with the highest GDP.

Top 10 countries with the highest GDP

Country	GDP (billions of $)	Corporate Tax rates
United States	19,417,144	35% + 0-12%
China	11,795.297	25%
Japan	4,841,221	32%
Germany	3,423,287	30%
United Kingdom	2,496.757	20%
India	2,454.458	30%
France	2,420.440	15% (profit < 38120€) - 33.00% (profit > 38120€)
Brazil	2,140.940	34%
Italy	1,807.425	27.50%
Canada	1,600.265	15% - 26% federal + 11-16% provincial

One sees a different picture when you look at GDP per Capita. According to the National Bureau of Economic Research, tax havens feature in the top 11 countries with the highest GDP per Capita.

The major tax havens have a lower population, they have less than one percent of the world's population (outside the United States), and 2.3 percent of world GDP, but host 5.7 percent of the foreign employment and 8.4 percent of foreign property, plant and equipment of American firms. The low population in tax havens makes it easy for tax havens to lower tax rates. Per capita real GDP in tax haven countries grew at an average annual rate of 3.3 percent between 1982 and 1999, which compares favourably to the world average of 1.4 percent. The growth rate of tax haven is more than double of the average growth rate of the world. It can be noticed that tax havens tend to attract a lot of foreign investment. It can be argued that high tax countries indirectly contribute to the economic prosperity of tax (Hines n.d)

Top 11 countries with highest GDP per capita

1 Qatar	$129 700
2. Luxembourg	$102 000
3 Macau	$96 100
4 Liechtenstein	$89 400
5 Singapore	$87 100
6 Bermuda	$85 700
7 Isle of Man	$83 100
8 Brunei	$79 700
9 Monaco	$78 700
10 Kuwait	$71 300
11 Ireland	$69 400

Table from Central Intelligence Agency 2016

3.3 Impact of strict tax laws on investment

One would expect foreign investors to consider the tax system of the potential country they are intending to invest in. It's not easy to measure effects of tax factors on transatlantic investments is accurate beyond the obvious one that taxation is always relevant. When it comes to foreign investment, tax considerations are seldom dominant, and in most cases, differences in taxation are usually negligible. Meeting reporting requirements of different tax jurisdictions may discourage foreign investment, however obtaining a tax benefit more important than tax differences in investment decisions. (Smith n.d)

Though tax might not be the main factor in influencing foreign investor's decisions however it still plays a critical role in the decision taken by the investor on whether to invest in a particular country or not. Therefore it is important for every country to ensure that they implement tax policies that are foreign investment friendly. This does not mean countries need to expose themselves to profit shifting activities that are conducted by some of the MNEs. There critical question is how to strike a balance between having strict tax laws and still be able to encourage foreign investment. It is in every countries interest to have foreign investors.

Most government believes it is important to focus on attracting foreign direct investment (FDI). The advantage of having more foreign investment is a reduction in unemployment, economic growth and infrastructure development. FDI is very important for governments as it contributes to the domestic country's income through introduction of new technologies and skills development. It is therefore important for the policy makers to ensure that tax laws are friendly toward foreign investors, in order to take advantage of the FDI. In trying to attract FDI, it is important for government to ensure that they still attain appropriate share of domestic tax from MNEs. While offering a competitive tax environment, it is important to ensure that the country's economy is not disadvantaged.

One of the major considerations in the analysis done by foreign investors would be the tax rate. The increase or decrease in the tax rate would have an impact on the investor's attitude towards a country. Foreign direct investment is like to decrease following an increase in tax rate on FDI, as they are becoming increasingly sensitive to taxation. When evaluation how FDI react to tax reform, it's not easy to ascertain how tax factors into FDI decisions, and what tax rates which investors consider to be reasonable. In most cases the comparisons may focus on statutory corporate income tax (CIT) rates and little attention might be given to indirect taxes. Or it may be that average effective tax rates or marginal effective tax rates matter more than corporate income tax (headline rates), as they play a significant role in the determination of the percentage of profits that are taxable. Corporate income tax rates may differ significantly from effective tax rates, to the extent that taxable profits differ from the real profits, therefore some investors look beyond the CIT rate, they also consider the expenses that are deductible, as they are interested in the effective interest rate. (OECD n.d)

Foreign investors compare the economic climate of different countries and invest on countries that have tax policies that a conducive to their needs. In today's global business environment, tax competition for FDI exists and government always need to take it into consideration when introducing tax policies. Governments can't make a mistake of thinking that investors don't conduct a comparison of tax policies across countries that are similar in location and market size.

CHAPTER 4
Lack of commercial substance

4.1 Introduction

The way of doing business has evolved over the years and this requires the tax legislation to be amended in order to keep up with changes that have emerged. It is becoming difficult to place absolute reliance on old court cases to address the current complex business transactions. Most taxpayers are constantly looking for loopholes in the tax legislation in order to minimize their tax liability. Moreover the current economic crisis has also served as a motive for taxpayer to get involved in transactions that would result in minimum or no tax expenses. South Africa might have a reduction in simulated transactions if the Advance Pricing Agreements (APAs) proves to be advantageous. The impact of general anti-avoidance rules on simulated transaction need to be analysed, in order to ascertain if they need to be tightened.

4.2 Simulating transactions to achieve BEPS

Most taxpayers avoid tax by entering into contracts that disguised their true nature in order to qualify for a tax benefit that would not be available if the true contract between them were revealed (SAICA 2009). Transactions that lack commercial substance are often simulated.

There's no definition of simulated transaction in the Income Tax Act and therefore we rely on court cases to ascertain whether a transaction was simulated. In a string of cases such as *Zandberg v van Zyl 1910, Commissioner of Customs and Excise v Randles, Brothers and Hudson Ltd,* it was understood that a transaction will not be regarded as simulated if the parties genuinely intended that their contract will have the effect in accordance with its tenor and the rule applies even if the transaction is devised solely for the purpose of avoiding tax. There are a number of gaps that can be found in the above principle. The mere fact that the parties genuinely intended to execute what is in the contract should not protect a transaction from being regarded as simulated.

During the *C:SARS V NWK Ltd* 2011 court case, Lewis JA stated that if the purpose of the transaction is only to allow the avoidance of tax, then the transaction will be regarded as simulated. Transactions that involve prices which are not at arm's length are often lacking commercial substance and they are simulated transactions. The purpose of schemes or transaction formed to achieve profit shifting is to avoid tax and therefore they meet the definition of simulated transactions.

> Practice Note 5 states that a taxpayer who has carried out a legitimate tax avoidance scheme i.e. who has arranged his affairs so as to minimise his liability, in a manner which does not involve fraud, dishonesty, misrepresentation or other actions designed to mislead the Commissioner, will have met his duties and obligations under the Act (Department of finance, 1987).

This means if a taxpayer structure their transaction in a way that would minimise the tax liability, the taxpayer won't be at fault if it's a legitimate tax avoidance scheme.

It's not clear cut what would constitute a simulated transaction which lacks commercial substance. Courts are usually requested to resolved disputes between taxpayers and the tax authorities to resolve matters relating to simulated transactions. Transactions relating to profit shifting usually lack commercial substance e.g goods are not sold at market related prices to connected parties. Tightening the general anti-avoidance rules which are contained in sections 80A to 80L of the Income Tax Act legislation dealing with simulated transaction would therefore play a critical role in eliminating profit shifting.

4.3 Advance Pricing Agreement.

According to the OECD's guideline for Advanced Pricing Agreement (APA), an APA is

> an administrative approach that attempts to prevent transfer pricing disputes from arising by determining criteria for applying the arm's length principle to transactions in advance of those transactions taking place (OECD n.d).

The South African Revenue Service (SARS) does not enter into advance pricing agreements with taxpayers at the moment. In trying to ensure that taxpayers are comfortable about their transfer pricing approach and methods used to arrive at an arm's-length price, jurisdictions such as the United Kingdom and the United States of America, make use of 'Advance Pricing Agreements' ('APAs'). Having APAs proved to be helpful in resolving transfer-pricing disputes. Unfortunately APAs are currently not in use in South Africa and SARS doesn't seem to be keen on introducing it in the foreseeable future. This means South African taxpayers are currently not able to benefit from the advantages of having an APA. (Oguttu n.d)

Denying taxpayers an opportunity to enter into these agreements has advantages and disadvantages. It is important to do a detailed analysis to ascertain whether it would be worthwhile for South Africa to incorporate APAs in the Tax Administration Act.

4.3.1 Advantages of APAs

The APAs offer better assurance on transfer pricing methods and are conducive in providing certainty and unanimity of approach (Garg 2016). Having APAs avoids unnecessary audits which waste both the taxpayers and the tax authorities' time. This would also enable taxpayers to do proper tax planning and remove uncertainties. The basic idea behind having an APA is to increase the efficiency of tax administration by encouraging taxpayers to voluntary disclose before the tax authorities all the facts relating to their affected transactions, this would then enable a taxpayer to work towards a mutual agreement. Tax authorities also benefit from having an APA, as it reduces the burden of compliance. This means there will be a reduction in the number of transfer pricing audits. Having an APA also gives taxpayers greater certainty regarding their transfer pricing methods, as it is always a challenge to choose an appropriate method, moreover an APA gives a platform to the taxpayer and the tax authorities to have a discussion and a resolution in advance.

A significant amount money is spent on transfer pricing audit, tax administrator have to allocate lot of resources to resolve transfer pricing disputes and this could be avoided through the introduction of transfer pricing. The developed countries like the United States of America and the United Kingdom adopted APA, one would expect a developing country like South Africa would to the same, so as to take advantage of the benefits listed below

- Complex and high risk transactions are addressed and resolved early – APA enable taxpayers to minimize the risk of a transfer pricing adjustment and they provide certainty through a negotiation process. APAs are likely to be undertaken by companies that have extremely complex inter-company transactions, which have a high degree of transfer pricing adjustment risk that may result in penalties. Having APA would ensure that taxpayers have certainty with regard to their transfer pricing policies.

- An APA will assist with avoiding double taxation – Most Multinationals' pricing of goods and services for transactions among themselves are usually governed by a global pricing policy. These global policies generally ensures to provide an arm's length return to various constituents of the MNE group, based on the functions performed, assets employed and risks assumed by each member of the group. When a revenue authority in a particular jurisdiction audits and disputes such pricing policy and raises a consequential demand, it might lead to double taxation for the Group as a whole. The process of APA will play a significant role in doing avoiding a situation whereby there is a double taxation.
- Taxpayers will avoid costs relating to tax audits – Tax audits are costly and APA will reduce compliance cost and costs associated with audit and appeals by eliminating the risk of transfer pricing audit and resolving unnecessary time-consuming disputes and litigations. This will also help revenue to allocate their resources on other things
- Transfer pricing documents require a lot of record keeping, having an APA will certainly reduce the burden of record keeping as taxpayer will knows in advance the required documents to be maintained to substantiate the agreed terms and conditions of the agreement.
- The negotiation between the taxpayer and revenue authority is good for both parties as the authorities get to understand the business better and the taxpayer can learn from competent authority guides on how transactions should be structure in order to ensure that prices for goods and service are at arm's length.

  (Garg 2016)

APAs would also play a significant role in reducing simulated transactions. The reduction in compliance cost that would encourage taxpayers to rather enter into an APA instead of participating in simulated transactions which may result in heavy penalties.

4.3.2 Disadvantages of APA

APAs can also be disadvantageous, they require extensive voluntary disclosure and this could result in concern about exposure to adjustments for open tax years. In most cases the non-factual representations made during the APA process cannot be used as evidence in legal or administrative proceedings, unless the proceedings regard a tax year, transaction and person covered by a successfully completed APA (Hansen n.d).

The disclosure process can also be expensive and time consuming because the disclosure is generally more extensive than for private letter ruling. This means a taxpayer would have to pay for provisional fees, expert opinion fees and employees' salaries.

The advantages of having APAs seem to outweigh the disadvantage and it would be worthwhile for South Africa to consider implementing it. This would also ensure that South Africa's legislation is in line with that of the developed countries.

CHAPTER 5

Actions to be taken to address base erosion and profit shifting

5.1 Introduction

Base erosion and profit shifting (BEPS) by multinational corporations has entered the public consciousness as a potentially important impediment to tax collections (Hines n.d). Therefore it is critical for BEPS to be urgently addressed in order to end further loses to the fiscus. The impact of BEPS on tax revenues is not easily quantified. MNEs are going all out to ensure that they to ensure they pay minimum or no tax in order for more profit to be allocated to shareholders. This means that a corporation that is located in a country with a 20 percent tax rate, and that has the opportunity to reallocate some of its taxable income to a country with a 15 percent tax rate, will typically arrange its financial and other affairs to reallocate most of its income to the lower-rate country. According to JR Hine (n.d.), the average member country of the OECD in 2011 raised 8.8 percent of its total tax revenue from taxes on corporate profits, portion of which represented taxes on multinational corporations. The tax contribution of Multinational Corporation might seem lower, however any form of contribution to Tax Revenue makes a difference.

The development of a country like South Africa is depended on tax revenue to be able to finance government expenditure. A shortfall in tax revenue caused by BEPS would further deteriorate South Africa's economic growth plans. Simplifying transfer pricing rules and ensuring they are in line with OECD would play an important role in increasing compliance. Aligning our transfer pricing law with that of other countries' would enable us to stay abreast will the latest trends.

5.2 Modification of transfer pricing rules.

According to the OECD, it is important for countries to understand modern business models and how MNEs operate in a globalised economy in order to curtail BEPS. Globalisation, the gradual removal of trade barriers, the increase in technological and telecommunication developments has caused products and operational models to evolve, changing the way modern MNEs are structured and managed and thereby creating the conditions for the development of global strategies aimed at maximising profits and minimising tax expenses (Davis Tax Committee Interim Report 2014).

South Africa's TP legislation is contained in Section 31 of the Income Tax Act 58 of 1962 and is supported by SARS Practice Note 7, which outlines the important principles and guidelines that taxpayers have to follow in determining an arm's length price. South Africa's transfer pricing laws were enacted in 1995 and Practice Note 7 was released in 1999, until recently there were no changes in the legislating to still remain relevant in the modern way of doing business. The changes that were recently made, which became effective as of the 1 April 2012 is focusing on all aspect of the contracting parties and not only on the pricing of transactions. The other changes in the TP legislation relates to the triggering of TP adjustments and the consequences for a South African taxpayer entity of such an adjustment. Transfer pricing adjustments will have to be made by the taxpayer that is party to the affected transaction in its tax return. This is different from the previous rules, which prohibited taxpayers from making Transfer Pricing adjustment themselves, but rather provided the SARS with the discretion to make such an adjustment if SARS was of the opinion that the transaction had not been priced on an arm's length basis.

There are still gaps in South Africa's transfer pricing legislation, as the following issues are not properly addressed, as required by the OECD. (Deloitte, 2016)

- Transfer pricing rules prevent excessive interest deduction. However the currently legislative environment is complex and could create uncertainties for taxpayers (Action 4)
- There was no clarity on which entities are supposed to have a TP document and what should be contained in the document. A public notice was recently issues which indicated that transfer pricing documentation would be required If an entity enters into a potentially affected transaction and the aggregate of the person's potentially affected transactions for the year of assessment, without offsetting any potentially affected transactions against one another, exceeds or is reasonably expected to exceed R100 million. This only applies to assessment relating to periods after 1 October 2016 (Action 13).

- Draft regulation that specifies country by country reporting standards for multinational enterprises was published on the 11th of April 2016. The regulations are effective from tax years beginning on or after 1st January 2016. The first CBC reports must be filed by 31 December 2017(Action 13).
- South Africa's CFC rules are complex and in some respect unclear, so the application of the recommendation in the report on Action 3 may welcome in helping to overhaul the legislation. However it is not clear whether South Africa would make any changes to the current rules (Action 3).

5.3 Comparison of South Africa's transfer pricing rules with those of developed countries

5.3.1 United State of America (USA)

The USA is very experienced when it comes to transfer pricing, as it has one of the oldest and most mature transfer pricing regime in the world. (KPMG, 2015 a)

There a number of similarities between South Africa and the USA's transfer pricing rules, below are the differences that were identified by the author. South African might have to look into these differences and perhaps consider amending its transfer pricing rules.

5.3.1.1 Affected transactions:

According to the USA's laws, the parties must be under common control. Control is based on a facts and circumstances test, and not on specific ownership thresholds. Currently, South African laws only look at ownership and do not consider a facts and circumstances test. This means a number of transactions could be left unchallenged.

5.3.1.2 Preferable benchmarking set

The tax authorities in USA have a preference for local comparable benchmarking set. The IRS expects that's to use US comparable to be used to benchmark a US tested party, in certain instances, the Canadian comparable can be used. Moreover there are detailed reporting requirement for public corporations that are used by providers who create company databases and by practitioners who prepare transfer pricing reports. (KPMG, 2015 a)

Having a standard comparable benchmarking is critical because it avoids a situation whereby taxpayers could manipulate the benchmarking to suit their desired outcome. South Africa lawmakers would have to consider adopting the same approach.

5.3.1.3 Advanced Pricing agreements

APA is a very important program that ensures that taxpayers comply with transfer pricing laws and it enables companies incorporated in USA to reduce the transfer pricing risk. According to the KPMG report, it was noticed that the IRS received 108 APA requests in 2014. Therefore it is clear that APAs remain an important instrument that can be used by the authorities to achieve certainty and mitigate transfer pricing risk for many multinationals. (KPMG 2015)

This is testament to the fact that the introduction of APAs would accelerate efforts of ensuring that multinationals comply with transfer pricing legislation. The IRS's combination of the Advance Pricing Agreement (APA) program and the competent authority program into a newly created group, the Advance Pricing & Mutual Agreement program (APMA), has reduced long court dispute which require lot of money to be spent on litigation fees. A more expedited processing and resolution of transfer pricing disputes has now been facilitated by the APMA. A proposed guidance which was issued in the late 2013 by IRS, it emphasised the importance of APMAs is consistent with the objectives of APMA to enhance integration between competent authority matters and APAs, to improve allocation of resources, and to increase transparency and efficiency (KPMG n.d).

5.3.2 United Kingdom (UK)

The transfer pricing legislation was introduced in April 2008. (KPMG n.d). Given the length of time that the transfer pricing legislation has been established in UK, South Africa can look into UK's transfer pricing tax laws for guidance as some of South Africa's laws are based on UK's laws. South Africa, like many other countries, bases certain of their efforts to establish and implement domestic taxation rules and regulations on the experience of the UK. In the past, South Africa has looked into a country like the UK, in developing and enacting of most of income tax provisions and it is therefore expected that it should also be the case when it comes to transfer pricing.

As an OECD member country, UK Income Tax Legislation on transfer pricing emphasise and encourage the arm's length principle. The transfer pricing legislation is based on a self-assessment system which requires all companies to determine whether their intergroup transactions are always carried at arm's length. When transfer pricing was first introduced to the UK, it was only in respect of cross-border intergroup transactions. An amendment was done to the UK transfer pricing legislation on April 2004, the amendment addressed deficiencies in the introductory legislation which failed to counter a range of UK tax planning structures that allowed companies to shift profits domestically to benefit from assessed tax losses. The scope of Transfer pricing legislation is now broader as domestic transactions have been included, providing the UK with one of the most aggressive transfer pricing regulation systems. (Spearman 2013)

5.3.2.1 Advance pricing agreements

Similar to the transfer pricing laws in USA, the transfer price laws in the UK makes provision for APA. The UK has had formal APA procedures since 1999.

5.3.2.1 Affected transactions:

According to UK's transfer pricing laws, the transfer pricing rules would apply when the following conditions are met:

- A provision has been made or imposed between two persons by means of a transaction or series of transactions;

- One of those persons was directly or indirectly participating in the management, control and capital of the other, or the same person or persons were directly or indirectly participating in the management, control and capital of both parties to the provision;
- The actual provision differs from the arm's length provision which would have been made between different enterprises and;
- The difference gives rise to a potential UK tax advantage.

The UK's affected transactions conditions are fairly similar to those of South African. However there are developments and trends that South African lawmakers need to take cognisance of.

5.3.3 Australia

Australia introduced new rules which apply to income tax years beginning on or after 1 July 2013. There are few differences between South Africa's transfer pricing laws with those of Australia.

5.3.3.1 Affected transactions

The parties involved in relevant transfer pricing arrangements need not to be related to one another and there are no control requirements or ownership threshold under Australian laws (Deloitte 2015). This is something South Africa should consider introducing as it would assist in eliminating schemes arranged by unrelated parties.

The statute of limitations on assessment of transfer pricing adjustments is seven years while in South Africa its three years, unless SARS can prove that the taxpayer was involved in fraud or there was misrepresentation.

5.3.3.2 Advance pricing agreement

Australian also has an APA program which is currently being updated to reflect changes to the global economy, community and ATO's profit shifting work. Under the

ATO's Advance Pricing Agreement (APA) program, a taxpayer with an APA is required to prepare and submit an Annual Compliance Report to the ATO disclosing the covered transactions, according to the requirements of Practice Statement Law Administration PS LA 2015/4. There is no formal requirement for taxpayers to provide their transfer pricing documentation to the ATO with the tax return (KPMG 2015 b).

5.4 Progress made by OECD

The Organisation for European Economic Co-operation (OEEC) was established in 1947 to run the US-financed marshal plan for the reconstruction of continent ravaged by war. It paved a way for a new era of cooperation that was to change the face of Europe. Encouraged by its success and the prospect of carrying its work forward on a global stage, other countries like Canada and the US joined OEEC members in signing the new OECD Convention on December 14, 1960. The OECD was officially established on September 30, 1961, when the Convention entered into force (Telegraph, 2011). OECD plays a significant role in ensuring that the international community works together to address global challenges.

With regards to dealing with BEPS, the most notable work done by the OECD is the introduction of action plans that can be taken by its members to combat BEPS. In the table below, one can see the progress made by South Africa regarding the implementation of Actions recommended by OECD.

South Africa : BEPS implementation plan (Deloitte, 2016)

Action	OECD Category	Notes on local country implementation plan	Expected timing
VAT on digital business (Action 1)	Common approach	VAT Act was amended with effect from 1st of April 2017 such that an enterprise rendering certain electronic services must register as a VAT vendor in South Africa and charge VAT on the supply of services. These services include ebooks, films and music. It is not know yet whether there would be any changes to the current legislations.	Not yet known
Hybrid (Action 2)	Common approach	South Africa already has legislation addressing hybrid instruments, although an expert	Not yet known

		group (Davis Tax Committee 'DTC') examining the tax framework has recommended that the hybrid instrument legislation be simplified to focus on legal principles rather than specific instruments or transactions. The rules should also be in line with international leading practice.	
CFCs (Action 3)	Best practise	South Africa's CFCs rules are complex and in some respects, unclear, so the application of the recommendation in the report of Action 3 may be welcome in helping to overhaul the legislation. However it's currently unclear whether South Africa would make any changes to the current rules	Not yet know
Interest deduction (Action 4)	Common practise	South Africa's exchange control, transfer pricing and income tax rules generally prevent excessive interest deductions. However, the current legislative environment is complex and could create uncertainty for taxpayers. It is unclear whether any changes will be made.	Not yet know
Harmful tax practise (Action 5)	Minimum standard	There is some concern about the possibility that South Africa's headquarter company regime could constitute a harmful practice. It is not yet know when or if there will be any changes to the existing legislation.	Not yet know
Prevent treaty abuse (Action 6)	Minimum standard	The DC has recommended that South Africa ensure that it prevent the use of the application of domestic anti avoidance provisions in its tax treaties. The main purpose requirement in the GAAR is akin to the PPT recommended by the OECD. The DC recommended that South Africa take steps to renegotiate its older treaties or sign protocols amending the titles and preambles of older treaties to the effect that they are not intended to create opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangement	Not yet known
Permanent establishment status (Action 7)	Revision of existing standard	It would be to South Africa's benefit to incorporate the changes to the definition of a PE into all of its tax treaties.	Not yet known

Transfer pricing (Action 8 – 10)	Revision of existing standard	The exchange control regulations restrict to the extent that to which abusive arrangement can be implemented in respect of the provision of intra group intangibles. Exchange control rules require prior approval of such arrangements and transfer pricing sign off is often a prerequisite for such approval. Manufacturing royalties are subject to certain caps imposed by the department of trade and industry – generally 6% of the turnover of South African entities.	Not yet known
Disclosure of aggressive planning (Action 12)	Best practice	See action 13 below re additional reporting requirements for Multinational Enterprises (MNEs)	Not yet finalised but proposed to be effective from 1 July 2017
Transfer pricing documentation (Action 13)	Common approach	In July 2016, the SARS issued a draft notice providing that where the taxpayer's aggregate potentially affected transaction for a year of assessment exceed 5% of gross income or R 50 million the taxpayer will be required to keep special records, books of accounts or documents, presumably as part of its transfer pricing documentation. Significant additional reporting requirement are proposed , for example operational flows, including product flow, cash flow of the transactions, as well as comparison to the flows in independent transactions and where a tested party is outside South Africa, copies of invoices and contracts between tested parties and its customers. The notice has not yet been finalised.	Not yet finalised but proposed to be effective from 1 July 2017.
CbC reporting (Action 13)	Minimum standard	Where the ultimate parent of the MNEs is tax resident in South Africa and has annual consolidated turnover exceeding ZAR 10 billion during the 2015 financial year, it would be required to prepare the CbC report for financial years on or after 1 January 2016. The SARS has confirmed that the template issued by the OECD should be used for the CbC report and the above requirement would not be applicable to South African intermediary holding companies. There are circumstances where the South African entity may be	1 January 2016

		required to submit the CbC report even though it is not the ultimate parent company of the MNE. This applies to so called constitute entities and the threshold that applies is EUR 750 million. South Africa is one of the countries that signed the multilateral competent authority agreement for the automatic exchange of CbC report.	
Dispute resolution (Action 14)	Minimum standard complemented by best standard	While South Africa is not one of the countries that is committed to binding arbitration in its bilateral tax treaties, South Africa has tax treaties with most of the countries that have so committed, so those treaties may need to be amended to include the specified timeframe for the resolution of disputes. In March 2015, the SARS published guidance on MAP procedure, including an explanation of what MAP entails and how to submit a request.	Not yet known

South Africa is making significant progress in trying to address the action plans recommended by the OECD, however as it can be seen in the table above, there are issues that still need to be addressed. The Davis Tax Committee has been tasked with the responsibility of addressing BEPS in South Africa and the main issues that they perhaps need to focus on are as follow:

- Simplifying the hybrid instrument legislation;
- Simplifying Controlled Foreign Company (CFC) rules;
- Simplifying transfer pricing laws relating to interest deduction, as they are currently creating uncertainties for taxpayers;
- Reconsider negotiating old tax treaties in order to avoid treaty shopping and also amend the Permanent Establishment definition in the treaties. Specified timeframe for the resolution of disputes need to be included in the tax treaties.

5.5 Court cases

A number of court cases can be used to enable South Africa to identify areas which require modification. Looking into the principles that come out from court cases would help South Africa to strengthen its tax laws. Despite this length of time, transfer pricing disputes in the United Kingdom (UK) are usually resolved by negotiation between Her Majesty's Revenue and Customs (HMRC) and the taxpayer.

5.5.1 DSG and others v HMRC

The DSG and others v HMRC case shows that South Africa can't always place comparables high in the ranking when trying to determine a transfer price as recommended by the OECD Guidelines. The court cases also shows that no matter how complex a case might be the determining an arm's length price between parties can always be achieved. The following issues were relevant:

The case can be summarised as follow:

The DSG and others v HMRC case is relating to a dispute between HMRC and a group of companies which form the largest retailer of electrical goods in the UK, comprising Dixons, Currys and PC World. DSG Retail Ltd (DSG) was the retail company and had a subsidiary, CIS. CIS, acting as agent for Cornhill Insurance plc (Cornhill), offered DSG's customers extended warranties on electrical goods. Cornhill paid CIS a sales commission. From May 1986 to April 1997 Cornhill was the insurer of the extended warranties sold to DSG's customers, retaining 5% of the risk and reinsuring 95% with a subsidiary of DSG that was incorporated in the Isle of Man, DISL. Cornhill ceded 95% of the risk premiums it received to DISL under the reinsurance contract, and in return DISL paid Cornhill a ceding commission of 1.5% of the premiums ceded to it. DSG had no direct contractual relationship with DISL.
In 1993, the arrangements were extended for five years and the profit commission arrangements with CIS were altered so that Cornhill paid CIS a greater commission. Cornhill agreed not to seek a corresponding increase in ceding commission from DISL. From 1 April 1997 there was a significant increase in the rate of Insurance

Premium Tax ("IPT") on the goods that DSG sold from the then standard rate of 2.5% to 17.5%. In order to avoid IPT, DSG restructured the arrangements so that instead of an insurance policy issued by Cornhill, customers were sold a service contract with ASL, an Isle of Man company independent of DSG. The fee that was charged for the repair contract did not attract IPT because it was not an insurance transaction. ASL then insured its risk with DISL

According to Chelsea Roche the case was addressing the following issues:

- Was there a provision between DSG and DISL?
- Did the actual provision differ from the provision that would have been made between independent enterprises?
- Did the provision confer a potential advantage in relation to UK tax?
- What adjustment is required?

The decision made by the court was as follow:
The court held that there was provision between DSG and DISL even though there being no direct contractual relationship between these entities. It became clear that during the negotiations with Cornhill and with DSG's bargaining power, DISL had been given an advantage in order to provide tax benefits to the whole group.
The Special Commissioners reached a conclusion and indicated that the arrangements were not at arm's length and that DSG set a price that "confers a potential advantage in relation to United Kingdom taxation" because DSG's profits did not include income it would have received for its provision of the business facility if DSG and DISL were dealing at arm's length. The comparables that were submitted by DSG were rejected and the special commissioners supported the use of the type of profit split formula suggested by HMRC. It was concluded that DSG's profits should be adjusted to that of an arm's length arrangement based upon the profit split method that was suggested by HMRC. The parties were given an opportunity to determine the actual quantum of the adjustment in order for a settlement to be negotiated, but the tribunal reached a decision that the adjustment should take the form of a commission payable by DISL to DSG.

The conclusion that one can draw from this case is that transfer pricing issues are never clear-cut. This case involved a lengthy and complex analysis of the contracts and transactions involved. This case shows the importance for MNEs to re-examine their transfer pricing policies and consider whether the most appropriate pricing methodology has been used. It also highlights the importance of performing a sound economic analysis by the tax authorities during transfer pricing audits.

5.5.2 Altera Corp. (the "Taxpayer") v. Commissioner (IRS) and Xilinx Inc v Commissioner

The *Altera Corp v Commissioner* cases tested the arm's length principle in more details and provided clarity regarding cost sharing regarding the development of intangible assets.

These cases can be summarised as follow:
In a cost sharing arrangement (CSA), two related parties are generally expected to share the costs of developing intangible property and in exchange, each party receives the rights to make use of such property in its respective territory. The costs to be shared would generally include compensation, such as engineers' salaries, but whether costs also include SBC (such as non-qualified stock options, ISOs or RSUs) has been the centre of the debate.
The Seagate vs IRS case was the first one that first highlighted this issue, it was relating to tax years 1990, 1991 and 1992. Both the IRS and taxpayer lost cross-motions for summary judgment, as the Tax Court indicated that the issue was inherently factual, not simply a legal issue, and a trial was therefore necessary. The IRS conceded on the case because they had no evidence that unrelated parties share SBC. The IRS also conceded the issue for all taxpayers for years prior to the revised 1995 Section 482 cost sharing regulations. It seems like the IRS believed the 1995 regulations provided the result it wanted, so it did not concede the issue going forward from 1995. Over time it was then noticed that, the IRS's reliance on the 1995 regulations was misplaced. In 2005, the Tax Court in Xilinx held that, even under the 1995 regulations, participants do not need to share SBC costs because unrelated parties would not share such costs. Xilinx presented a variety of evidence and its own

executives' opinions that unrelated parties do not share SBC. The IRS did not offer any evidence that unrelated parties shared SBC on the basis that whether such parties actually shared SBC was irrelevant because the 1995 regulations required that "all costs" relating to the development of intangible property covered by a CSA must be shared. The IRS had a strong view that SBC was a cost that must be shared whether or not the cost would be shared by unrelated parties engaged in a comparable intangible development arrangement. The taxpayer strongly countered that the regulations commanded that the arm's length standard needed to be applied "in every case" and, therefore, whether uncontrolled parties shared SBC in arrangements comparable to a CSA was relevant.

The outcome of the Xilinx case essentially turned on the inconsistency in the regulations between the "arm's length in every case" requirements versus the "all costs" requirement. In 2010 it was noticed that the Ninth Circuit ultimately affirmed the 2005 Tax Court decision, determining that the overarching purpose of the Section 482 regulations is to put controlled parties on par with uncontrolled parties, so the IRS "all costs" requirement must yield. Even as the Xilinx trial was under way, Treasury proposed a new regulation expressly requiring SBC to be included in CSAs. The proposed regulation declared that such inclusion is consistent with the arm's length standard. During the comment period mandated by the APA, comments were received from taxpayer groups and tax advisory firms that unrelated parties do not actually share SBC costs in joint development agreements and similar arrangements. According to Ryan, some commentators provided industry surveys and analyses of SEC filings to support their point, but the Treasury regulation was finalized in 2003.

In most cases multinationals with CSAs and SBC followed the 2003 regulation – except for Altera. It purposefully took a position contrary to the regulation and it seems like it followed the Xilinx case developments carefully.

According to Ryan, the important things that came out from these cases are as follow:

- Although Treasury had claimed that the regulation follows the arm's length standard, Treasury did not cite any source of information in the Preamble supporting the regulatory conclusion that unrelated parties share SBC costs.

- The assertion that Treasury need not look for unrelated party transactions similar to cost sharing because they cannot be found is illogical. Rather, it is only after a search that one can conclude something cannot be found.
- When the IRS argued that comparable third-party transactions could not be found because CSAs involve high-profit (i.e., crown jewel) intangibles, the Court questioned why Treasury would lump all CSAs together – even those not involving crown jewels.
- Treasury did not adequately respond to the mountain of comments submitted by commentators, which provided that third parties in joint ventures and other co-development arrangements do not share SBC costs. Although Treasury's failure to respond to an isolated comment or two would probably not be fatal to the final rule, Treasury's failure to meaningfully respond to numerous relevant and significant comments certainly is.

It is important for the law makers to ensure that transfer pricing laws achieve its intended purpose. IRS amended its tax laws after the Xilinx case in order for the fiscus to be advantageous, however they didn't consider if the amendment would still be in line with the arm's length principle. The ruling in the Altera case is generally regarded as a major win for the taxpayers. Given the outcome of the Altera case, multinationals that has been following the final regulation requiring the allocation of SBC in cost sharing arrangements, will have to consider removing these SBC costs going forward and filing protective amended returns for prior tax periods to preserve their ability to claim refunds (Weiss 2016).

Determination of an arm's length principle must be supported by the transaction data between unrelated parties otherwise such cases would have far reaching implications for the tax regulations, as it opens the gates in the future for taxpayers to challenge the rationality of tax regulations.

CHAPTER 6
Discussion and conclusion

6.1 Introduction

The objective of this chapter is to discuss the outcome of the research and to provide the conclusion of the study. This chapter will summarise the findings of the research, suggest recommendations and propose areas requiring further research.

6.2 Outcome of the research

The research focused on whether South Africa tax lawmakers have done enough to address the challenges that BEPS brings. An analysis of Section 31 of the Income Tax Act was done, in order to ascertain whether it was strong enough to deal with BEPS. It was noticed that a new Section 31 introduced interesting concepts, however it did not address all the issues addressed in OECD's action plans.
The risk and challenges imposed by BEPS were also highlighted. BEPS need to be resolved urgently, otherwise lot of countries would run into major financial problems. Governments find themselves in a difficult position whereby they don't know whether to turn their states into "tax havens' or to introduce strict tax laws.
Some MNEs are introducing complex schemes which enable them to simulate transactions, with the hope of obtaining tax benefits. It is imperative for lawmakers to introduce laws that would be able to handle these complex schemes.

6.3 Recommendation

Given APA advantages that were highlighted in chapter 5 of this research, South Africa will really have to consider introducing APAs. SARS is spending lot of time and money doing Transfer pricing audit, this can be minimised through the introduction of APA. SARS' Transfer pricing audits are usually resolved through reaching a settlement with the taxpayers, therefore South Africa might as well consider introducing APA. This will not only minimise the spread of BEPS, it will also give taxpayer certainty. The stability that will be brought by APA will also make it easy for foreign investors to consider investing in South Africa. It's not pleasant to get surprise transfer pricing audits which may result in unexpected tax debt.

The Davis Tax Committee has been tasked with the responsibility of assessing South Africa's tax policy framework, given the challenges that are brought by BEPS, DTC will have to priorities the review of transfer pricing tax laws. The committee will have to consider the modern business models and transactions. In chapter 5 of this research we noticed that there are a number of action plan that South Africa still need to address in order of South Africa's tax laws to be in line with OECD recommendations. DTC would have to continue finding ways of ensuring that our tax laws are able to address all the business trends. The DTC needs to be given timelines to address the actions recommended by the OECD. Ideally South Africa will have to ensure at the latest by the end of 2018, all the action should have been addressed.

A survey has to be conducted by SARS to assess whether taxpayers find the transfer pricing laws easy to understand and apply. Taxpayer will have to indicate the ambiguous parts of the act that they struggle with understanding. Taxpayers will find it easy to comply if clear and easy to understand, without having to make many assumptions.

Countries like the USA and the UK have been dealing with transfer pricing for a number of years and it would be worthwhile to engage them on how South African transfer pricing laws can be improved. SARS need to work on improving relation with these countries. It will also help if SARS can understand their audit methodology and assess if will work in the South Africa's environment. South Africa will also have to develop skills needed to address transfer pricing. SARS will have to consider increasing its staff size and skill set to review current TP arrangements and ensure relevant compliance.

It is also critical for South Africa to relook at the tax treaties and ensure that there are no loopholes that could provide platform for the spread of BEPS. Some of the tax treaties that South Africa has with other countries are very old and they are not addressing the current business climate. SARS will have to go through an exercise of assessing all the tax treaties and make sure they are still relevant. All the tax treaties that are exposing South Africa to BEPS risks will have to be amended.

6.4 Areas requiring further research

More countries are considering lowering their taxes in order to encourage foreign investment and reduce the spread of BEPS. A detailed study on whether this is a move in a right direction and ascertaining the impact this would have on countries that refuse to lower tax rates. The current president of the USA, Donald Trump, also indicated that he is intending on cutting taxes in order to bring money back to USA, he said "We're going to cut taxes massively. We'll cut business taxes massively. They're going to start hiring people. We're going to bring the $2.5 trillion that's offshore back into the country," (Samuels 2016).
A research on how a tax rate can have an impact on the tax compliance would give governments an indication on how they should structure their tax policy. Would Cutting Corporate Tax Rates Really Grow the Economy?

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